Insight

The National Flood Insurance Program in 2025

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Executive Summary

- The National Flood Insurance Program (NFIP) is the only broadly purchased flood insurance in the United States, but the program is expensive, cumbersome, and outdated, and owes $20.5 billion to Treasury.
- In 2021 the NFIP introduced its most significant reform in the program's history – a more tailored approach to risk in setting pricing; yet improved granularity brings logistical challenges and the program is still subject to premium price increase caps.
- A federal backstop for flood insurance will likely become only more necessary in the future – but government is no replacement for private actors in setting prices or assessing risk.

Introduction

The National Flood Insurance Program (NFIP) is the principal provider of flood insurance in the United States and plays a crucial role in reducing the financial loss impacts of flooding for more than five million Americans. Administered by the Federal Emergency Management Agency (FEMA), the NFIP was originally intended to be the facilitator of a private market of flood insurance and an insurer of last resort, but it has since morphed into the market itself via a burdensome federal program that has cost taxpayers at least $40 billion, is losing $600 million annually, and remains $20.5 billion in debt to the Treasury.

While the program is inefficient and far more expensive than originally intended, structural reform has been difficult to accomplish. Since fiscal year 2017, for example, the program has undergone 32 short-term extensions and brief lapses. Instead of meaningfully reforming the NFIP's structure, Congress has preferred merely to reauthorize it – an approach that

Congress has taken for most of the program's 50-year history. Only two major reforms have been enacted across this period because legislators face an admittedly complicated problem: keeping flood insurance affordable while ensuring the program's fiscal solvency. Reform is made only more difficult politically as the issue is less one of partisan politics and more a feature of state geography.

The History of the NFIP

The NFIP was created by the National Flood Insurance Act of 1968 to address two key policy concerns: first, to minimize the burden on federal disaster relief assistance; and second, to supplement and subsidize a private flood insurance market that otherwise would not be able to provide flood insurance at a cost homeowners could afford.
Despite managing about five million flood insurance policies that provide $1.3 trillion in coverage to more than 22,000 communities in 56 states and jurisdictions, participation in the NFIP is not required by law in the majority of cases. Nonetheless, the NFIP remains the only real option available for obtaining flood insurance. By participating in the NFIP program, communities are required to adopt FEMA-mandated floodplain management standards, serving the additional goal of attempting to limit the risk posed by these areas.

FEMA is responsible for performing annual Flood Insurance Studies (FIS). FEMA uses the data generated from these studies to develop and adopt flood maps called Flood Insurance Rate Maps (FIRMs) via its Risk Mapping, Assessment, and Planning (Risk MAP) process. The key element of a FIRM is that it shows areas exposed to at least a 1-percent risk of flooding, which it calls Special Flood Hazard Areas (SFHAs). In calculating the premium a homeowner must pay for their NFIP policy, FEMA classifies properties on the basis of a small number of fairly blunt metrics, including occupancy type and elevation, but the key driver of price is the specific risk zone in which the home can be found on the FIRM.

Although policies are in theory based on a real risk or hypothetical market pricing, this supposed sensitivity is belied by a wide series of carveouts, most obviously grandfathering provisions that allow roughly 15 percent of home rates to stay the same when the risk zone within a FIRM changes. The presence of such carveouts is just one of a number of criticisms leveled at the NFIP, from a small coverage pool and extremely outdated program technologies to mapping errors and FIRMs that are only updated every three to five years.

Risk Rating 2.0

In 2021 the NFIP changed its pricing methodology, representing one of the most significant adjustments since the program's creation in 1968. Risk Rating 2.0 tailors FEMA's Risk MAP process and, in particular, assesses individual homes on the basis of individual risk,

replacing the blunt metric of elevation of homes within a certain flood zone. FEMA now considers a wider range of variables, from flood frequency and type of flood to distance from water source, and considers homes on a case-by-case basis. Perhaps the most important metric, however, is the cost to replace. By considering how much it would cost to rebuild individual homes, FEMA hopes to address a longstanding concern that homes of significantly different value with all else being equal pay the same insurance premium, leading to lower-value homes effectively subsidizing the cost to rebuild higher-value homes.

Although there is legitimate concern about the considerable additional costs and experience burden on FEMA to operate the NFIP at this higher level of risk granularity, anything that brings NFIP premiums closer to a true market reality by appropriately reflecting risk is to be welcomed and, indeed, is necessary to stop the NFIP from hemorrhaging taxpayer dollars. The necessary corollary of this adjustment, however, is significant premium increases. Nonetheless, the NFIP must continue to adhere to existing legal caps on premium increases, capped out at 18 percent annually. As of April 2023, Risk Rating 2.0 is fully enacted.

How to Fix the NFIP

Risk Rating 2.0 represented a significant step forward for the NFIP. Efficient pricing is part of economically rational adaptation, and it also keeps new building and development out of ecologically sensitive areas. Despite this increased risk sensitivity, the NFIP continues to report millions of dollars in losses as severe weather events continue to increase in number and severity. The NFIP's pattern of shortfall, debt, and taxpayer bailouts doesn't have to be set in stone. Instead, there are a number of relatively simple reforms that can be made to the program to help ensure it is available and stable for future disasters.

Charge premiums that accurately reflect the risk

While Risk Rating 2.0 represents a sea change over the previous approach, premium caps and the (correct) perception that the NFIP need not concern itself with basic solvency demonstrate the shortcomings of a federal approach to risk assessment and pricing. Current NFIP premiums have four fatal flaws: 1) The premiums do not reflect the risk; 2) Full-risk premiums are too low; 3) Caps on premium increases are too low; and 4) Premium rates rely on inaccurate data.

