ISSUE BRIEF

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STRUCTURE OF THE RESIDENTIAL FLOOD INSURANCE MARKET

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This Issue Brief draws on our recent report, *The Emerging Private Residential Flood Insurance Market in the United States.*[1]

A CHANGING MARKET

For the past 50 years, residential flood insurance in the United States has been almost exclusively provided by the NFIP.[2] In the past few years, a small market for private residential flood insurance has emerged. We estimate that private flood insurance currently accounts for roughly 3.5 to 4.5 percent of all primary residential flood policies purchased, but that share is growing. This brief describes the structure of the residential flood insurance market.

THE PLAYERS

Admitted and Surplus Lines Firms

Flood insurance can be written by either admitted or non-admitted companies. Admitted carriers are licensed by the states in which they operate and file their rates and forms with the state regulator. In the case of insolvency, their claims are backed by state guaranty funds. Non-admitted carriers, also called surplus lines carriers or excess and surplus (E&S) companies, though approved by the state, have no requirements on their rates and forms and are not backed by state guaranty funds, but they may have higher minimum solvency requirements than admitted carriers. Rate and form freedom allows them to specialize in potentially volatile markets—nonstandard, unique, complex, or catastrophic risks.

KEY FINDINGS

- Private flood insurance is available from both admitted insurers whose rates and forms are regulated by the states, and non-admitted insurers who have rate and form freedom but are still subject to solvency and market conduct requirements.
- Private market growth has largely been driven by global reinsurers. In the admitted market, reinsurers assume most of primary insurers' risk, often in excess of 90%, In the non-admitted market, Lloyd's of London backs the majority of residential flood policies.
- Consumers access the flood market through insurance agents who help them find the best coverage options for their property. As such, agents should be well-versed in the offerings and mechanics of both private insurers and the NFIP.

[1] Available online at https://riskcenter.wharton.upenn.edu/wp-content/uploads/2018/07/Emerging-Flood-Insurance-Market-Report.pdf.

[2] There has historically been a small private market for two types of flood policies. The first is lender-placed policies. These are flood policies that a lender purchases on behalf of a borrower when the borrower fails to comply with the mandatory purchase requirement. The second is "excess" policies, which are flood policies that provide coverage beyond the NFIP coverage caps.

Although E&S companies do have rate and form freedom, it is a misconception that they are not regulated at all. US based surplus lines companies must be licensed in at least one state, which imposes solvency and market conduct requirements. States may also impose other regulations on surplus lines companies and they license and oversee surplus lines brokers. In all states, surplus lines policies are subject to a surplus lines tax, which is similar in principal to insurance premium taxes imposed on admitted insurers. Surplus lines insurers based outside of the United States are overseen by a committee of state regulators through the National Association of Insurance Commissioners.

In most states, insurance laws and regulations require agents to make a diligent effort to place risks in the admitted market before turning to a surplus lines carrier. This generally means that a risk must be denied by three or more admitted insurers before it can be placed in the surplus lines market. However, state regulators may waive these "diligent search" requirements for certain types of insurance products and coverages that are difficult to place with admitted carriers. For flood insurance, 19 states have waived the requirement to varying degrees.

<u>Agents and Brokers</u>

Admitted and E&S insurers take different approaches to distributing their policies. Admitted insurers write policies directly to a customer, through a captive agent who writes only their policies, through independent retail agents who connect consumers to insurers and provide quotes from multiple companies, or may access business through brokers and managing general agencies. E&S insurers tend to work with wholesalers or brokers—intermediaries between a retail agent and an E&S insurer who work on behalf of the insurance agency to access the E&S market. The broker must have a surplus lines license and a standard license for selling property and casualty insurance (unless the state has reciprocity standards where no underlying property and casualty license is required).

