



**Consumer Federation of America**

**TESTIMONY OF**

**J. ROBERT HUNTER,  
DIRECTOR OF INSURANCE,  
CONSUMER FEDERATION OF AMERICA**

**BEFORE THE**

**COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS  
OF THE  
UNITED STATES SENATE**

**REGARDING**

**OVERSIGHT OF THE NATIONAL FLOOD INSURANCE PROGRAM**

**OCTOBER 18, 2005**

Mr. Chairman and members of the Committee, I appreciate the invitation to appear before you today to discuss current issues regarding the National Flood Insurance Program. I am J. Robert Hunter, Director of Insurance for the Consumer Federation of America. CFA is a non-profit association of 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy and education. I am a former Federal Insurance Administrator under Presidents Ford and Carter and have also served as Texas Insurance Commissioner. As Administrator, I ran the National Flood Insurance Program (NFIP) in the 1970s.

## **BACKGROUND – MY DECADE WITH THE FLOOD INSURANCE PROGRAM**

Congress created the NFIP as a result of President Truman's concern that flood insurance was unavailable in areas of Missouri affected by significant flooding. Truman's question led to a major study by the National Academy of Sciences (NAS), the so-called "feasibility study," that determined that there was a way for the federal government to underwrite flood insurance.

The NAS approach was elegant: in exchange for a land-use control agreement by a community to steer new construction away from high-risk locations and to otherwise mitigate construction in hazardous zones, the federal government would make subsidized flood insurance available to already existing at-risk buildings in the community that agreed to participate. The federal government would map each community to show the probability of flooding in a particular area within 100 years.<sup>1</sup> In the 100-year zone, the first floors of new construction would be elevated to the elevation of the 100-year storm. In the highest-risk zones, where water moved with velocity (the floodways of rivers and the storm surge areas) there would be no construction. New construction would not get the subsidized rate but would pay full actuarial rates. If a community granted a variance and allowed a structure to be built below these standards, flood insurance would be available but the price could be extreme. Lenders were required to protect the collateral with flood insurance if the mortgage was on a structure in a high-risk flood zone.

During my tenure at the helm of the NFIP, I learned that Congress was not fully committed to the implementation of the program they designed. I once took a lot of heat from a congressional delegation when I priced the cost of flood insurance for a well-connected individual's \$200,000 home at \$50,000 a year because it was built outside of the dunes on a beach and was therefore far more vulnerable to flooding. On another occasion, I almost lost my job as Administrator because I refused to bend in my determination to fully implement the land-use provisions that one powerful senator felt were harmful to some special interests (developers and land owners) in his state. Fortunately, William Proxmire, then the Chair of this Committee, stood by me through these political hurricanes.

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<sup>1</sup> The 100-year standard was a compromise between those who felt a tougher standard was required to save lives and property and those who felt the standard should be low to encourage community participation. The 100-year concept is also somewhat misleading in that it is a probabilistic standard of a one percent risk of an occurrence within a year. Such an event could actually happen twice in a year, while the average occurrence remains only once in a century (much like flipping a coin could produce five heads in a row while the probability remains at 50 percent).

In fact, my experience has shown me that political pressure from Congress (sometimes offered with the best of intentions) can threaten the overall viability and effectiveness of the flood insurance program. One danger is the potential for the program to turn into either a back-end disaster relief program (as you know, there have been well-intended but misguided proposals to grant retroactive flood insurance to victims of Hurricane Katrina) or, even worse, a front-end relief program that sells below-actuarially-priced insurance to new construction before the flood, exposing taxpayers to unnecessary risk and encouraging unwise construction.

Another danger I have experienced is program error. An environmental group complained to me that the coastal storm surge projections appeared to be too low on our maps. The flood insurance program (“the Program”) engineers were sure they had done the mapping properly, but we discovered that they had left the wave-height off of the storm surge heights, making them far short of the actual 100-year surge. It was a serious scientific error but an even more disastrous political one, as we had to go back to communities that had fought developers to put in place the first maps and raise the required elevations significantly.

During my tenure, I also had to remove private insurers from administering the Program for two reasons that are important to reflect on today: a conflict of interest in claims handling and excessive costs for program administration.

