Research

The NFIP is Due for Some Major Reforms

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The National Flood Insurance Program (NFIP), the primary underwriter of flood insurance in the U.S. since its inception in 1968, is up for renewal in 2017, and with its renewal are sure to come proposals to improve upon an indebted and inefficient program. This primer explains the history of the NFIP, policy weaknesses, and potential reforms. As the deadline for renewal draws near, policymakers should consider several program changes and avoid a blanket stamp of approval.

Biggert-Waters Flood Insurance Reform Act

When Biggert-Waters was passed in 2012, it was a welcome change of pace from the all-too-common Congressional action that's more focused on meeting a renewal deadline and less focused on actually fixing anything. In Biggert-Waters' case, coincidentally just ahead of a generational flooding event in Superstorm Sandy, some real fixes were made.

It's important to note that the Biggert-Waters reform took place in the context of a financial mess. When Hurricanes Katrina, Rita, and Wilma struck the Gulf Coast in 2005, the NFIP went $19 billion into debt (of which only about $2 billion has been repaid). The NFIP took on an additional $7 billion in debt following Superstorm Sandy, creating a total debt of $23 billion to the U.S. Treasury.

Representatives Biggert and Waters realized that much of the NFIP's insolvency was due to premiums that were artificially low and did not reflect the true financial risk of living in high probability flood areas. Accordingly, Biggert-Waters reassessed and updated Flood Insurance Rate Maps (FIRMs) which allowed the program to more accurately set premiums that aligned with risk based on geological changes, improvements in technology and weather modeling, and various states of public infrastructure (like the levees in New Orleans, for example). It also required FEMA to end subsidies for certain NFIP policies.

Premium increases were met with opposition from those policy holders, but Biggert-Waters offered a compromise by capping rate increases on a percentage basis in an effort to avoid rate shock. It also targeted its subsidy reductions on those policies for second homes, businesses, and properties that were repeat victims of flood damage. Unfortunately, barely two years later, Congress decided to unravel the progress that Biggert-Waters had made.

Homeowner Flood Insurance Affordability Act

Even after a 2013 GAO study showed that only 8 percent of NFIP policyholders would see their premiums increase as a result of Biggert-Waters' reforms, policymakers felt the need to step back in and unwind many of its national safeguards in exchange for lower premiums for policyholders. Before Biggert-Waters had even passed, then Senator Mary Landrieu proclaimed that she would "repeal it, radically amend it, or delay it" because of her perception that it would make flood insurance unaffordable.

Unfortunately, instead of considering options that would balance affordability with national preparedness – such as vouchers for low-income flood-prone homeowners – the Homeowner Flood Insurance Affordability Act (HFIAA) renewed many of the antiquated policies that Biggert-Waters did away with, halted any risk-based premium adjustments until FEMA was able to complete an affordability study, and capped any premium increases at amounts so low it would be nearly impossible for the NFIP to ever get back in the black.

Current State of the NFIP

Fast forward to the NFIP as it stands today, nearly two years after President Obama signed HFIAA into law. It's still in debt, no real improvements have been made since Biggert-Waters in 2012 (and most of those were repealed or significantly delayed), and participation is critically low. Three of the biggest problems are explained below.

Low Compliance

Of the approximately 1.5 million structures in designated Special Flood Hazard Areas (SFHAs) that are required to have flood insurance, only about 783,000 are covered, or about 53 percent. The least compliant state is Minnesota with 9.93 percent of mandatory structures covered and the most compliant state is Louisiana with 80.75 percent mandatory structures covered.

Obviously the fewer policies in place means fewer premiums being paid means less revenue for the NFIP. And for a program that has been in debt to taxpayers for over 10 years, weak compliance with the law might be one concern, but lower revenue as a result of that noncompliance is the bigger issue.

Premiums

Biggert-Waters made some big strides towards normalizing the NFIP's premiums. Unfortunately, most of that was reversed with the NFIAA. As they are now, premiums have four fatal flaws: (1) They don't reflect the risk; (2) There are artificially low caps on premium increases; (3) Even "full risk" premiums are too low; and (4) Premium rates rely on inaccurate data.

Premiums don't reflect the risk

The trick with flood insurance is that, unlike other property or health insurance, claims on flood insurance policies usually happen at the same time. Losses are low in some years but extremely high in others (i.e., 2005 and 2012). Because of this, the NFIP has consistently struggled to find the right premium that would be appropriate for small, "average" flood events, but that would also cover catastrophic events. Further confounding matters is the need to subsidize premiums for low-income areas. NFIP has attempted to account for all of this by establishing Flood Insurance Risk Maps (FIRMs) to account for higher risk, and therefore, higher premium, areas, but many properties were built before the first FIRMs were ever created. Without the ability to charge proper risk-based premiums or generate sufficient loss revenues, NFIP will never be self-sustainable.

Full-risk premiums are too low

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 disaster for the property. For comparison's sake, private flood insurers charge premiums that include a margin to cover both profit and a portion for loss reserves. NFIP, on the other hand, charges "full-risk" premiums which account only for the amount of a loss relative to the historical average loss per year, a number which doesn't take into account the rare, catastrophic flood losses like those of 2005 and 2012 that have driven NFIP so far into debt.

