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Federal Flood Insurance: Inundated with Unresolved Issues

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The National Flood Insurance Act of 1968 created the National Flood Insurance Program (the "NFIP"), and the program celebrated its 50th anniversary on August 1, 2018. The general purposes of the NFIP are two-fold: (1) to offer flood insurance to properties in areas prone to flooding, thus transferring financial risks from property owners to the federal government; and (2) to reduce the risk of flooding through the development of floodplain management standards, thereby reducing federal expenditures on disaster assistance.

No law or regulation requires participation in the NFIP, and therefore communities may choose whether to participate. However, only communities that adopt and enforce floodplain management standards have access to federal flood insurance. The NFIP requires the Federal Emergency Management Agency ("FEMA") to identify and map flood hazard areas, and any federal entity that makes, guarantees, or purchases mortgages in a community that participates in the NFIP must require property owners to purchase flood insurance if the property is in a Special Flood Hazard Area ("SFHA"). An SFHA is an area with a chance of flooding during a 1-in-100 year flood or with greater frequency. The federal government issues over five million flood insurance policies per year, providing approximately $1.28 trillion in coverage.

Problems with the NFIP: Inadequate Premiums and Perverse Incentives

The NFIP is actuarially unsound, collecting less money in premiums than it pays in claims. In a September 2017 report, the Congressional Budget Office concluded that, after taking into account all expenditures and premium income, the NFIP had an expected one-year shortfall of $1.4 billion. The program receives premiums, annual appropriations, and may borrow from the U.S. Treasury when the balance of the National Flood Insurance Fund is insufficient to pay the NFIP's obligations. FEMA may borrow no more than $30.425 billion to operate the NFIP, and the program collects approximately $3.6 billion in premium revenue annually. By law, premium rates in the NFIP are to be based on consideration of risk and accepted actuarial principles. FEMA considers the specific risk zone on a Flood Insurance Rate Maps (a "FIRM"), the elevation of a structure relative to the base flood elevation, occupancy types, the cost of servicing policies, and other risk factors. So why is the NFIP actuarially unsound?

One problem is that Congress has directed FEMA to subsidize the insurance policies on properties built or substantially improved before the first FIRM. As of September 2016, approximately 16.1 % of all NFIP policies received a pre-FIRM subsidy. Similarly, FEMA enables property owners to pay their existing premiums even when a new FIRM reclassifies the property as one with a higher risk of flooding, i.e., "grandfathering." Approximately 10-20% of properties are grandfathered, and the figures may increase over time, as new FIRMs are issued, and as discussed below, as global sea levels rise.

But flooding caused by coastal hurricanes is the most significant factor. Perhaps not unsurprisingly, coastal counties account for three quarters of all NFIP policies nationwide. Prior to Hurricane Katrina in 2005, the NFIP took in more in premiums than it paid out in claims. But the NFIP paid out more claims after Hurricane Katrina than the program had previously paid out in its entire history. In 2017, Hurricane Harvey flooded Houston with 40 inches of rain in 48 hours, flooding 800 wastewater treatment facilities, 13 Superfund sites, and damaging 300,000 structures, resulting in $125 billion in damages. Following Hurricanes Harvey, Irma, and Maria, which collectively inflicted $265 billion in damage, FEMA borrowed $5.825 billion from the U.S. treasury, reaching its $30.425 billion borrowing limit. On October 26, 2017, Congress forgave $16 billion of the NFIP's debt, to allow the program to pay claims for Harvey, Irma, and Maria. FEMA borrowed another $6.1 billion on November 9, 2017, to fund estimated 2017 losses, bringing the NFIP's debt to $20.525 billion, leaving $9.9 billion in borrowing authority.

Hurricane Katrina, Superstorm Sandy, the 2017 flood season, and currently Hurricane Florence are not anomalies. Floods are the most common and most destructive natural disaster in the United States. Every state has experienced flooding in the last ten years. Compounding the problem, global sea levels are rising according to the National Oceanic and Atmospheric Administration, which means storm surges push further inland, which in turn means more frequent and destructive flooding. But the NFIP relies on historical data when determining flood risks and premium rates. After recent flooding in Missouri, for example, 26% of insurance claims came from areas that were considered at low risk of flooding. FEMA is required by law to assess the need to revise and update flood risk zones every five years, but FEMA is not required to update flood maps, and some FIRMs were last updated in the 1980s. Under current law, the only ways the NFIP can pay off its debt are from the accrual of premium revenues greater than claim payments, and from payments made from the Reserve Fund. FEMA estimates, under the most optimistic scenario for future flooding, it will take 13 years to repay its debt and 20 years under more realistic flood projections. As a result, the actuarial problem is likely to worsen.