The conflict of interest was that insurers, functioning through an association – the National Flood Insurers Association (NFIA) – refused to pay claims the General Counsel of HUD (where the Program was housed in the 1970s before it was moved to FEMA) had ruled were covered by the flood insurance policy. Insurers would not pay because they feared that if they paid claims under the flood program that were similar to those they sought to deny under their privately written homeowners’ policies with similar policy language, they would have to pay the homeowners’ policy claims as well.

The expense problem was that we determined that non-competitive bids for servicing flood insurance policies had largely been granted by the NFIA’s executive committee to the very companies on NFIA’s executive committee (i.e., self-dealing) and were very expensive. Since the Program entailed a subsidy, these excess costs would fall upon taxpayers. We asked for competitive bids but NFIA refused. Ultimately, we removed NFIA from the Program. The cost of administering the Program fell by half and all claims that were declared to be legitimate by HUD were paid.

Finally, before I was Administrator, I was the Chief Actuary of the NFIP and had the task of making the rates using a multi-disciplinary team of hydrologists, land-use experts, underwriters and others. It is a complex job, but the process should be well established by now. Technological developments should make the task easier and more accurate, raising serious questions about why private sector insurers could not develop properly priced flood insurance policies at this juncture and take on at least some of the risk.

I accompanied the first Administrator, George Bernstein, to Mississippi to witness the devastation of Hurricane Camille. At that time, we were briefed by the Corps of Engineers that

had Camille struck one degree to the west, New Orleans would have been flooded -- in exactly the fashion that occurred with Katrina 35 years later -- after the hurricane passed the city and the wind pushed Lake Pontchartrain back over or through the levees. I remember the briefing in great detail because I was born in New Orleans and was shocked at the potential for huge damage and loss of life in my hometown. I am very sad that this happened; particularly given the knowledge we had as a nation at least as early as 35 years ago, if not since Hurricane Betsy in 1965. It is a tragedy and a scandal that the federal, state and local governments did not deal effectively with this known risk in all the intervening years.

## **NFIP ISSUES IN THE WAKE OF KATRINA**

Mr. Chairman and members of the Committee, I have more questions than answers to give to you today since we are all still assessing the full effects of Hurricane Katrina and watching how the NFIP will function in the after-flood runoff of claims. For instance: How will FEMA deal with and audit the obvious conflicts of interest that the Write Your Own insurance companies have in handling, on the same properties, both wind claims adjustments (where the insurer pays 100% of the damage found) and flood claims adjustments (where the insurer pays no part of the damage found and indeed gets an adjusting fee for services in handling the claim)?<sup>2</sup> Will claims be paid promptly? How will complaints from policyholders be handled? Will FEMA raise some of the same concerns being raised by attorneys for those without flood insurance when it comes to determining the allocation of flood and wind losses? Were the maps accurate in their 100-year projection...if not, why not?

I do, however, have several ideas for your consideration on some of the key questions that this tragic hurricane raises.

### 1. Long-term Solvency

Obviously, Congress cannot decide not to pay legitimate claims to those persons holding flood insurance policies. These policies have the full faith and credit of the country behind them. But Katrina and Rita, with payouts likely to be measured in the tens of billions of dollars, raise the question of how best to make sure the Program works in ways that do not bust the federal budget in the future and indeed minimize taxpayer exposure. In this context, the subsidy of existing structures is an important consideration. When the flood insurance program began, it was assumed that existing structures would, over time, be “washed out” (literally or figuratively) from the Program. But there are many subsidized structures still in the Program.

I believe that the time has come to find ways to lower the subsidy over the relatively short term. I submit the following ideas for your consideration:

- A 500-year mitigation and purchase requirement, rather than the current 100-year standard (as I explain below), would mean no subsidies in the areas that have experienced storms between 100-year and 500-year storm levels.

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<sup>2</sup> Attached is our September 12, 2005 letter raising this concern with FIA/FEMA, to which we have had no response.

