

# POLICY #5: RIGHT-SIZING INSURANCE AND INNOVATIVE POLICY DESIGNS



This policy work group will explore whether tailoring insurance products to the specific needs and risk of a household and/or innovating on policy design can increase purchase of flood insurance.

## **The NFIP Policy**

The standard National Flood Insurance Program (NFIP) policy has not had substantial changes in decades. The policy covers up to \$250,000 of building coverage and \$100,000 of contents coverage to residences. For those with a mortgage from a regulated lender in the Special Flood Hazard Area (SFHA), federal law requires that policyholders must hold the lesser of either the NFIP coverage cap, the outstanding principal on the loan, or the insurable value of the structure. For properties outside the SFHA with a favorable loss history, coverage only comes in certain discrete increments. Minimum deductibles are between \$1,000 and \$1,500 depending on the policy type and rating class. Higher deductibles are available in \$1,000 increments to \$5,000 and legislation in 2014 added a \$10,000 deductible. Contents coverage is always actual cash value coverage – something that often is an unpleasant surprise for consumers when they file a claim. Replacement cost coverage for buildings is only available for primary residences and when the amount of coverage equals or exceeds 80% of the replacement cost of the building (or NFIP coverage cap).

## **Wider Options in the Private Market**

There is greater product variety in the emerging private flood market. For example, we found most private insurers offered higher limits and broader coverages than the NFIP.<sup>1</sup> Almost all private policies cover structures and contents on a replacement cost value rather than actual cash value basis, or at least provide the option to do so, as well as offering coverage for additional living expenses. Some offer expanded basement coverage or even debris removal expenses. Assurant offers FlexCash: \$10,000 is paid to the insured in the event of a flood, with no restrictions on how the funds are used. And multiple firms provide coverage similar to the NFIP's Increased Cost of Compliance (ICC) coverage to bring damaged homes into compliance with current building regulations, but often for higher limits. Of note, outside the SFHA, the private sector has begun offering low coverage flood endorsements to homeowners policies, although current numbers are small. Many of these are turn-key products from a reinsurer designed for areas unlikely to ever see catastrophic flood levels.

## **Right-sizing Insurance**

Can better fitting insurance policies to policyholder needs improve demand for flood insurance? There is little evidence on this point, but there are two reasons that many policyholders may not have a flood policy that is well suited to them. First, there are findings in certain locations<sup>2</sup> that agents may not

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<sup>1</sup> Kousky, C., H. Kunreuther, B Lingle, and L. Shabman (2018). The Emerging Private Residential Flood Insurance Market in the United States. Wharton Risk Management and Decision Processes Center, July.

<sup>2</sup> <https://riskcenter.wharton.upenn.edu/resilience-lab-notes/oregon-improves-agent-knowledge-of-flood-insurance/>

be well-versed in flood insurance and thus write flood policies in mandatory areas that are not a good match for consumers, such as being for a coverage limit that exceeds the replacement cost of the structure. Agents may not recommend the appropriate deductible, not switch consumers from pre- to post-FIRM rating when it saves money, and not recommend mitigation measures that could reduce costs. Such errors could lead consumers to more quickly drop their flood coverage or limit voluntary purchase. This is coupled with and perhaps exacerbated by lack of consumer knowledge of flood risk and disaster insurance. Note that fixing this does not require new product designs, but improved agent and consumer understanding of flood insurance.

Second, there could be limitations to the current NFIP policy that suppress demand. If someone has a finished basement, for example, the NFIP policy may not give them the coverage they need. If they have nowhere to stay should their home be flooded, they may need loss of use coverage. If they live in an area of shallow flooding or ponding (e.g., AH Zone), they may need a low deductible, low coverage policy that doesn't meet the mandatory purchase coverage requirements. If they live behind a levee, they may need a high deductible, high coverage policy that is only priced for levee failure. Either more variety in the NFIP product or private offerings could better meet the needs of these consumers.

It may not take expensive policy changes to make consumers more comfortable and happier with their insurance. Many firms are adding small additions to policies that appear to be designed to increase consumer satisfaction. For instance, Assurant offers coverage for food spoilage. It also appears that consumers find it easier when all policy terms match, so many companies are offering flood on terms comparable to the consumer's homeowners coverage.

### **Innovating to the moonshot**

Is even further innovation in policy types that would increase demand possible? For instance, is there a role for parametric flood insurance? For community-based flood insurance?<sup>3</sup> Or for more innovative public-private layering of coverage? For example, could FEMA's Individual Assistance become essentially a free deductible of between \$5,000 and \$10,000 with those in floodplains purchasing a higher deductible, and thus lower cost, policy? USIC-Puerto Rico has been experimenting with a different type of policy: they are including \$3,000 of contents coverage with a zero deductible in homeowners policies and consumers can go to the NFIP or the private market for additional coverage. NSF Edge is offering an NFIP wrap-around product.

### **Questions**

- How might policy innovation and tailoring policy terms to the needs and risk of individual households increase customer demand?
- Could/should the NFIP alter the standard flood policy? What private sector policies and innovations might expand flood coverage?
- How do we improve insurance agent and consumer knowledge about flood insurance?

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<sup>3</sup> Kousky, C. and L. Shabman (2015). A Proposed Design for Community Flood Insurance. Washington, DC: Resources for the Future, December.