The NFIP also allows homeowners to recover over and over again. Repetitive-loss properties are those that have four or more separate claim payments for more than $5,000 each, or at least two claims with a cumulative total in excess of the value of the property. FEMA has identified almost 12,000 NFIP-insured properties that qualify as repetitive-loss properties, although some estimate the number to be significantly higher. And although such properties represent 1% of the country's covered properties, they are responsible for 30% of flood insurance claims. Seven of the nation's ten most frequently damaged properties are in Houston. Those seven properties had 107 damage claims totaling $9 million; the combined total value of those properties is $426,000. But rather than encouraging homeowners to relocate, the NFIP incentivizes homeowners to accept hurricane damage as normal and rebuild in areas prone to flooding.

Enforcement of the NFIP is also subject to manipulation. Under the "substantial improvement rule," if a structure is substantially damaged, i.e., the cost of restoring the structure to its pre-damaged condition would equal or exceed 50% of the structure's market value prior to the damage, the structure must be destroyed or elevated to above the base flood elevation. Under FEMA regulations, an acceptable estimate of market value can be obtained from "qualified estimates based on sound professional judgment made by the staff of the local building department." Following catastrophic flood events, local officials may overestimate property values and underestimate flood damages rather than force flood victims to destroy their homes or undertake expensive elevation projects.

The Houston Chronicle examined claims records of severe repetitive-loss properties and found 16% had evidence of damage beyond the 50% substantial damage threshold *before* flooding again. After Hurricane Ike, among more than 5,000 damage assessments in Galveston, most were declared below the 50% threshold, including several homes that took on eight to fifteen feet of storm surge. In other words, damage assessments bore little correlation with water depth inside homes, which is usually an indicator of the severity of damages. As a result, many property owners may rebuild at ground levels.

In short, the NFIP has become a coastal hurricane insurance program. The program subsidizes coastal development by allowing homeowners to pay premiums incommensurate with flood risks and paying claims for properties that suffer repetitive losses. Not surprisingly, the NFIP will go bankrupt, absent congressional debt forgiveness.

Another problem is property owners choosing to forego flood insurance. An AP analysis found the number of flood insurance policies peaked in 2009, at 5.7 million, and has been steadily falling. The total amount of flood insurance coverage peaked in 2013, and has dropped every year since. Following a disaster, property owners buy policies. After Hurricane Harvey, for example, there was an 18% increase in flood insurance policies in Texas, as Houston surpassed Miami as the city with the most flood insurance policies in the country. But as memories of floods fade and premium prices rise, the willingness of homeowners to purchase flood insurance policies wanes. After Superstorm Sandy in 2012, flood insurance policies increased by 12.5% in New York, but since 2013, policies have decreased in New York by 8%.

Recent Congressional Action

In 2012, Congress enacted the Biggert-Waters Flood Insurance Reform Act (“Biggert Waters”). The goal was to make the NFIP actuarially sound by increasing flood insurance rates to reflect the true cost of owning coastal property. Biggert Waters attempted to accomplish this in several ways, including: (1) eliminating subsidized flood insurance for certain properties, including repetitive-loss properties; (2) increasing the rate at which premiums could be increased from 10% to 20%; (3) requiring premiums for new flood insurance policies to be based on true flood risks; and (4) phasing out grandfathering.

Biggert Waters predictably increased flood premiums, and prices in many areas rose rapidly, becoming less affordable for homeowners. Anecdotally, some premiums went from $600 a year to $6,000 a year. So Congress passed the Homeowner Flood Insurance Affordability Act of 2014 (the “Affordability Act”), which repealed much of Biggert Waters, and reinstated price-protected flood insurance policies. The Affordability Act, for example, slowed the phase-out of the pre-FIRM subsidy for most primary residences, and limited the maximum annual increase in premium rates to 18%. Whereas Biggert Waters eliminated the practice of grandfathering rates to policyholders after the issuance of new FIRMs, the Affordability Act reinstated the practice. Biggert Waters and the Affordability Act illustrate the fundamental tension between improving the solvency of the NFIP by better aligning premiums with risks while keeping costs low for homeowners. The Congressional Budget Office issued a report on the NFIP in September 2017, identifying four main policy reforms for congressional legislation on flood insurance:

(1) increase receipts; (2) reduce subsidies; (3) shift costs away from the NFIP; and (4) better align rates with risks.