- Subsidies should be immediately ended on structures with market values in excess of some significant amount (for instance \$500,000).
- Subsidies should be eliminated on all additional homes for an insured with more than one home.
- Subsidies should be phased out over a certain number of years (perhaps 10) on all structures with market values greater than, for example, \$250,000 but less than \$500,000.
- Subsidies should be eliminated on all structures that have experienced more than one flood with over \$5,000 in Program losses in the past.
- Subsidies should be reduced for homes with market values under \$250,000 each time the home is sold. This should be done in increments that will eliminate the subsidy over three sales of the structure. Persons who have received flood insurance claims payments or flood disaster relief should not get a subsidy when purchasing a new home.

These ideas require study of course, particularly to assure that they are crafted, as I tried to in the above list, to avoid adversely impacting truly low and moderate-income individuals.

I must raise the question of why private insurers cannot assume a greater role in writing flood insurance? The original reason insurers objected to a private role when NAS conducted the feasibility study was that they said they could not price policies to avoid adverse selection -- attracting properties that were extremely likely to be flooded. This concern could be resolved today by using technology to better assess risk and by requiring the purchase of the coverage (perhaps up to the 500-year storm level) to assure the spread of risk. Congress should explore a long-term program to shift flood insurance back into the private sector where political pressures to bring rates below the actuarial level will not be present.

However, if the Program is to remain a fully federal one, then why continue the Write Your Own Program (WYO)? It appears to be terribly expensive<sup>3</sup> and has not accomplished what insurers said it would (i.e., increasing market penetration of flood insurance). It results in wind/water claims adjustment conflicts of interest that could be avoided by using competitively bid contractors. When I was Texas Insurance Commissioner, I was shocked that the then Administrator of NFIP refused to give out the Program's toll-free telephone number out of fear that agents selling WYO coverage would be upset if the number was publicized. (I had to wait

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<sup>3</sup> I have not been able to get current data from FEMA on this point, but I looked at it a few years ago and this was the case. I have a call into FEMA for the latest information, and I will supply it to the Committee when I get it, if I do get it. The Committee should ask for this information from FEMA to determine the program's actual cost. I suggest not only looking at the costs of service compared to that of a competitively bid contractor but also to compare the cost to that of private insurers selling homeowners insurance (a more complex product than flood insurance and more costly to produce since homeowners insurance is not simply added to a policy as WYO flood insurance is). In 2004, underwriting expenses for the homeowners line were 28.4% of written premium, of which commissions were 13.0% and state taxes were 2.6% -- so that the comparable figure for servicing to compare to flood insurance is 12.8% (28.4% - {13.0% + 2.6%}). Source: Best's Aggregates & Averages, 2005 Edition.

until the Administrator left a press conference to give the number out so Texans who sought to buy flood coverage would have the information and taxpayers would get a break on costs of administration).

I urge this Committee to immediately request a GAO study of the efficiency of the WYO program compared to those of competitively bid contractor programs. Such a study would likely show that the costs of the WYO program are too high, use of contractors should be expanded and the WYO contracts should be renegotiated to save significant taxpayer cost. At the very least, the payment of commission dollars to insurers who do not use commissions (such as USAA) should stop. Why should taxpayers pay agent commissions when no agent receives such commissions?

Coverage levels should also be variable, at the consumer's option. The use of a higher deductible policy with a lower premium is one option that should exist. Policyholders could also be permitted to raise the \$250,000 cap on coverage, but only at full actuarial prices, even for currently subsidized structures.

The 100-year storm standard for the elevation of new structures and the purchase requirement within that area should be revisited. Requiring coverage up to the 500-year storm for the nation would result in greater spread of risk, fewer surprises when storms occur and greater market penetration. The price for flood insurance outside the 100-year area would be very reasonable.

A very serious concern is the low market penetration that the flood insurance program has achieved. Over 2 million homes were insured in the 1970s when I left the Program. In 2004 there were only 4.4 million, about double the 1970s level. In less than 10 years, we sold what it took an additional 15 years to match despite amazing population growth along the coasts and lender requirements to purchase insurance in the high flood hazard zones. Something is wrong.