<u>Managing General Agencies</u>

A managing general agency or managing general underwriter (MGA/ MGU) works on behalf of the insurer and organizes and manages its book of business. The MGA/MGU will employ the underwriters, develop premium-setting practices, issue policies on the insurer's behalf, and manage claims payments. They get a fee or share of premiums for these services. An MGU, as opposed to an MGA, also undertakes the underwriting. MGAs vary significantly in their size and scope. Some offer a wide range of E&S products; others focus on only a specific category of coverage or just one product. Some operate nationally; others work only in a given region or locality.

<u>Reinsurers</u>

Reinsurance protects insurers against catastrophic losses and helps diversify risks globally. Reinsurance has been and will continue to be critical to the growth and development of the US private flood insurance market by helping insurers spread risk in the same way that insurance plays this role for homeowners. For US flood, reinsurers are playing a large role in the market.

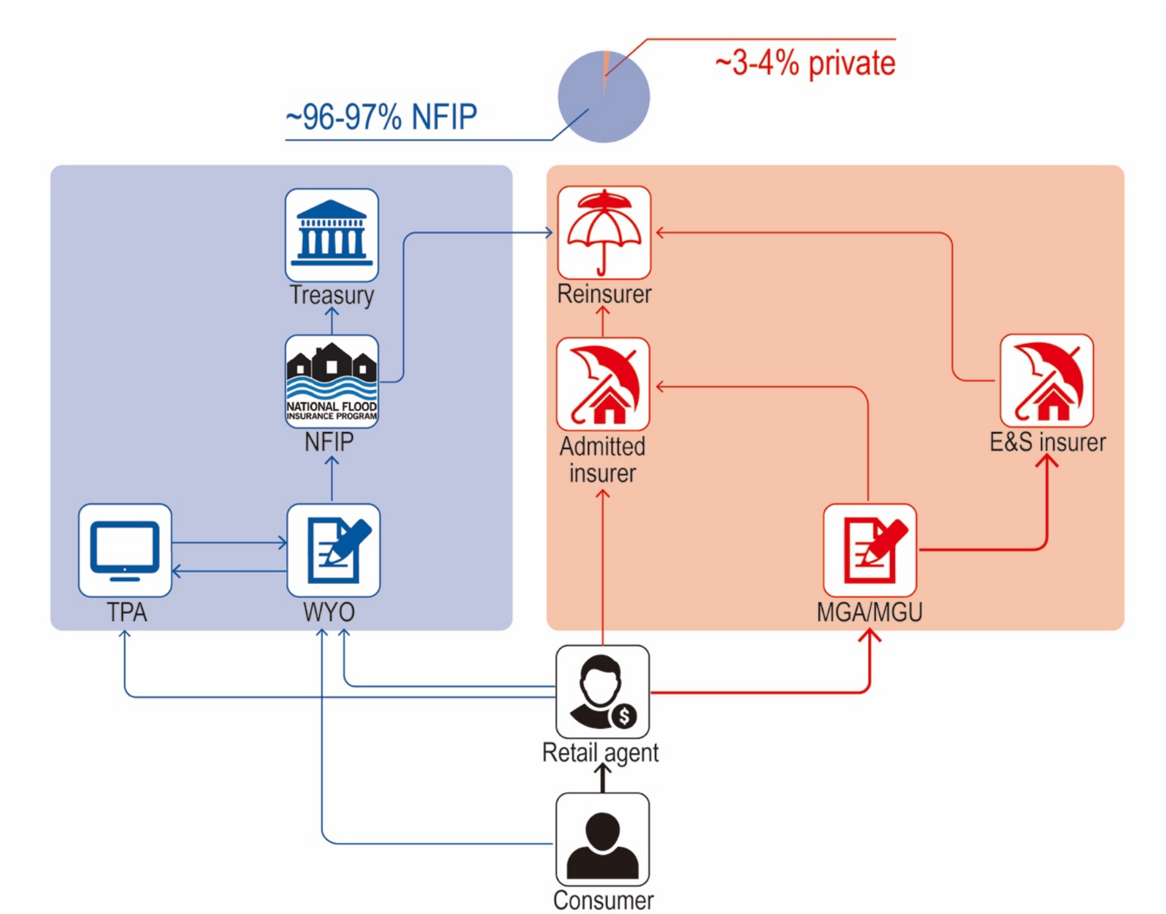
We identified two dominant types of reinsurance relationships for residential flood. In the first, the reinsurer simply provides the financial protection, but takes on a substantially greater share of the risk than is standard for property insurance. This may be done as a separate agreement and not rolled into other existing reinsurance treaties, such as a catastrophe excess of loss contract. We heard the reinsurance sector often takes in excess of 90% of the flood risk in a quota share model—meaning, the reinsurer would take 90% of flood premiums and pay 90% of flood claims. In the second dominant model, the reinsurance company offers a white label or turn-key flood product. These products are fully designed by the reinsurer. In this way, the reinsurer takes on many functions traditionally done by the primary insurance company, such as setting underwriting guidelines, rating, and developing forms.

