

**Testimony of Scott Richardson**

*Policy Advisor, The Heartland Institute*

*Former Director of Insurance, State of South Carolina*

**As Prepared for Delivery  
June 23, 2011**

**Chairman Johnson, Ranking Member Shelby, and Members of the Committee:**

I am here today to address an issue of great concern to the National Flood Insurance Program's future and to explain how a proposal that has been brought before your committee by Sen. Roger Wicker presents what I believe is a solution to a problem that has long plagued coastal communities.

As a former insurance agent, member of the South Carolina State Legislature, and Director of Insurance of the State of South Carolina, I have seen the difficulties that coastal communities, their residents, insurers, courts, and insurance regulators—in short, just about everyone involved in coastal insurance—face in the course of dealing with severe windstorms. I speak, of course, of the problem of indeterminate loss. The problem of what is to be done when a storm is so severe that it leaves nothing in place to determine whether wind or water caused damage.

This is a particular problem because it undermines the insurance system that undergirds our entire modern economy by allowing for certainty. Insurance allows people to build skyscrapers, develop miracle drugs, advance technology, drive automobiles, and operate businesses with the knowledge that the risks implicit in doing these things will be managed in an effective manner. Our current system for managing the risk of severe windstorms does not create that certainty. Indeed, it creates *uncertainty*. It is broken and it needs to be fixed.

In this testimony, I aim to outline the problem of indeterminate loss, describe how the current flood/wind loss allocation system fails many communities, outline why other solutions are not practical, describe how a Standardized Loss Allocation Model would work, go over several public policy concerns involved in implementing a Standardized Loss Allocation system, and describe how I believe it will solve the problem of indeterminate loss.

**The Problem of Indeterminate Loss Resulting from Windstorms**

Hurricanes rank among nature's most destructive phenomena. High winds, wind-driven debris, and the storm surges that follow hurricane landfall can do enormous damage to everything in their paths. In many cases, over areas of several miles, all above-ground traces of buildings can be torn apart, leaving nothing but foundation slabs in place.<sup>1</sup> I have seen total losses myself:

---

<sup>1</sup> A good example of the total destruction that can result from a hurricane and the damage it causes can be found at Dan Swenson and Bob Marshall, "Flash Flood: Hurricane Katrina's Inundation of New Orleans, August 29, 2005," *New Orleans Times Picayune*, September 13, 2005, <http://www.nola.com/katrina/graphics/flashflood.swf>. See also "Total

what remains after a particularly severe storm resembles a moonscape.

Because they combine high winds with storm surge, hurricanes cause both wind and water-related losses in very close proximity to one another. When nothing above remains of a structure and both wind and storm surge were sufficient to cause its total destruction, claims adjusters, consumers, and insurers currently have no practical way to determine how to distribute losses between NFIP, which provides nearly all flood coverage, and private insurers or state residual wind insurance markets, who cover wind and related damage. When a home is totally destroyed, there's no simple way to resolve disputes over who should pay for losses. When this happens, the current U.S. system for paying insurance claims can cause enormous problems for consumers, insurers, and regulators. The problems are most serious when people do not have flood insurance and therefore try to get insurers that sell wind insurance policies to cover damages that may have resulted from flood. Insurers often refuse these claims and say flooding (which they do not cover) caused the damage, leaving consumers with little recourse besides litigation.<sup>2</sup> This, in turn, can lead to enormous and protracted legal battles among insurers, consumers, and regulators.

### **The Problems Communities Face and the Inadequacy of Other Solutions**

Following the terrible 2005 hurricane season—the season of hurricanes Rita, Wilma, and Katrina—nearly all states impacted by major hurricanes saw significant litigation between insurers and insured over responsibility for wind and water claims. Many of these legal disputes stretched over months and years. Many people and many communities did not get the resources they needed and deserved to rebuild. The costs of litigation, of delayed rebuilding, and of damage to the fabric of communities, were all immense.

Fundamentally, these problems exist because separate parties are responsible for paying for wind and water damage. A huge incentive exists for insurers and consumers alike to shift the responsibility for paying any given claim to someone else and, right now, it's difficult (sometimes impossible) to determine what (and therefore who) is responsible for any given damage.

Proposals have been made to solve this problem by unifying responsibility for flood and wind damage. If a single party is responsible for covering both flooding and wind damage, the problem of indeterminate loss would no longer exist. In principle, I believe that this unification of responsibility under private insurers is a worthy long-term goal. Many provisions in the flood reform bill before you would increase the private sector role in the flood insurance program but, based on my knowledge of the insurance industry, I simply do not believe that the major private insurers could or would cover all flood risk in the near future. Thus, even if you take every step towards privatization of the flood insurance program that has been proposed, the problem of indeterminate loss will continue to exist for some time.

---

Devastation from Hurricane Katrina,”

[http://www.katrinadestruction.com/images/v/hurricane+katrina+photos/Img\\_19kd45-slidell-katrina-lr2.html](http://www.katrinadestruction.com/images/v/hurricane+katrina+photos/Img_19kd45-slidell-katrina-lr2.html).

