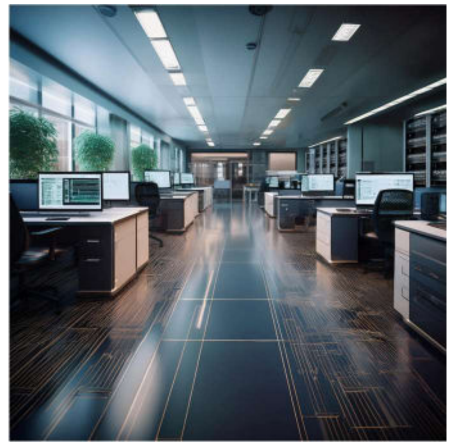
Reclaiming Excellence: Insourcing Flood Insurance Business Services



Solstice Innovations is an insurance technology and services company. Our flagship platform, Equinox™, is a complete ecosystem for Flood, Homeowners, and more. We aim to enable clients to meet their evolving demands while increasing efficiency and decreasing costs.

This case study assumes the reader has basic knowledge of the NFIP. Additional details on the history and challenges that WYOs face are included as an addendum.

INTRODUCTION/BACKGROUND

The Federal Emergency Management Agency (FEMA) is responsible for the National Flood Insurance Program (NFIP). Since 1983, insurance companies have sold and administered NFIP policies on FEMA's behalf under the Write Your Own (WYO) program in exchange for an expense allowance determined and paid by FEMA.

The WYO companies quickly found that the NFIP product, while on the surface seemed very similar to Homeowner's insurance, was, in fact, significantly more complex.

Major drivers included the fact that the NFIP is neither pure insurance nor a pure government benefit program. It is a hybrid with nuanced differences requiring in-depth knowledge and skill sets that are uncommon in private insurance, as well as the necessity of communicating and working frequently with FEMA. Additionally, the average insurance agent tends not to be as familiar with the NFIP's unique products and quoting process.

As a result, most WYO carriers realized they needed outside help, which gave rise to the "Flood Vendor" niche market.

This market included outsourcing the enabling technology, back-office operations, financial reporting, and numerous audit requirements associated with the NFIP to a handful of flood vendors specializing in and singularly focused on it, creating a more efficient, cost-effective business model. In many cases, outsourcing was essential to the WYO's ability to participate in the NFIP.

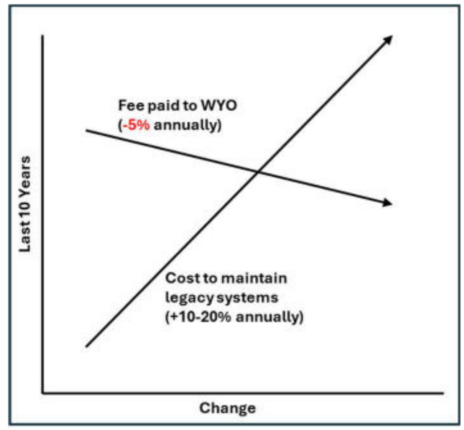
The flood vendor outsourcing model worked very successfully for several decades but is now facing disruption, especially given FEMA's already completed and additionally planned modernization initiatives, which have simplified the NFIP Program, and economic pressures.

THE CHALLENGE

The WYO expense allowance has continuously decreased over the last two decades while the agents' commission rates and traditional vendor fee structures have remained the same or increased.

Legacy flood vendor systems are relatively inflexible and struggle to adapt to FEMA's modernization initiatives, resulting in higher maintenance costs and decreased ability to make meaningful client-driven enhancements. As technical costs increase, the tendency is to take other cost-cutting measures, often focused on business operations, resulting in decreased quality, service, and overall satisfaction.

Consequently, many WYOs are challenged to continue in the NFIP because the risk and reward structure has become imbalanced.



SOLUTION

In late 2021, FEMA implemented one of the most dramatic changes in the NFIP's history, modernizing how flood risks and rates are determined, with an initiative known as Risk Rating 2.0. This initiative established a new rating methodology that is more akin to private insurance methods. Additional modernization initiatives will continue to cause the NFIP policies to behave more like private insurance products. Beginning with the new rating methodology, these initiatives have reduced, but not eliminated, the need for specialized skills required by WYOs (and, by extension, flood vendors).

Meanwhile, Solstice Innovations' Equinox™ flood and homeowners insurance technology ecosystem is a modern solution that is highly configurable and less expensive to maintain than legacy NFIP flood systems. It simplifies the flood insurance quote and policy administration processes for agents, policyholders, and underwriters. Data, graphics, and NFIP unique information are made available automatically and on-demand, reducing the depth of NFIP expertise required by users.