The problem with flood insurance is that, unlike other property or health insurance, claims on flood insurance policies usually happen all at once. Losses are low in some years but extremely high in others. As a result, the NFIP has consistently struggled to find the right premium that would be appropriate for average, small-flood events, but that would also

cover the catastrophic ones. Further confounding matters is the need to subsidize premiums for low-income areas to make flood insurance affordable for all at-risk properties. Congress has attempted to keep premiums affordable by setting caps on premium increases, but the caps remain too low to keep the program afloat.

On the flip side of subsidized premiums are "full-risk" premiums, which are supposed to be high enough to cover the cost of any given flood event for a particular property. For comparison's sake, private flood insurers charge premiums that include a margin to cover both profit and a portion for loss reserves. The NFIP, on the other hand, charges full-risk premiums that account only for the amount of a loss relative to the historical average loss per year – a number that doesn't take into account the rare, catastrophic flood losses such as those in 2005, 2012, and 2017.

NFIP policyholders should be charged premiums that reflect the actual amount of risk of loss to their properties, and therefore the actual amount that NFIP could foreseeably have to pay out for a claim. As a first step, NFIP should update its FIRMs to more accurately inform buyers and builders of the risk to their property and base its pricing decisions accordingly. Further, NFIP should phase out the most antiquated of the grandfathered premium rates that came from previous, politically charged flood risk zone reclassifications.

Rate shock caused by an immediate increase in premiums could be avoided by grandfathering in the most actuarily sound rates for current NFIP policy holders and, for new buyers of existing properties and for new construction, the new, reformed, risk-based rates would apply. When buyers realize the higher flood insurance premiums, fewer potential buyers will bid on risky properties, thus sending a signal to the market that less value should be exposed to the most severe flood risk.

On the other hand, existing policyholders could still be subject to premium increases, but these would be reasonably capped at 10 or 20 percent per year. Combined, the policies of unsubsidized rates for new buyers and builders and a gradual, phased-in rate increase for existing policyholders will help reverse the program's chronic shortfalls.

Increase the size of the coverage pool

Approximately 9 percent of all properties in the United States are considered to be in an SFHA. Because only participating counties with federally backed loans actually require participation in the NFIP, there is a significant flood insurance gap – inland areas flooded by Hurricane Helene had NFIP participation between 1 and 2 percent, with coastal regions only 20 percent. Uninsured properties mean an increased need for direct aid from FEMA in the wake of a disaster. On the flip side, the fewer properties that have flood insurance mean

fewer premium payments coming into the NFIP each month to cover the costs of claims payouts.

As such, the number of NFIP policyholders should be increased, not only to raise the level of compliance among structures situated in SFHAs, but to raise the amount of premium revenue coming into the program. FEMA should increase its oversight of the insurance purchase requirements for individuals with federally insured mortgages located in designated flood zones. Driving growth in sectors like the mortgage industry that fall short of compliance requirements will not only help spread risk among more stakeholders but will also increase program income, ultimately helping to reduce the NFIP's debt to taxpayers.

Update program technology

Many of FEMA and the NFIP's technologies and processes date back to the 1960s when the program began. For example, homebuyers in SFHAs are required to purchase a new elevation certification that must be completed by a surveyor each time a property is bought and sold because there is no central database of the flood elevation data. By simply creating a central repository for flood zone data or allowing homebuyers to rely on GPS data instead of requiring a (pricey) physical surveyor, the dissuasive costs of buying into the NFIP could be significantly reduced. Further, the NFIP should implement a secure platform for processing claims, business analytics, and customer care. Private insurers already have these real-time systems that are faster and more accurate than those used by the NFIP and FEMA which often provide data and reports that are dated by several months.

Share risk with the private insurance market

Last, but perhaps most effective, the government should share more risk with private markets. Not unlike proposals that have been circulated to share the risk of subprime mortgages with the private mortgage insurers, the NFIP could reduce its exposure to flood risk through increased participation of private flood insurers. This would not only reduce the NFIP's risk exposure; it would allow FEMA to focus on emergency relief work and flood risk mitigation and let the market focus on underwriting flood insurance policies.

The correlated nature of flood risk makes the development of a solely private flood insurance market highly unlikely in the near term, but this should ultimately be the goal of policymakers. Short of that, there are options that would allow for a more efficient sharing of risk. For example, some combination of scenarios in which private insurers either provide primary coverage to a majority of policyholders or acquire the transferred risk from the NFIP by way of reinsurance, or private insurers and the NFIP jointly underwrite primary flood risk and pool any reinsurance would all be feasible. In any of those cases, the NFIP

could act as a reinsurer of last resort (particulalry relevant for the estimated four percent of properties that are completely uninsurable) or could provide primary insurance that is focused solely on residual market risks left over from what private flood insurers could not or would not underwrite.

Conclusions

As the frequency and severity of flooding and other severe weather events increases, the United States must reconsider its relationship with the NFIP. Recent efforts to modernize pricing structures aside, the NFIP is a prime example of the moral hazard and dubious accountancy present when governments enter markets. That Congress has not managed to pass a clean authorization of the program, let alone embark on the wholesale reform it so badly needs, indicates that a government solution to this problem might not be possible or indeed desirable. A federal backstop for flood insurance will likely become only more necessary in the future – but let's not pretend the government is a replacement for private actors in setting prices or assessing risk.