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No Retreat on Flood Insurance Reform

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The House is slated next week to decide whether taxpayers will continue to subsidize flood insurance for private property. The pending legislation would rescind reforms adopted in 2012 to stem the debt incurred by the government's unworkable insurance scheme. But a variety of legislative alternatives exist that would assist flood-prone property owners without foisting the cost on taxpayers.

Well-Intended but Unsustainable. Virtually all flood insurance is issued by the federal government under the National Flood Insurance Act of 1968. Intended to reduce federal disaster payouts, the program has actually promoted development in flood zones and thus worsened the devastation of natural disasters. Like most government giveaways—well-intended though it was—the National Flood Insurance Program (NFIP) is financially unsustainable, with a debt to taxpayers of $24 billion and counting.

Congress took steps in 2012 to reduce the subsidies and require rates to be based on a property's degree of flood risk—an essential element of viable insurance. The Biggert–Waters Flood Insurance Reform Act established a multi-year phase-out of premium subsidies for commercial properties and vacation homes, and for primary residences after ownership changes.

Members of the "flood caucus" and others are now attempting to renege on the reforms at the behest of local politicians and property owners who complain that their premiums are too costly. The $1.1 trillion omnibus spending bill approved in January prohibits the Federal Emergency Management Agency (FEMA) from implementing some rate changes for one year. Meanwhile, the Senate approved legislation this month to delay the subsidy phase-out for four years.

The anti-reform campaign is largely fueled by claims that legions of property owners are suffering calamitous premium shock. In fact, only 8 percent of the 5.5 million policyholders face an imminent increase, which will phase in over several years.

To abandon reforms means saddling taxpayers with the cost of insurance for private development. Maintaining the subsidies would also prevent private insurers from freeing property owners who are currently captive to the government's flood insurance monopoly.

The Single-Payer System. Federal flood insurance is available to property owners in communities that adopt building standards and floodplain management approved by FEMA, which administers the NFIP. Some 22,000 communities currently participate.

Areas where flood risk is worst are designated as Special Flood Hazard Areas. Property owners within them are required to obtain flood insurance to be eligible for disaster relief. Congress in 1973 also required flood insurance for a real estate loan in a flood hazard area made by federally regulated lenders, federal agency lenders, and government-sponsored enterprises such as Fannie Mae and Freddie Mac.[1]

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Private insurers sell and service the policies on behalf of the government and receive generous fees for doing so—fees that consume more than a third of all premiums.[2]

The original Flood Insurance Act authorized subsidies to encourage enrollment in the program.[3] In general, owners of properties built before FEMA issued a community's flood risk map, or before January 1, 1974, pay subsidized rates. Properties constructed after 1974, or after the date a community's initial flood risk map was issued, are supposed to pay rates that reflect the actual risk of flooding.[4]

A Dose of Sanity. A series of disasters, including Hurricane Katrina, forced the NFIP to borrow from the U.S. Treasury to settle claims. The Biggert–Waters Act was intended to restore a semblance of solvency to the program by basing rates on flood risk.

The law set a schedule of rate changes by property type. Rates for the following will increase by 25 percent annually, until the actuarial rate is reached: business properties, properties that have experienced severe repetitive losses, properties that have collected benefits equal to or exceeding their fair market value, and properties that have experienced damage exceeding 50 percent of the fair market value or have required improvements costing more than 30 percent of the fair market value.

Subsidies would also be terminated when a property owner allows a policy to lapse or refuses flood prevention assistance following a major disaster. The act likewise eliminates subsidies for any property not insured by NFIP on the date Biggert–Waters took effect and any property purchased after the date of enactment.

Fatal Flaws. Biggert–Waters is an acknowledgment by Congress and the President that the NFIP is financially unsustainable. Other structural elements render the program fatally flawed, including:

- **Wealth redistribution.** The use of taxpayer funds to subsidize the lifestyle preferences of a select few is inherently unjust.
- **Dysfunctional pricing.** Even under Biggert–Waters, subsidies will persist for an estimated 715,000 policies. Also, a large proportion of the FEMA risk maps are obsolete.[5]
- **Moral hazard.** Property owners expect the government to provide disaster assistance regardless of their insurance status. Consequently, NFIP enrollment is skewed to the most flood-prone properties.
- **Uncontrolled costs.** More than one-third of the premiums are paid to private insurers who sell and service the policies but hold no risk liability. With direct access to Treasury, FEMA has little budgetary discipline.
- **Unintended negative consequences.** Because property owners do not bear the full cost of flood risk, they are less likely to be dissuaded from locating in flood-prone areas and less likely to undertake preventive measures.

Going Forward. The anti-reform campaign is propelled by exaggeration and political self-interest. Property owners who have long relied on taxpayers for their insurance premiums are reluctant to relinquish their subsidies. Although claims of widespread massive rate hikes are erroneous, some politicians are catering to a small group of angry constituents rather than holding firm on policies that benefit a quieter majority.

Congress should not reverse Biggert–Waters based on hype. The statute already calls for an "affordability study." Where actuarial rates would be literally

1. This requirement expanded the overall number of insured properties, including those qualified for subsidized premiums.
2. Erwann O. Michel-Kerjan, "Catastrophe Economics: The National Flood Insurance Program," *Journal of Economic Perspectives*, Vol. 24, No. 4 (Fall 2010).
3. Policymakers assumed that disaster payments would decrease as the number of policyholders increased. That has not been the case.
4. The flood risk map is used to determine building standards.
5. According to the Government Accountability Office, 50 percent of the NFIP's 106,000 maps were more than 15 years old in April 2008, and another 8 percent were 10–15 years old. See Government Accountability Office, *Flood Insurance: FEMA's Rate-Setting Process Warrants Attention*, GAO–09–12, October 2008, http://gao.gov/products/GAO-09-12 (accessed February 20, 2014).

unbearable, Congress could consider extending the phase-in period or the annual rate of premium change without abandoning risk-based rates.

The ultimate goal, however, is to minimize reliance on taxpayers. Private insurers are interested in underwriting wide swaths of properties in flood zones that do not face catastrophic risk. But that will not happen until lawmakers eliminate a variety of barriers to entry, including subsidies. The following reforms are also needed to enable a transition to private insurance:

- Validate that private insurance policies will satisfy requirements for mandatory coverage. This could prompt private insurers to market new insurance products.

- Allow state insurance regulators to oversee solvency and capital requirements for insurance companies in their jurisdictions. This would increase accountability and reduce insurer uncertainty related to federal agencies issuing conflicting rules.

- Allow policyholders to submit premium payments in monthly installments, which could make coverage more manageable.

- Require FEMA to share with private insurers its aggregate premium and claims data and supply property-specific data at the request of a property owner.

Reform, Not Retreat. The Biggert–Waters Act brought much-needed reform to the NFIP. It represents a major step toward minimizing government's role in flood insurance. To retreat now would be irresponsible to both taxpayers burdened by subsidies and property owners who are restricted to the government's irrational rates.

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