Premium rates rely on inaccurate data

NFIP attempted to account for risk in its premiums when it established FIRMs. Unfortunately, under its current system, FIRMs data is inaccurate. Having to respond to political pressure not to reclassify flood zones in certain areas as "high risk" which would raise premiums on some lower-income groups, NFIP has taken a very lax approach to updating its FIRMs year after year. Not only that, but since property owners are able to be "grandfathered in" to underpriced premium rates even when their properties are reclassified as "high risk," NFIP is gaining nothing by relying on FIRMs when setting premiums. One GAO study found that NFIP's own managerial malpractice has led to the use

of inaccurate data to price payments and a lack of adequate procedures for managing insurance policy and claims data, despite a $40 million investment in a new IT management system.

The caps on premium increases are artificially low

NFIAA set arbitrary caps on NFIP premium increases. The authors' main goal was making flood insurance affordable to even the lowest income homes. While that is a noble goal, in order to sufficiently fund a national program, limits on fees charged to program participants must take into account any fluctuations in program costs and outsets. When NFIAA capped premium increases, it did not take into account all risk factors. And, while premiums shouldn't immediately jump to the higher, more appropriate level, nor should they be increased so slowly that the program continues to dive deeper into the red.

Debt

In order to make flood insurance as affordable as possible for as many people as possible, the NFIP has historically heavily subsidized around one fifth of its policies and cross-subsidized others. Subsidizes combined with various rate setting problems discussed above have ensured that the program is unable to manage its financial obligations in the long run.

From the program's inception in 1968 until Katrina struck in 2005, the NFIP was primarily self-funded. In 2005, after incurring $17 billion in flood claims, the NFIP's losses exceeded premiums by $15.5 billion. Under current program policy, interest is owed on any monies borrowed from Treasury to fund the NFIP which further deepens its financial woes. In January of 2013, Congress increased the program's borrowing authority to $30.4 billion in response to the immediate needs after Superstorm Sandy – this was increase of $9.7 billion or nearly 47 percent.

To make matters worse, prior to Biggert-Waters, the program was statutorily prohibited from establishing loss reserves or purchasing reinsurance. A 2013 GAO report stated that "[t]he potential losses generated by NFIP have created substantial exposure for the federal government and U.S. taxpayers. While Congress and Federal Emergency Management Agency (FEMA) intended that NFIP be funded with premiums collected from policyholders and not with tax dollars, the program was, by design, not actuarially sound. As of November 2012, FEMA owes the Treasury approximately $20 billion – up from $17.8 billion pre-Sandy – and had not repaid any principal on the loan since 2010."

What Should Be Done?

There are a number of options for legislators to consider when reforming and renewing the

program this year.

Increase the number of policies through enforcement 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. To do so, FEMA should increase its oversight of the insurance purchase requirements for individuals with federally insured mortgages located in designated flood zones per Biggert-Waters. Driving growth in sectors like the mortgage lending industry that fall short of compliance requirements will not only help to spread out risk among more stakeholders but will increase program income from premiums which will ultimately help to reduce the NFIP's debt.

Charge premiums that reflect risk

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 at some point in the future. 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 grandfathered premium rates that resulted solely from the previous, politically-charged flood risk zone reclassifications. Risk of a catastrophic flood event is dependent on a number of impacts including weather patterns, infrastructure development, and erosion, and it is not the federal government's (nor the taxpayers') duty to assume the risk for every coastal property.

Opponents of an immediate increase in required NFIP compliance and/or an immediate increase in premium rates for existing policyholders argue that doing either would cause rate shock throughout the program. This can be avoided simply by grandfathering existing policies. For new buyers of existing properties and new construction, the reformed risk-based rate would be applicable. When buyers realize the higher flood insurance premiums, fewer potential buyers will be bidding on the risky properties. This both helps to ease the net financial burden on the buyer and sends the market a signal that less value should be so exposed to the risk of flooding.

On the other hand, existing policyholders could still be subject to premium increases, but these would be capped at a reasonable increase – 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 to reverse the programs chronic underfunding and bring the program into operational solvency.

Share risk with the private insurance market

Another option to help return the NFIP to self-sufficiency is to share the risk with the private flood insurance market. Not unlike proposals that have been floated to share the risk of subprime mortgages with the private market for mortgage insurance, the federal government could reduce its exposure to flood risk through increased participation of private insurers. Not only would this reduce the NFIP's risk, but it would allow the federal government to focus on flood risk mitigation and let the market focus on underwriting flood insurance policies.

The correlated nature of flood risk makes the possibility of a totally private flood insurance market highly unlikely. However, there are options that would allow for efficient sharing of risk across the board. For example, some combination of scenarios in which private insurers either provide primary coverage to a majority of policy holders or they acquire the transferred risk from the NFIP by way of reinsurance or they jointly underwrite primary flood risk and pool any reinsurance. In any of those cases the NFIP could act as a reinsurer of last resort or could provide primary insurance that is focused solely on residual market risks left over from what the private insurers could not underwrite.

Update program technology

An easy way to improve the NFIP is simply to update the program's technology. The NFIP currently is using technologies and processes dating back to the 1960s. For example, homebuyers in SFHAs are required to purchase (for several hundred dollars) 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 available to the public. By just creating a central repository of this data or allowing homebuyers to use GPS data instead of requiring a physical surveyor would cut down on a substantial portion of costs that are dissuading consumers from buying into the NFIP. Additionally, the NFIP should implement a secure platform for processing claims, business analytics, and customer care. Private insurers already have such real-time systems that are faster and more accurate than those used by the NFIP which often provide data and reports that are as much as three months old.

A little bit of improvement could go a long way in a program that is vital to the stability of so many homeowners. But without some major policy changes, the NFIP will continue to be in debt, resting that stability on the backs of taxpayers. Before Congress renews the NFIP in 2017, it should seriously consider updating many of the program's dated policies.