Multiple reinsurance companies are in the US flood market, including many backing the NFIP. Lloyd's of London in particular has been playing a large role in the development of the US flood insurance market. Lloyd's syndicates stand behind many types of flood risk in the United States: the NFIP, commercial, lender-placed, and residential. Many MGAs are Coverholders for Lloyd's syndicates. Coverholders are companies or partnerships authorized by a syndicate to enter into insurance contracts on behalf of the syndicate.

MARKET STRUCTURE

The figure below depicts the structure of the residential flood insurance market in the United States. A consumer can purchase flood insurance either through the NFIP (blue) or through the private market (red). The figure shows the links from the consumer to the ultimate risk holder. We estimate more than 95% of current residential flood policies sold are currently purchased through the NFIP. That number will likely shrink somewhat as the private market grows in the coming years.

STRUCTURE OF THE RESIDENTIAL FLOOD INSURANCE MARKET



A property owner who wants to purchase a flood insurance policy typically contacts a retail insurance agent. To write an NFIP policy, the agent must have completed the NFIP training required by the state and be appointed by the insurer or MGA providing coverage. The agent searches for the best policy options available based on the property's flood risk, typically by entering information about the property into an online portal, which then determines what types of coverage the consumer is eligible for and at what price. An agent will not usually have access to all available product offerings. If the agent is qualified to write both NFIP and private coverage, they may quote both types of policies or the one they feel is best for their client. Depending on the price and coverages, the consumer may choose to go with the NFIP or a private carrier.

If a customer chooses an NFIP policy, the agent will most likely place the risk with a so-called "Write Your Own" (WYO) company. These are firms that market policies and process claims for the NFIP in exchange for a share of premiums. They bear no risk and not involved in rate-setting. Some policies, such as severe repetitive properties, may be placed directly with the NFIP through the Special Direct Facility. WYO companies typically rely on third-party administrators (TPAs), such as Marsh's Torrent Technologies and Aon's National Flood Services, to carry out NFIP-related tasks. WYO companies may rely on TPAs to quote NFIP premiums, communicate with policyholders, collect premiums, handle claims, provide IT services, and manage finances, including passing on premium dollars to the NFIP. Often, agents will work through TPAs to place policies, as well. For some WYO companies, a customer could bypass the agent and go directly to the company, such as through a website.

Alternatively, the property owner could choose a private policy through either the admitted or the surplus lines market. An admitted insurer would then be backed by reinsurance. Admitted companies may also be providing the homeowners policy and then the flood may be an endorsement to that policy or they may write excess or standalone flood policies. A surplus lines policy is often done via an MGA. Some MGAs may write directly to consumers, bypassing agents. MGAs may also rely on TPAs for certain services, such as claims handling, while doing policy administration themselves. Behind the MGA is usually an E&S (re)insurer. MGAs provide access to customers for insurers and may provide underwriting expertise, but they do not bear any of the risk. MGA products tend to be standalone flood products.

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