Testimony on:

Implementation of the Biggert-Waters Flood Insurance Act of 2012: Protecting Taxpayers and Homeowners

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Committee on Financial Services
Subcommittee on Housing and Insurance
U.S. House of Representatives
November 19, 2013

*The views expressed here are my own and not those of the American Action Forum. I thank Satya Thallam for his assistance in preparing this testimony.

Chairman Neugebauer, Ranking Member Capuano and members of the Subcommittee thank you for the privilege of appearing before you. In this testimony, I hope to make three main points:

- The National Flood Insurance Program (NFIP) has a history of underpricing that has produced chronic program financial deficits and poor economic incentives;

- The Bigger-Waters Insurance Reform Act of 2012 undertook the desirable reforms of updating and making more accurate the flood maps used in assessing risk and adjusting premiums to more accurately reflect risk. The basic character of these reforms should be preserved; and

- There are policy options regarding the transition to accurate insurance rates or complements to improved insurance pricing that Congress may wish to consider.

In what follows, I will elaborate.

Introduction

In an attempt to create a robust national market in flood insurance in 1968 Congress created the National Flood Insurance Program (NFIP). Over time, this program would experience significant growth to the point where it is now "one of the longest standing government-run disaster insurance programs in the world."[1]

The creation of the NFIP followed a previous attempt by Congress – the Federal Flood Insurance Act of 1956 – to facilitate a primarily private flood insurance market. This Act met with little interest owing to the peculiarities of this type of insurance, in particular the fact that policyholders' losses occur at the same time. The result is that losses "are low or nonexistent in some years and then sky-high in other years."[2]

The average amount of coverage per policy, the population in coastal and other high risk areas, and insurance take up rates have all increased over the life of the program, resulting in significant growth overall in the size and scope of the NFIP.

The Nature of Flood Insurance

The cost, or expected payout, for a flood insurance program is driven by two components:

- Flood risk. The likelihood of major weather and geological events that cause flooding is controlled by nature. However, the way these risks are reflected in

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[1] Erwann O. Michel-Kerjan, "Catastrophe Economics: The National Flood Insurance Program," *Journal of Economic Perspectives*, Vol. 24, Iss. 4, pp. 165-86, Fall 2010.
[2] *Ibid*.

insurance pricing is dependent on the accuracy of Flood Insurance Rate Maps (FIRMs), weather modeling, and other predictive measures. Outdated assessments lead to underpricing, program financial shortfalls, and growing long-term program debt.

- Behavioral choices. People ultimately choose where build and how much value to put at risk. The location of new construction, the size and value of buildings constructed, the steps taken to mitigate risk, and so forth are all economic decisions influenced by the risk borne by private sector decision makers. While no one chooses when and where a storm will hit, someone *does* decide if they will build or live in a particular area. This nonrandom portion of risk is affected by public actions (public infrastructure such as levees), private actions (building enhancements mitigate impact), and hybrid actions (local zoning ordinances). The issue is not whether a person ought or ought not live in a particular area, but the cost of doing so. As one economist recently put:

> *Subsidized premiums encourage the over-population of flood-prone regions, as well as discourage residents of those areas from taking appropriate care to protect their properties from flood damage…Allowing these premiums to rise to unsubsidized levels would – by encouraging people to make more prudent decisions regarding where to live and about how to protect their properties – reduce both the property damage and the number of fatalities caused in the future by storms, heavy rains, and swelling rivers.*[3]

Proper pricing of flood insurance risk means that construction decisions are fully informed by the likely costs. If so, the location and scale of construction will put at risk value equal to the cost of insurance. Accordingly, premiums will on average cover the losses due to disaster. A consistent pattern of shortfalls suggests that premiums are too low and excess value is being put at risk.

The Financial Condition of the NFIP

There are essentially three phases to the financial history of the National Flood Insurance Program. From the program's inception to 1986, its operations were supplemented by Congressional appropriation. From 1986 until 2005, the program was self-sustaining through policy premiums and fees. However, "in 2005, the NFIP incurred approximately $17 billion in flood claims caused by Hurricanes Katrina, Rita, and Wilma."[4] In 2005 alone, losses exceeded premiums by $15.5 billion.[5] Under the conditions of the program interest

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[3] Donald Boudreaux, "Premium Politics," Open Letter to Sen. Robert Menendez, *Café Hayek*, blog post, October 31, 2013, http://cafehayek.com/2013/10/premium-politics.html.
[4] Rawle O. King, "National Flood Insurance Program: Background, Challenges, and Financial Status," Report 7-5700, Congressional Research Service, July 1, 2011, http://www.fas.org/sgp/crs/misc/R40650.pdf.
[5] NFIP statistics, calculated by author.

is owed on funds borrowed to cover program deficits, which further deepens the financial hole.

