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REPORT

The Lender-Placed Flood Insurance Market for Residential Properties

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Prepared for the Mitigation Division of
the Federal Emergency Management Agency

Approved for public release; distribution unlimited

RAND

INFRASTRUCTURE, SAFETY, AND ENVIRONMENT and
INSTITUTE FOR CIVIL JUSTICE

The research described in this report was sponsored by the Mitigation Division of the Federal Emergency Management Agency under contract number HSFEHQ-04-F-0431.

Library of Congress Cataloging-in-Publication Data

978-0-8330-4155-5

Published 2007 by the RAND Corporation
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Summary

The National Flood Insurance Program (NFIP) provides the majority of flood insurance on residential properties in the United States.[1] While insurance agents sell nearly all NFIP policies through private insurance companies, NFIP policies are still underwritten by the federal government. Flood insurance is also available from private insurers that assume the risk of losses themselves. However, little systematic information is available about the size of the private market, how the policies offered by private insurers compare with those offered by the NFIP, or the reasons buyers choose private market policies over federal program policies. This report provides information in each of these three areas.

Overview of the Private Market for Residential Flood Insurance

Established by Congress in 1968, the NFIP makes flood insurance available to homeowners, renters, and businesses in communities that participate in the NFIP. Such communities agree to adopt and enforce a floodplain management program aimed at reducing flood losses. Early in the program, the federal government found that making insurance available was not sufficient to induce large numbers of people to purchase flood insurance, and, in the Flood Disaster Protection Act of 1973, Congress established the mandatory purchase requirement (MPR). The MPR requires homeowners in areas at high flood risk to purchase flood insurance if they have a mortgage with a federally regulated lender. Lenders must ensure that the property is covered by flood insurance for the term of the loan and are required to purchase flood insurance on behalf of the property owner if the property owner fails to do so.

Private insurers provide flood insurance through the voluntary and the lender-placed markets. In the voluntary market, homeowners choose whether to purchase flood insurance underwritten by private insurers or the NFIP. Only a few private insurers offer policies in the voluntary market, and the number of policies written outside the NFIP remains very small. In 1991, the NFIP introduced a special program to enable lenders to more easily force-place policies: the Mortgage Portfolio Protection Program (MPPP). However, the MPPP policy is little

[1] The Federal Emergency Management Agency (FEMA), which is part of the U.S. Department of Homeland Security (DHS), runs the NFIP.

used now, and, instead, lenders for the most part force-place policies that private sector insurers underwrite. This study focused on the size and characteristics of this lender-placed market.[2]

Large lenders subject to the MPR typically hire firms referred to as *trackers* to monitor whether the homes in their portfolios carry the required amounts of flood and other insurance. If a home in a high-risk flood area lacks insurance, trackers often first call to confirm whether the home has flood insurance and then send out a series of letters that culminates in the force placement of flood insurance if the homeowner fails to purchase insurance. Federal regulation requires a 45-day notice period before force-placing flood insurance.

Size of the Lender-Placed Flood Insurance Market

To develop estimates of the number of lender-placed policies that private insurers underwrite, we collected data from a sample of lenders, trackers, and insurers. While the sample sizes were not large (four insurers, four trackers, and five lenders), the insurers and trackers participating in the study represent a sizable share of the lender-placed market by policies issued and loans tracked.[3] The lenders participating in the study represent a modest share of the market by loan volume. We used methods detailed in the report to extrapolate the number of policies that participating firms reported to the industry as a whole.

As shown in Table S.1, estimates based on the different data sources are internally consistent and point to between roughly 130,000 and 190,000 private lender–placed flood insurance policies. The figures count only primary flood insurance policies—that is, policies that assume that no other flood coverage on the property. Lenders were not able to provide data on policies in place on second mortgages and home equity loans, and adjustments were made to estimate the number of such policies. Construction of quantitative measures of the statistical

Table S.1
Estimated Number of Primary Lender–Placed Flood Insurance Policies Written by Private Insurers

Source of Data Used for Estimate	Policies in Place (thousands)
Insurers	128 to 187
Lenders	
Excluding second mortgages and home equity loans	110
With adjustment to account for second mortgages and home equity loans	154
Trackers	142

NOTE: Estimates reflect policies in place some time between mid-2004 and early 2006.

2 Private insurers provide flood insurance for most commercial structures and, in contrast to practices for residential structures, provide it through the voluntary market rather than the mandatory market. Investigation of the size of the flood insurance market on commercial studies was outside the scope of this study.

3 Knowledgeable stakeholders interviewed for the project indicated that eight insurers write the vast majority of lender-placed flood insurance policies and that seven firms track the vast majority of loans tracked by the tracking industry.

uncertainty of the estimates was beyond the scope of this study, but the consistency of the estimates across the different data sources increases confidence in the findings.