One of the rationales for allowing insurers back into the NFIP was that they would achieve greater market penetration. They have failed to do a very good job other than to receive costly reimbursement for their servicing of policies. Further, the success of the lenders in requiring coverage on properties receiving new loans in flood prone areas is questionable and also needs to be studied. Are lenders failing to follow through to keep homes covered after they are purchased? I am aware that many lenders do have tracking programs to assure continuous coverage. However, questions persist because of the continued low penetration of flood coverage 35 years after the founding of the Program. Better market penetration will help assure NFIP solvency.

Consideration should also be given to increasing the amount of mandatory coverage in at least the 100-year flood risk zone. Flood after flood shows market penetration of ten to twenty percent. This is a serious problem. What is the "hook" for expanding mandatory coverage beyond the purchase requirement on federally backed mortgages, which appears not to work very well all by itself? This is a tough question, but an answer must be found. Perhaps non-federal lenders could be required by states to get flood cover on high-risk homes. As an

incentive, federal benefits for flood plain management programs in participating states could be increased in those states that required their banks to require flood insurance coverage. A review of federal benefit programs in high-risk flood areas might reveal other ways to obtain greater mandates on structures/inhabitants in the flood plains. Also, communities could, as part of their flood management requirements to qualify for the NFIP, demand covenants on the sale of properties in flood plains stipulating that flood insurance must be carried in the future. I am not expert in these matters, but it is clear that experts on federal benefit programs and real estate should help find the answer to this vital question of expanding coverage in high-risk areas.

I have always thought that some of the burden for obtaining coverage for new structures should fall on the builders of these structures. Consideration should be given to requiring builders of new homes to purchase a 30-year (or at least a 5 or 10-year) policy. There are many advantages to this idea, including an immediate infusion of higher premiums into the Program; but most important is the mitigation effect that such a requirement will have. Consider the difference in purchase price of two identical homes with builder-purchased flood coverage if one is built in harm's way the other is not. It won't take long for contractors to learn not to build in high-risk areas if they cannot market the high-risk homes.

There should also be verification by a GAO audit that participating communities forbid building in floodways and other "V" Zones, such as storm surge areas. GAO should study the actual development that has taken place after the Flood Insurance Rate Maps ("FIRM") were put in place in participating communities to see how the development conforms to the requirements of the FIRMs. If mitigation is not working, costs will go up and people will be killed. Mitigation failures must be fixed or the Program will just encourage unwise construction into the future.

Finally, the act to reduce losses to repetitively flooded properties passed by Congress last year should be a significant help in controlling costs.

## 2. Map Accuracy

Serious questions have been raised about the accuracy of the maps in Katrina-affected areas. Congress should order a review of the mapping methods and results using actual storms compared to predicted storms in recent years. A team of expert agencies (NAS, NOAA and others) should review mapping to assure that the most scientifically advanced methods are being used and that errors are not being made. To the extent that maps are not up-to-date and accurate, construction may be occurring at elevations that are dangerous to life and property, and the Program may be effectively subsidizing unwise building practices through inadequate flood insurance rates.

While we await this study, I recommend that two steps be taken:

- a) Maps should be upgraded at least once every three years.

- b) Maps should include a three-year projection of increased flood heights due to development.

### 3. WYO Conflicts of Interest: Wind v. Water

Since Hurricane Katrina devastated the Gulf Coast, there has been much public discussion about whether damage to homes was caused by wind and rain, or by flooding. Many policyholders have policies covering wind and rain damage (under homeowners' policies), but not flooding, which is a separate policy underwritten by NFIP.

Despite press releases and public pronouncements by the insurance industry that those without flood insurance should get nothing if their homes were eventually flooded,<sup>4</sup> the situation is far from clear-cut. Some consumers purchased what they were told was full hurricane coverage and were not clearly notified by insurance representatives that flood coverage was not included. They may have been misled. Others were told flood insurance was unnecessary.<sup>5</sup>

Moreover, even though a property may have been washed away by the storm surge, it was likely first hit by heavy winds, so that by the time the water wiped out the property, some percentage of the property was already destroyed by wind and rain. And suppose the storm surge, caused by low pressure, was 10 feet, but wind caused waves on top for another 5 feet. If someone's home is at 12 feet and damaged, was not wind the "proximate" cause of the damage?

