

ISSUE BRIEF

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Reauthorize and Reform the Flood Insurance Program

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Congress should reauthorize and reform the National Flood Insurance Program (NFIP). The failure of Congress to pass a longer term reauthorization since the last one expired in September 2008 has delayed necessary reforms. In addition, since there are no private providers of general flood insurance coverage in the United States, all such policies come through the NFIP. The lack of reauthorization is increasing risk to both flood-prone properties and the NFIP itself.

One of the goals of the pending reauthorization is to ensure that all owners pay the appropriate actuarial premium rather than subsidized rates. This would be a first step toward encouraging private insurance companies to enter the market and would set the stage for an eventual move of the entire program to the private sector.

Where It Stands Now. The House passed the Flood Insurance Reform Act (H.R. 1309) in July 2011, but so far the Senate has failed to act. Their similar bill, the Commission on Natural Catastrophe Risk Management and Insurance Act of 2011 (S. 1940), is pending. An amendment by Senator Tom Coburn (R-OK) to the 60-day extension Congress passed in May starts the process of eliminating subsidies on vacation and second homes.

This is an important first step, but it is no substitute for a more comprehensive series of reforms. Additionally, the House Financial Services Committee included NFIP reauthorization in its budget reconciliation bill. However, its attempt to count the higher premium income against the amount needed to avoid the automatic budget cuts on December 31 is really double-counting that income increase.

NFIP's Finances. Congress created the NFIP in 1968 to reduce the cost of federal disaster aid. Property owners with structures located in a floodplain (defined as an area with a 1 percent chance of flooding each year) must buy flood insurance coverage that is designed to replace government disaster grants and loans. FEMA estimates that for every \$300

in flood insurance claims that are paid, federal disaster aid is reduced by \$100.

Currently, the NFIP insures approximately 5.6 million structures and their contents for a total of \$1.25 trillion. While the NFIP is designed to be self-supporting in average years—meaning that its income from premiums is supposed to equal the amount paid in claims and spent on operating expenses—the program has lost money in three of the past eight years.

As a result of Hurricanes Rita and Katrina in 2005, the NFIP sustained huge losses that required Congress to raise the program's borrowing authority from the Treasury to \$20.8 billion from the previous \$1.5 billion authority. Currently, the NFIP owes the Treasury about \$17.5 billion and must pay about \$900 million in annual interest payments on that sum.

As its total premium income is about \$3.1 billion annually, even in good years with low losses, the NFIP will likely be able to pay only the interest on this huge loan. Unless Congress allows major reforms, the loans are unlikely to be repaid.

How the NFIP Works. Property owners can purchase federal flood insurance policies through most

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property insurance brokerages. The NFIP insures properties located in the roughly 20,000 participating communities that contain about 95 percent of properties in high-risk flood areas. In order to receive a mortgage from a federally insured financial institution, a homeowner must buy flood insurance if the property is located in a floodplain. If flood insurance is required and the mortgage lender offers escrow accounts for items such as homeowner's 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.

Moreover, the law assumes that flood-control measures such as levees and dikes 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 cover only the remaining balance on a structure's mortgages, not the cost of actually replacing it.

Needed Reforms to the NFIP. The NFIP's finances suffer from subsidized rates on older structures

and the small percentage of buildings filing repeated claims. The two problems overlap. Structures that existed before a community joined the NFIP—roughly 24 percent of the total—pay subsidized rates that imply a substantially lower risk of flooding than actually exists. The Government Accountability Office estimates that some premiums are only 35 to 40 percent of what they would be without the subsidy.¹ This reduces the NFIP's income by an estimated \$1.3 billion annually.

In addition, approximately 90 percent of repetitive loss structures are among those older buildings receiving subsidized premiums. The 1 percent of NFIP-insured properties with repeated damage comprised about 25 percent of NFIP claims. The House-passed bill and proposed Senate legislation would take steps to correct these problems by phasing-in actuarial premiums for both types of structures. In addition, both would also phase-in full actuarial premiums for buildings that must be newly covered with flood insurance because of mapping changes.

The Senate bill would increase NFIP premium income by about \$4.6 billion over the next 10 years.² While not enough to solve all of the program's financial troubles, it would enable the NFIP to start to repay its taxpayer loans.

The Senate bill also authorizes the start of a small reserve fund paid for by additional premiums that is designed to cover unanticipated losses. This is also a good step, but the

fund is likely to be too small to cover losses from major storms. Congress would be wiser to focus on enabling the NFIP to repay its debts first and then starting a reserve fund.

First Steps to a Private Program. The several private flood insurance providers in existence when the NFIP was created left the market in the face of subsidized premiums. Moving toward requiring building owners to pay the full actuarial cost of their coverage would encourage the private sector to compete with the NFIP.

This is not a guarantee of success, as insurance companies remain in business by selling coverage to a wide array of customers, most of whom do not suffer a loss in any given year. In the case of flood coverage, only homeowners likely to suffer a loss are likely to purchase coverage, creating a pattern like the NFIP's, where losses may equal or exceed premium income far too often for the company to make a profit. Additional steps are likely to be needed.

However, today's NFIP, with subsidized premiums that do not allow for any repayment of its federal loans, will remain a pending disaster as long as Congress fails to reauthorize the program and enable serious reforms. Congress should stop delaying and act.

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1. JayEtta Z. Hecker, "Challenges Facing the National Flood Insurance Program," testimony before the Subcommittee on Housing and Community Opportunity, Committee on Financial Services, U.S. House of Representatives, April 1, 2003, <http://www.gao.gov/new.items/d03606t.pdf> (accessed June 8, 2012).

2. Senate Report 112-098, "Flood Insurance Reform and Modernization Act of 2011," 112th Cong., http://thomas.loc.gov/cgi-bin/cpquery/?&sid=cp112FHq9B&r_n=sr098.112&dbname=cp112&selsel=TOC_32057& (accessed June 8, 2012).