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Fixing Flood Insurance Before the Next Disaster: House Bill Takes Several Steps in the Wrong Direction

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The worst thing that Congress can do to the broken federal insurance program is to expand it. The House of Representatives is about to consider a bill, the Flood Insurance Reform and Modernization Act (H.R. 3121), that combines higher flood insurance coverage with an expensive and ill-conceived new program covering wind insurance that would launch on June 30, 2008. Provisions to make the existing program more financially sound by increasing premiums on some older structures, however, would be delayed until 2011. This approach is both irresponsible and bad policy. Congress should not add an expensive new program that directly competes with private insurance to this already bankrupt program.

The 2005 hurricane season proved just how precarious the financial health of the National Flood Insurance Program (NFIP) is. In average years, NFIP premiums have been enough to pay for losses and the program's operating expenses, but losses in 2005 required NFIP to borrow almost $25 billion from the federal government. Losses in 2005 are expected to be one-and-a-half times larger than the total claims paid by NFIP during its entire history. Weather experts warn that the U.S. is entering a cyclical period that may see more hurricanes and much more destructive ones. Clearly, the current financial structure of NFIP will be insufficient to pay claims that result from severely destructive storms. The program must be thoroughly reformed if it is to survive without regular federal bailouts.

Unfortunately, H.R. 3121 does very little to improve this situation, while increasing coverage in a way that will make losses caused by the next major disaster even higher.

Policy Mistakes in H.R. 3121. NFIP faces massive debts to the federal treasury that its leadership doubts the program will ever be able to repay, and the House bill is almost certain to make things even worse. Among the policy mistakes contained in the bill are that it:

- *Adds expensive new wind damage coverage:* Starting on June 30, 2008, NFIP will be required to offer a new combination of wind and flood insurance. Coverage would be provided at unsubsidized rates that would supposedly cover the real cost of providing that insurance, but a study by Towers Perrin suggests that even under favorable assumptions, the new program is expected to run operational deficits. The new combined coverage would be available at much higher limits than existing flood insurance coverage. Homes could be covered up to $500,000, with an additional $150,000 for contents and loss of use, while business structures could be covered up to $1,000,000, with up to $750,000 for contents and business interruption. These higher limits would vastly increase NFIP's exposure to potential losses. In addition, with little

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evidence that NFIP is able to effectively manage its existing programs, the combination of flood and wind insurance is likely to be well beyond the agency's competence. This coverage should be left to private companies that have the ability and expertise to administer wind loss coverage.

- *Increases flood insurance coverage:* H.R. 3121 also increases the maximum amount of traditional flood insurance available, from $250,000 to $335,000 for homes and from $500,000 to $670,000 for businesses. This higher exposure will lead to higher losses after the next major storm hits. NFIP already provides subsidized flood insurance coverage to thousands of beachfront vacation homes, and higher coverage levels will ensure that even more taxpayer dollars are used to rebuild them.
- *Covers basements and crawl spaces:* Currently, flood insurance excludes damage to enclosed areas below the living levels of the house. H.R. 3121 allows owners to purchase risk-based coverage for areas that are most likely to be damaged. This would also increase NFIP's losses in any storm or flood.
- *Delays introducing risk-based premiums until 2011:* Currently, NFIP offers subsidized premiums to structures built before the later of the start of NFIP in 1974 or the date that the local community joined the program. The House bill would phase in actuarially based premiums for nonresidential structures or second homes that currently receive subsidized flood insurance rates, but not until 2011. There is no reason for such a delay. Furthermore, the bill merely requests a Government Accountability Office study of ending subsidized rates for all structures, rather than phasing out subsidies.

How Today's NFIP Works. Congress created NFIP to reduce federal disaster aid. It requires homeowners in a floodplain (defined as an area with a 1 percent chance of flooding each year) to buy insurance that replaces government grants and loans. FEMA estimates that for every $300 in flood insurance claims that is paid, federal disaster aid is reduced by $100.

