Private Insurers Play a Limited, but Key, Role in Underwriting Residential Flood Insurance

Most flood insurance for residential properties is provided by the National Flood Insurance Program (NFIP), which Congress established in 1968 to make flood insurance available to homeowners, renters, and businesses in communities that participate in the NFIP. Because relatively few homeowners purchased flood insurance early on, Congress established the mandatory purchase requirement (MPR) in 1973. A property owner in an area at high flood risk is required to purchase flood insurance if the property is mortgaged with a federally regulated lender. The lender must ensure that the property is covered by flood insurance for the term of the loan and is required to place flood insurance on behalf of the property owner if the property owner fails to do so.

Rather than purchase insurance through the NFIP, lenders typically purchase flood insurance from private insurers. In contrast to the NFIP market, in which the private sector sells the policies but the federal government underwrites them, in the lender-placed market, private-sector insurers both sell and underwrite the policies. Such policies must meet or exceed the coverage provided by NFIP policies to satisfy the MPR. A RAND Corporation report aims to improve understanding of the lender-placed market.

- Based on assessments from different data sources, the report estimates that there are roughly between 130,000 and 190,000 private lender–placed insurance policies. This estimate covers policies that assume no other flood coverage on the property. Private insurers also write gap policies, which are policies that add coverage to an existing flood insurance policy. Data on the number of gap policies are limited, but including them may increase the estimate of private policies in place to between 180,000 and 260,000.

- Still, the number of policies is small compared to the 5 million residential policies written by the NFIP, and, thus, the private market does not greatly increase the proportion of residences covered by flood insurance.

- The study shows that, although private policy coverage does meet or exceed that of NFIP policies in many areas, it is also more limited than NFIP policies are in other dimensions. This failure to meet or exceed NFIP policies in some dimensions raises the possibility that some private policies do not comply with MPR requirements, but policymakers must assess whether these differences are significant.

- Private policies offer features that are more attractive than NFIP policy features to lenders. These include backdating, gap policies, and automatic coverage that enhances a lender's ability to tailor the coverage to its portfolio's particular characteristics, as well as the general ease in using private policies.

The study concludes that, although the private insurance industry's primary role in providing flood insurance for residential structures is to administer the NFIP, the industry does underwrite flood insurance in a limited, but important, niche. In doing so, it increases incrementally the number of homes protected by flood insurance, while developing innovative policy provisions that respond to lender and borrower needs and providing streamlined services that reduce the costs that lenders incur in complying with the MPR.

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