Indeed, the outcome of the litigation that is being pursued on this question is not the "slam dunk" that the insurance industry says it is. Some courts have found that where wind and flooding both cause damage, as long as the wind damage is a "proximate" or "efficient" cause of the damage, insurers cannot dodge paying on a claim.

- After Hurricane Camille, this issue was litigated in the Mississippi state courts. The state's highest court confirmed that it was essentially up to a jury to decide whether wind was a proximate cause of the damage and to appropriately apportioned the damage: "[i]t is sufficient to show that wind was the proximate or efficient cause of the loss or damage notwithstanding other factors [that] contributed to the loss."<sup>6</sup> In that case, the policy read: "This coverage does not insure against loss ... caused by, resulting from, contributed to or aggravated by ... flood, surface waters, tidal water, or tidal wave, overflow of streams or other bodies of water, or spray from any of the foregoing, all whether driven by wind or not."<sup>7</sup>

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<sup>4</sup> The Property Casualty Insurance Association of America, the major industry trade association, issued its first press release with this message on August 31, 2005, and has issued similar press releases nearly every day since.

<sup>5</sup> Reports to the Americans for Insurance Reform Katrina Insurance Hotline indicate that when policyholders were purchasing homeowners' insurance, insurance agents said that additional flood insurance would not be necessary, as the policyholders did not live in flood zones.

<sup>6</sup> *Grace v. Littitz Mutual Ins. Co.*, 257 So.2d 217, 224 (Sup. Ct. Miss. 1972) (citing *Lititz Mut. Ins. Co. v. Boatner*, 254 So.2d 765 (Miss. 1971); *Kemp v. American Universal Ins. Co.*, 391 F.2d 533 (5<sup>th</sup> Cir. 1968)).

<sup>7</sup> *Id.* at 219.

- Mississippi is not the only state where this approach is taken. Other courts have also found that in cases of total damage caused by a possible combination of a covered peril (wind) and other excluded perils (flood), where the proximate cause of damage is a covered peril, insurers must pay the claim.<sup>8</sup> As the Ninth Circuit has explained, “in determining whether a loss is within an exception in a policy, where there is a concurrence of different causes, the efficient cause – the one that sets the others in motion – is the cause to which the loss is to be attributed, though the other causes may follow it, and operate more immediately in producing the disaster.”<sup>9</sup>

Courts have repeatedly held that disputes over ambiguous contract language, such as in a homeowner’s policy, are to be resolved in the policyholder’s favor.

- It has been settled law for over 100 years that where language in insurance policies is ambiguous, questions will be resolved in favor of the policyholder.<sup>10</sup>
- According to a West Virginia court, “[a] provision in an insurance policy may be deemed to be ambiguous if courts in other jurisdictions have interpreted the provision in different ways. This rule is based on the understanding that one cannot expect a mere layman to understand the meaning of a clause respecting the meaning of which fine judicial minds are at variance.”<sup>11</sup>

The attitude of the insurance industry in the aftermath of Hurricane Katrina, as they force policyholders to fight to get their claims paid, is consistent with the industry’s efforts to limit claims payouts in other hurricane situations.

- In Florida, in the aftermath of Hurricane Andrew, a court ordered insurance companies to pay their full claims, relying on an explicit statutory provision called a “value added” law, which stated that a policy that covers one peril, even if it expressly excludes another possible contributing peril, must be paid in full.<sup>12</sup> The insurance industry’s response was to lobby the legislature to change the law, which occurred.<sup>13</sup>

The importance of this legal dispute to the flood insurance program is obvious. To the extent that insurers underpay wind when allocating damage between their homeowners’ policy and the NFIP policy, taxpayers will suffer. It is also true that the more lax the federal government is in demanding that the allocation be fair to taxpayers, the more likely it is that

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<sup>8</sup> Murray v. State Farm Fire and Casualty Co., 509 S.E.2d 1, 11 (W.Va. 1998) (“When a loss is caused by a combination of covered and specifically excluded risks, the loss is covered if the covered risk was the proximate cause of the loss.”); Bartholomew v. Cameron Country Mut. Ins. Co., 882 S.W.2d 173 (Mo. Ct. App. W.D. 1994).