Private insurers also appear to write a sizable number of gap policies, although the data on gap policies are sketchy. Gap policies add to the coverage of an existing flood insurance policy and are issued when the lender determines that there is insufficient coverage. Including gap policies may increase the number of private policies to between 180,000 and 260,000. This prediction is quite speculative, however, and further investigation of the number of gap policies is warranted. Gap policies do not increase the total number of households covered by flood insurance but rather increase the dollar amount of flood insurance in place.

The number of private policies is not large compared with the 5.0 million residential policies written by the NFIP. Including this relatively small number of private policies thus does not result in a large increase in estimates of the proportion of structures covered by flood insurance.[4] However, the number of policies currently in place is not the only measure of private insurers' importance in implementing the MPR. First, few lender-placed policies remain in effect for the one-year policy term, with the implication that far more policies are issued per year than the number of policies currently in place indicates. Second, the automatic coverage endorsement that many lenders purchased increases the number of homes effectively insured beyond the number of policies in place.[5]

Comparison of Private and NFIP Policies

Private policies used to satisfy the MPR must meet or exceed coverage provided by NFIP policies. To assess whether private policies satisfy this requirement, we compared the provisions of five private policies with the standard flood insurance policy used by the NFIP (the policy that lenders can place through the NFIP's MPPP).

The administrative features of private policies are, for the most part, broader or more flexible than those of the NFIP policy. Private insurers offer several optional endorsements and provide features such as backdating, gap policies, and automatic coverage that enhance a lender's ability to tailor the coverage to its portfolio's particular characteristics. In terms of administrative features, the only area in which private policies are more limited is the appeal of claims payments.

Private policies provide broader coverage for some risks than the NFIP policy does but provide less broad coverage for other risks. On the one hand, private policies cover mudslides, while the MPPP policy does not. On the other, some private policies have stronger mold exclusions than the NFIP policy has. In addition, the private policies reviewed do not cover testing,

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[4] Dixon, Clancy, et al. (2006, p. 15) estimated that 1.76 million of the 3.57 million single-family homes in Special Flood Hazard Areas (SFHAs) carry policies from the NFIP (49 percent). If private lender–placed policies increase the number of single-family homes insured by 160,000, the market penetration rate for flood insurance (including both NFIP and non-NFIP policies) would rise to 54 percent.

[5] With the automatic coverage endorsement, all homes in the lender's portfolio subject to the MPR are in effect covered for losses.

monitoring, or cleanup of pollution that occurs during a flood event, while the NFIP policy covers cleanup even though it excludes coverage for testing and monitoring.

We also found that, in terms of the types of and limits on losses that private policies cover, private policies compare favorably with the NFIP policy in many dimensions, but they also come up short in a few. Areas in which the private policies reviewed meet or exceed NFIP policy provisions include

- the policy limit on structure coverage
- situations in which the policy pays replacement cost rather than actual cash value of the loss
- additional living expenses
- basement coverage.

Areas in which the provisions of some private policies were more restrictive than the NFIP policy include

- debris removal
- coverage for loss avoidance measures
- limits on increased cost of compliance coverage.

The failure to meet or exceed NFIP policies in some dimensions raises the possibility that some private policies do not comply with MPR requirements. It is up to policymakers to assess whether these differences are significant. Some of the private policies may have been updated since we obtained the policies (early to mid-2005), and additional research is warranted on the extent to which coverage in these dimensions has improved over time.

Perceptions of the Advantages of the Private Market

We interviewed lenders, insurers, and trackers about the advantages and disadvantages of force-placing policies through the private market rather than through the NFIP. We interviewed 11 firms in total, either in person or via phone.

Private policies offer a number of features attractive to lenders that NFIP policies do not. The stakeholders interviewed highlighted the ability to backdate private policies to the start of the letter cycle and the automatic coverage endorsement. They also praised the service that private insurers provided and the ease of using their products. Lenders appeared very satisfied with the products and services that private insurers provided and expressed no interest in using the MPPP to force-place policies. The MPPP would need to change in fundamental ways to attract private lenders and trackers to use it.

Role of Private Insurers

Congress established the NFIP in part due to the ongoing unavailability of private flood insurance. Over the years, however, a deepening partnership has emerged between the federal government and the private insurance industry. The primary role the private insurance industry plays in providing flood insurance to residential structures is to administer the NFIP. However, private insurers underwrite flood insurance in a limited, but important, niche. In doing so, they increase the number of homes protected by flood insurance, developing innovative policy provisions that respond to lender and borrower needs and providing streamlined services that reduce the costs lenders incur in complying with the MPR.