Insight

The Pathway to Solvency For Flood Insurance Gets Murky

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Major policy reforms don't come around very often. Bipartisan reforms even less so. Which is why the Biggert-Waters Flood Insurance Reform Act was a welcome respite from the usual partisan cold-shouldering of recent years. The legislation, passed in 2012, was a fairly remarkable bit of theriac conjuring for a majorly ill National Flood Insurance Program (NFIP).

As it would happen, the bill passed just ahead of a once-in-a-generation flooding event in the form of Superstorm Sandy. What Sandy hath wrought, beyond massive damage to Northeastern coastal areas, is a major political pushback on the 2012 reform law, and possibly the end of the flood insurance program's path to solvency.

It's important to note the peculiarity of many disaster insurance schemes, in particular flood insurance. Unlike health insurance, flood insurance claims are correlated, meaning losses tend to occur at the same time. As one expert put it, this means losses "are low or nonexistent in some years and then sky-high in other years." Because of this, a purely private market in this type of insurance can be difficult to establish. As such, since 1968 we've had the NFIP, which followed previous lackluster attempts at facilitating a private flood insurance market.

Since its inception, the program has grown in both number of policies and total coverage. Unfortunately, since the beginning "the program was, by design, not actuarially sound" according to a 2013 GAO report. Net premiums (premiums minus losses paid) generally hovered around zero for decades until the major hurricane events of 2005. Because the NFIP did not maintain reserves (let alone reserves adequate to cover such an event), the program immediately went deep into the red. Cut to present day, the program is over $20 billion in the hole – a number that would be even worse if NFIP wasn't given favorable lending terms from the U.S. Treasury (read: taxpayers).

Biggert-Waters took on the unenviable task of realigning the program's long-term trajectory in two major ways. First, by undertaking a major updating and reassessing of Flood Insurance Rate Maps (FIRMs), the program can attempt to more accurately align rates with expected risk based on geological changes, improvements in technology and weather modeling, and various states of public infrastructure (like levees). Second, the law wrestles with the roughly one in five policies which benefit from subsidized rates by bringing those rates into line with expected cost.

Some, though not all, subsidized rates would see increases over time through either annual changes or via new rate impositions upon sale. Of course any increase in rates was bound to meet with disfavor by the affected – especially in acutely affected states like Florida, Louisiana, and New Jersey. The bill attempted to mollify opposition by capping rate increases on a percentage basis to avoid rate shock, as well as focusing realignment on second homes, commercial properties, and severe repeat loss cases. In a recent testimony, Douglas Holtz-Eakin offered other mechanisms to ease the transition such as means-testing rate changes and offering individual mitigation credits.

Nonetheless, Congress is offering a full-throated rebuke of the 2012 reform before it ever really got off the ground. FEMA (who operates the NFIP) was only in the process of determining new rates and flood maps, with changes scheduled to be implemented in late 2015 (at the earliest). Now, a new bill which would substantially delay or dismantle many of the prior reforms seems poised to pass the House.

The pathway to a fiscally sustainable flood insurance program was always going to be paved with higher costs for some – such is the nature of undoing subsidies. But should the country be unfortunate enough to experience another year of weather like 2005 or 2012, the National Flood Insurance Program will likely be washed away altogether, and policyholders will be left wanting for coverage at any price.