The flood component of Equinox™ is designed to natively take advantage of FEMA's modernization initiatives. Combining these initiatives with Equinox™ makes it easier than ever for clients to take the back-office in-house, using existing resources, while removing this expense from their flood vendor fee.

This ultimately means that outsourcing business services to a flood vendor is no longer advantageous for the WYO community - and is no longer borderline mandatory for anyone.

RESULT/IMPACT

WYOs can save up to 50% or more on vendor fees by insourcing flood insurance business services. Of course, bringing services in-house has an incremental cost, but the expense is insignificant given the enhanced Equinox™ tools combined with FEMA's modernization initiatives. To prove it, Solstice has developed resource and cost models for insourcing that provide the WYO with realistic estimates, so insourcing/outsourcing is now a strategic management decision rather than a forced tactical one.

Several less tangible reasons for insourcing also exist, including brand protection, the ability to differentiate services on an otherwise undifferentiated product, and complete control over staffing, workflow, and quality of service.

Designing, implementing, and maintaining technology that supports the NFIP still requires in-depth NFIP expertise. But, together, FEMA's modernization initiatives and Equinox™ make insourcing flood insurance business services a viable option for all WYOs, no matter their size or level of NFIP expertise, perhaps for the first time in the NFIP's history.

Addendum

The Solstice Innovations team has extensive knowledge and experience in the NFIP. This section includes additional details on the NFIP history and challenges that WYOs face.

- In 1968, FEMA created the National Flood Insurance Program (NFIP) in response to unaffordable rates and a lack of private companies participating in the flood insurance market, given the catastrophic nature and the corresponding material risk of major hurricanes and flooding events.
- In 1983, FEMA created the Write Your Own (WYO) Program to increase distribution and expand participation in the NFIP by opening it up to private insurance companies, giving them roughly one-third of the premium as the "expense allowance" to perform all insurance functions (including policies issuance/management, claims processing, accounting, system, agent management, and training, etc.); all while assuming no balance sheet risk. This low-risk, lucrative dynamic led to many private carriers entering the WYO Program, peaking at 133 carriers, many believing this product was highly accretive to their other P&C lines of business, making it incrementally minimal from an expense perspective to take in-house.
- Most WYO companies quickly learned that the NFIP product, while on the surface seemingly very similar to Homeowners, was, in fact, significantly more complex, including an onerous level of oversight requiring the company to provide highly detailed monthly reporting back to FEMA as well as endure several compliance audits.
- Most of the WYO companies were ill-equipped to adjust to the unique and nuanced nature of the NFIP and quickly fell out of compliance with FEMA, creating reputational risk, leading to the emergence of the "Flood Vendor" market.
- While FEMA pays the WYO an expense allowance, the WYO, in turn, pays the agents and flood (and data) vendors, whose commissions and fees are based on a percentage of the Written Premium.
- While the flood vendor outsourcing model worked well for many years, Congressional demands on FEMA have caused downward pressure on the expense allowance,
- An inherent challenge with the NFIP Program is that there are only 2 economic components - rates and agent commission - and one is fixed. In this case, rates are set by the NFIP and, therefore, the same, regardless of which company sells it. This dynamic has placed undue upward pressure on the only other economic component, agent commissions. In other words, if companies can't economically compete on this product with rates, they are in a situation where they must start 'buying' the independent agents with higher commissions just to compete. This dynamic escalated in the early 2000s, when commissions in states that were big in the NFIP due to heavy flooding events (i.e., Florida, Texas, Louisiana, etc.) began to increase. The WYO Arrangement Letter that each carrier must sign with FEMA each year clearly states that they recommend WYO Companies pay 15% commissions – but it is not mandated, nor does FEMA get involved in what WYOs pay in commissions. The result is many WYO companies engaging in a 'commissions war' just to maintain or grow their NFIP books, leading to a commission structure today in many flood markets that is consuming a large portion of the NFIP expense allowance, leaving less and less for what it is intended for: technology/systems processing, back office operations (both functions often

outsourced to a flood vendor for a fee) and managing, marketing and training agents (essentially done by the WYOs).

- FEMA's new rating methodology was accompanied by a mandate that all WYOs (and hence the flood vendors) integrate with FEMA's new rating engine rather than calculate rates within their own systems. This resulted in several things, including but not limited to massive technology changes to strip rating functionality from the WYO (and vendor) systems and consistent rate determinations regardless of which WYO a policyholder prefers.
- Many WYOs face a double-edged, razor-sharp sword: finding it difficult to maintain profitability while seeing a decline in the quality of service to their customers. When flood insurance is a tiny fraction of the carrier's mainstay business, this creates an unacceptable risk to their brand, even though the underwriting risk lies with FEMA.