<sup>2</sup> Jihyun Lee et al., “Flood Insurance Demand along the Gulf and Florida Coast,” *Southern Agricultural Economics Association*, 2010, <http://ideas.repec.org/p/ags/saea11/99239.html>.

Thus, if Congress is not to privatize flood insurance entirely, it ought to come up with another solution to the problem of indeterminate loss. And I believe that a Standardized Loss Allocation model as Sen. Wicker's COASTAL Act envisions is such a solution.

### **Standardized Loss Allocation—How It Works**

Under a Standardized Loss Allocation (SLA) system, insurers, NFIP, and state-run or state-mandated residual insurance markets such as wind pools and Fair Access to Insurance Requirements (FAIR) plans would agree in advance to distribute liability based on standardized loss allocations models. The sizes of the distributions would be based on extrinsic, meteorological evidence. This approach would solve almost all of the problems implicit in the current system and could potentially save money for both NFIP and private insurers. Implementing it properly, however, will require the collection of more meteorological data. I'd like to use the remainder of my testimony to describe how it would work and what public policies should be implemented to make sure that it is effective.

### **How an SLA System Would Work and How It Solves Problems**

An SLA system would begin by establishing a model for assessing the damage resulting from each major storm based on four major inputs: direct observations, information about building characteristics, indirect aerial observations of storm surge, and widely used storm models. Direct observations are what they sound like: direct information, collected by scientific instruments about wind speed and storm surge. Information about building characteristics –particularly elevation information that would provide input as to the consequences of storm surge – is not always included in current insurance underwriting standards but is necessary in certain cases to determine the exact damage resulting from storm surge. Aerial observations collected during and immediately after a storm (as well as satellite imagery collected during a storm) could provide additional information on storm surge since few instruments can withstand the most severe storm surge. Finally, a wide range of storm modeling techniques would work together to build a model that could, ideally, provide a very good estimate of the extent to which wind or water caused the damage to a given structure. The National Oceanic and Atmospheric Administration and several private-sector modeling firms already have created such models; building a standardized national one would not require significant additional scientific work.

### **Public Policies to Implement an SLA System: Improved Data Collection**

All this said, some minor public policy changes would have to be made to assure the success of an SLA system. These would primarily involve improving data collection. Although the scientific instruments and mathematical techniques needed to develop a standardized loss allocation model already exist, there are places where data collection could be improved. This is not universal: Particularly along the Gulf Coast, the Coastal-Marine Automated Network (C-MAN) already provide the data now needed. In some other areas—areas further from the coast and thus less likely to be hit by hurricanes—the available data may not be quite as good and measures should be undertaken to improve data quality over time. Sen. Wicker's COASTAL Act asks the National Oceanographic and Atmospheric Administration to form partnerships with private entities, other federal agencies to place new sensors on federal government property. It

also envisions paying some or all of the costs for keeping an expanded network in place by leasing space on new observation posts (many of them on existing federal property) to mobile phone providers, other weather-related businesses, and anyone else who has need for such access. This particular funding approach certainly has promise, but Congress, the Federal Emergency Management Agency (which oversees the flood program), NOAA, and state and local agencies should, over time, consider other proposals as well.

### **Public Policies to Implement an SLA System: Making the System Universal But Voluntary**

A standardized loss allocation system is a good idea but it should not become a straightjacket. There are far too many unknowns for it to be wise to force the system on every consumer, every community, every insurer and every insurance agent in the country. Instead, participation should be voluntary.

To facilitate universal but optional participation, NFIP should participate in an SLA model for all policies written under the Write Your Own program and not participate in it for most policies written by independent agents under NFIP Direct. This is the approach that Sen. Wicker's bill takes and it is one I believe that the Committee should take care to continue and to clarify in the bill's legislation language.

A voluntary system will provide a choice to all consumers, insurers, and state residual insurance market mechanisms. Individuals who want to opt out of the SLA program can purchase a direct policy, since nearly all independent insurance agents in the country will write them, and thereby get the same flood coverage at the same price as they would otherwise. Private insurers and residual insurance market mechanisms that don't want to take part can simply leave (or never join) the Write Your Own program. In short, it seems possible to make SLA-based policies an available option for almost everyone without mandating them for anyone.

### **Conclusion: An SLA System is Better**

An SLA system would work better than the current system. For those participating in the system, the model essentially would end litigation, assure payments to consumers, shore up NFIP finances, and provide certainty to NFIP itself. With payments determined by formula alone, there would be little to litigate: The use of the model would be written into policy language for both NFIP and private-sector coverage, and anyone challenging it in court would have to present expert scientific testimony indicating why the model was invalid. If anyone went through the trouble to do this, it would probably help improve the system by pointing out flaws in the models.

Customers, even those who live in flooded areas but lack flood insurance, generally would be assured of at least some payments from their wind insurance policy rather than outright claims denial. NFIP itself, likewise, would rarely if ever face the prospect of having to pay the full cost of damage caused in part by wind. Insurers, finally, would have the same assurance, that they would never have to pay total losses when flood has done part of the damage. Quite simply, an SLA system promises to be less expensive, more certain, and more efficient than any currently available alternative.

I am delighted to take your questions.