Flood Insurance Reauthorization

Congress last fully reauthorized the NFIP in Biggert Waters, and the program was set to expire on September 30, 2017. Congress has now passed seven short-term extensions, and the NFIP is now set to expire on November 30, 2018. If the NFIP lapses, FEMA would no longer have the authority to sell new flood insurance policies or renew existing policies, and the authority for the NFIP to borrow funds from the U.S. treasury would decline from $30.425 billion to $1 billion. Because homeowners in high-risk flood areas with mortgages from federally regulated or insured lenders are required to purchase flood insurance, a prolonged lapse would affect approximately 40,000 home closings per month. A lapse is not unprecedented, as the NFIP went without authorization for a month in the summer of 2010, which canceled or delayed approximately 1,400 home closings per day. Accordingly, Congress needs to fully reauthorize the NFIP soon, and the program requires fundamental reform, primarily to better align premiums and risk.

Congressional Initiatives

The House of Representatives passed H.R. 2874, The 21st Century Flood Insurance Reform Act (the "Reform Act"), on November 14, 2017. The Reform Act would reauthorize the NFIP through fiscal year 2022; increase the annual minimums of premiums and decrease the annual limit on premium increases; require FEMA to incorporate into premium rates the differences between inland and coastal properties; allow flood premiums to be based on risk assessment models, data, and tools other than flood maps, for example, sea-level rise projections; require participating communities to develop and implement a publicly available community specific plan to mitigate flood risks to areas repeatedly damaged by floods; eliminate subsidies for multiple loss properties; and deny coverage to a property owner who does not implement flood mitigation measures if the property is an extreme repetitive loss property (cumulative claims in excess of 150% of the maximum coverage amount).

The Reform Act also aims to increase transparency by requiring FEMA to disclose its methodology for calculating premiums. FEMA must also communicate to policyholders a property's flood risk, the history of flood claims on a property, and the effect of filing further claims. Importantly, the Reform Act also requires state and local governments to impose a duty on any seller or lessor of improved real estate to disclose to a purchaser or lessee any previous flood damage, flood insurance claims, and any obligation to purchase flood insurance. Communities must adopt this requirement, by statute or regulation, in order to participate in the NFIP.

The Reform Act also aims to develop the market for private flood insurance. Private flood insurance must provide coverage at least as broad as the NFIP. Mutual aid societies—organizations of members who share common ethical or religious beliefs—may sell private flood insurance, in accordance with state law. The required purchase of flood insurance would be limited to residential properties (the requirement currently applies to all types of properties). And the Government Accountability Office must report on the feasibility of reducing premiums and eliminating the need for coverage by authorizing flood damage savings accounts. The Reform Act is pending in the Senate.

Conclusion

With the National Flood Insurance Program celebrating its 50th anniversary and the debut of the 2018 Atlantic hurricane season with Florence, a discussion of federal flood insurance could not be timelier. Unfortunately, the program is inundated with unresolved issues. Fundamentally, the NFIP is actuarially unsound because premium rates are misaligned with flood risks. Most problematic, the program has become a coastal hurricane insurance program, subsidizing (and thus encouraging) property owners to build and rebuild structures in areas prone to flooding, a problem that will become worse as sea levels rise and floods become more frequent and severe.

The pendulum swung toward fiscal solvency with Biggert Waters in 2012, and then swung back toward affordability, as Congress eliminated much of Biggert Waters with the Affordability Act of 2014. Now, after several short-term extensions, Congress needs to reauthorize the NFIP and fundamentally reform the program. The House passed the Reform Act in 2017, which has now moved to the Senate, where the Reform Act awaits further action. Regardless of its passage, some of its proposals are welcome, such as better aligning premiums with risks, increasing the transparency of the NFIP, and allowing for private alternatives.

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