<sup>9</sup> Berry v. Commercial Union Ins. Co., 87 F.3d 387 (9<sup>th</sup> Cir. 1996) (quoting Sabella v. Wisler, 377 P.2d at 895).

<sup>10</sup> McMaster v. New York Life Ins. Co., 22 S.Ct. 10 (1901).

<sup>11</sup> Murray, at FN5.

<sup>12</sup> Mierzwa v. Florida Windstorm Underwriting Assoc., 877 So.2d 774 (Fla. Dist. Ct. App. 2004).

<sup>13</sup> <http://www.independentagent.com/VU/NonMember/DisasterFAQs.htm>;  
<http://www.insuranceneutral.com/print.asp?a=top-pc&lnid=295390280>

persons without flood insurance will receive unfair or no compensation under their wind policies. Take the situation of two damaged homes next to each other, one with flood coverage and one without. If the federal government is vigilant regarding the home with flood coverage and the resulting allocation is 50/50 versus the insurer suggestion of 25 percent wind/75 percent flood, the insurer will be hard-pressed to assess the similarly damaged home next door at 25 percent wind damage.

For the benefit of taxpayers' and those with no flood insurance, it is essential that the government assure a fair and proper allocation of the wind/flood damage by the WYO insurance companies who have a serious conflict of interest. CFA urges this Committee to insure that the GAO audits these allocations starting right now, so that any tendency of the insurers to diminish their wind losses for their own benefit is stopped quickly.

## CONCLUSION

It is vital to the nation that the NFIP work efficiently and comprehensively to protect as many Americans as possible against floods that occur in the future. There are serious questions about how the Program is working today that cry out for study and resolution. Today's hearing is an important first step in accomplishing this important task. I will be happy to respond to questions at the appropriate time.



## Consumer Federation of America

September 12, 2005

David I. Maurstad  
Acting Director, Mitigation Division  
and Federal Insurance Administrator  
Federal Insurance Administration/FEMA  
500 C Street, SW  
Washington, D.C. 20472

Dear Administrator:

As a former Administrator of the Flood Insurance Program, I am concerned about the potential for claims settlement abuses in the aftermath of Hurricane Katrina. On the one hand, FIA must pay claims promptly in a very complex situation. On the other, the potential for taxpayers to be overcharged by insurers claiming illegitimate flood losses is real.

I urge you to bring in the CEOs of the major write-your-own insurers and tell them that, when there is a loss to be adjusted where both wind and flood damage is present, they should not hold up payments during the determination period. They should pay the claim promptly, make the best determination of the wind/flood allocation possible and carefully document that allocation.

I would also urge you to tell them that you fully understand that there is potential for abuse by insurers and that you will carefully audit all allocations where there is both wind and flood damage. Insurers that also have wind coverage on a particular property have a conflict of interest in adjusting flood claims, as wind payouts come out of their reserves and flood payouts do not.

I believe GAO should be brought into the auditing of how these claims are allocated at once. I will soon be asking the appropriate Congressional Committee Chairs and Ranking Members to consider this action.

I also urge FIA to continue to require a separate adjuster for flood losses when both wind and flood damage is present. I was very concerned to read this statement in the September 8<sup>th</sup> *New York Times* about a meeting of insurers and regulators in Atlanta:

The attendees also discussed the convention of using separate insurance adjusters to assess wind damage and water damage. The consensus seemed to be that using one adjuster would streamline the process and make it less contentious.

“Less contentious” in this case could well mean less protection for the taxpayer. When the insurer can profit by pretending that wind damage is in fact flood damage, having separate adjusters is an essential step in helping to keep the process honest.

I look forward to your action and response.

Yours truly:

A handwritten signature in cursive script that reads "J. Robert Hunter".

J. Robert Hunter  
Director of Insurance

cc: The Honorable Richard C. Shelby  
The Honorable Paul S. Sarbanes  
The Honorable Michael G. Oxley  
The Honorable Barney Frank  
The Honorable Richard H. Baker  
The Honorable Paul E. Kanjorski