Currently, NFIP insures approximately $800 billion in structures and contents. It is self-supporting in average years, meaning that its income from premiums usually equals the amount paid in claims and spent on operating expenses. The program takes in about $2 billion in premiums and fees per year and, between 1994 and 2004, paid about $867 million in claims annually. If claims do exceed the income from premiums, NFIP can borrow up to $3.5 billion from the Treasury Department. This line of credit was temporarily increased from $1.5 billion in September 2005 to give the program the ability to handle claims resulting from Katrina and Rita. Further increases are expected so that NFIP can cover all storm-related claims.

Property owners can purchase federal flood insurance policies through most property insurance brokerages. NFIP insures 4.7 million properties located in the 20,000 or so communities that participate in the program. These communities contain about 95 percent of properties in high-risk flood areas. In order to receive a mortgage from a federally insured financial institution, homeowners must buy flood insurance if their property is located in a floodplain. If flood insurance is required and the mortgage lender offers escrow accounts for items such as homeowners insurance or local taxes, then flood insurance must be paid through the escrow account also.

About 40 percent of mortgages, however, are made by unregulated lenders, which do not have to comply with these requirements. This includes a high proportion of mortgages for manufactured housing, which is usually financed by the dealer. Additional millions of structures in flood-prone areas are not covered by flood insurance because the homeowner failed to buy or renew a policy. In addition, the law requires flood insurance only where there is a 1 percent chance of a flood and assumes that flood control measures such as levies and dykes will protect the properties near them. It also does not require NFIP coverage in low-lying areas where surges are likely following major storms but not otherwise. Significantly, many NFIP policies only cover the remaining balance on a structure's mortgages, not the cost of actually replacing it.

The average homeowner pays $300 a year for about $130,000 of coverage. Homes can be covered for up to $250,000 for the structure and up to

$100,000 for contents. Businesses can purchase up to $500,000 in coverage for both the building and its contents. Premiums are based on a number of factors, from the risk of flood in the area to the presence of a basement, the height of the property above expected flood levels, and the community's efforts to control flood damages. Maximum residential coverage costs as little as $320 and as much as $1800 annually, depending on these factors.

About 76 percent of policyholders pay risk-based premiums that include the possibility of a catastrophic loss. However, structures that existed before the community joined NFIP—24 percent of the total—receive flood insurance at subsidized rates that imply a substantially lower risk of flooding than actually exists. GAO estimates that some premiums are only 35 to 40 percent of what they would be without the subsidy. The total value of this subsidy is an estimated $1.3 billion annually.

If a property has two or more claims of over $1,000 each in 10 years, NFIP can offer to move, raise, flood-proof, or even buy the property to reduce the overall cost to the program. At one point, according to NFIP estimates, just 1 percent of insured properties were responsible for about 25 percent of claims, mainly due to repeated flooding and rebuilding in the same location. According to GAO, structures with repeat losses represented almost a third of all claims paid between 1978 and March 2004. The areas in Alabama and Mississippi affected by Hurricane Katrina include roughly 2,400 structures with repeat losses, while the areas of Louisiana damaged by the storm include roughly 20,000 structures that have had repeat claims.

As a result of Hurricanes Rita and Katrina, NFIP sustained huge losses that required Congress to raise the program's borrowing authority from Treasury to $20.8 billion from the previous $1.5 billion authority. Currently, NFIP owes the Treasury about $17.5 billion, and the deficit is expected to grow by about $900 million annually.

Conclusion. It is hard to conceive of a more irresponsible approach to NFIP reform than to saddle the program with expensive expansions in its current coverage areas and a huge new program while delaying most ways to reduce its current deficits and debts until 2011. Though the House bill does include some responsible improvements to NFIP's repeat-claim mitigation program, there is also little evidence that NFIP has been able to effectively administer this program, so the impact of any improvements is likely to be very limited.

Congress should fix NFIP's current deficiencies before it evens thinks about expanding the coverage it offers. In addition, Congress should completely drop the idea of providing wind damage insurance, which private companies already offer at competitive rates without any of the shortcomings of NFIP.

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