As a recent Government Accountability Office (GAO) report put it:

> *The potential losses generated by NFIP have created substantial exposure for the federal government and U.S. taxpayers. While Congress and Federal Emergency Management Agency (FEMA) intended that NFIP be funded with premiums collected from policyholders and not with tax dollars, the program was, by design, not actuarially sound. As of November 2012, FEMA owes the Treasury approximately $20 billion—up from $17.8 billion pre-Sandy—and had not repaid any principal on the loan since 2010.*[6]

In January of this year, Congress increased the program's borrowing authority to $30.4 billion in order to meet immediate and ongoing needs related to Superstorm Sandy. This represented an increase of $9.7 billion, or nearly 47 percent.[7]

The GAO report goes on to say this underfunding and heavy borrowing need was predictable given "structural weaknesses" in the program.[8] In fact, by at least one measure of the financial health of the program – cumulative "total operating result"[9] – the NFIP has never been in the black. Since the program is not run as a profit-making enterprise, this shouldn't be too much of a surprise. However, this cumulative total operating result has been growing more negative over time.[10] An appropriately operated program should have a total operating condition that hovers around zero. In inflation-adjusted terms, the NFIP "has continuously been running a deficit since its inception in 1968."[11] That cumulative deficit was $1.5 billion in 2004, which may have been manageable, before the major events of 2005 hit.

As the figures in the appendix illustrate, the NFIP has grown inexorably larger on almost all margins over time: total coverage amount, number and total losses paid out, number of policies, losses per policy, and coverage per policy have all increased substantially since 1978, and continued to increase since 2005. Between 1978 and 2012 there was a $1.24 trillion increase in total coverage and $194,791 increase in coverage per policy. More

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[6] U.S. Government Accountability Office, "High Risk Series: An Update," Report to Congressional Committees, GAO-13-283, February 2013, http://www.gao.gov/assets/660/652133.pdf.
[7] *Ibid*.
[8] *Ibid*.
[9] Total operating resultThis is calculated as: (premiums + other earnings) – (claims + operating expenses).
[10] *Supra* note 1, at figure 3.
[11] *Supra* note 1.

recently, from 2006 to 2012 there was a $239 billion increase in total coverage and $38,573 increase in coverage per policy.[12]

It can be tempting to look at 2005 and 2012 as relatively freak events, unlikely to repeat in the near future. Unfortunately, similar events are bound to occur in the future. Another Hurricane Katrina or Superstorm Sandy, whenever it occurs, may take with it any hope that the National Flood Insurance Program can be saved. That is, unless necessary reforms can be implemented without delay.

The Biggert-Waters Insurance Reform Act of 2012

Congress undertook reforms in the Bigger-Waters Insurance Reform Act of 2012. The Act has been interpreted as the source of higher costs – a news story last month highlighted various homeowners facing rising flood insurance premiums.[13] It is typical of many stories that single out the impact of rising premiums, especially for those in high-risk coastal areas. These stories miss the key point: the costs are not new; they are simply beginning to be reflected in the price of insurance. Ultimately, the costs of the NFIP are paid – either by spreading them among policyholders, or by taxpayers who will end up footing a larger and larger bill over time.

The recent reforms simply reduce the cross-subsidization of risk and more closely align risk and price for policyholders. The main thrusts of the recent NFIP reform is primarily two-fold:

- Update and make more accurate the flood maps used in assessing risk; and
- Adjust premiums to more accurately reflect risk

These objectives should be wholeheartedly applauded. By eliminating subsidized rates on new policies and loss repeating properties, reform goes a long way toward a more sustainable flood insurance program. However, as the GAO notes, even if the program's current debt obligations were completely forgiven, rate increases for subsidized policies would necessitate 150 to 325 percent increases to generate sufficient reserves.[14]

Policy Options

From an economic perspective, the preferred policy is a program that accurately assesses risks and aligns program premiums with expected costs. While the recent reform

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[12] NFIP data, calculated by author.

[13] Les Christie, "Flood insurance costs soaring for thousands of homeowners," CNNMoney.com, October 21, 2013, http://money.cnn.com/2013/10/21/real_estate/flood-insurance/.

[14] *Supra* note 6.

legislation moves towards that goal, in recent months there has been significant pushback on implementation of the reform.[15] There are, however, options that may improve the financial condition of the NFIP, move toward the preferred policy, but generate less near-term disruption.

Grandfather existing policies. Although this has the disadvantage of accepting underfunding of existing policies, it avoids rate shock. For new buyers of existing properties and new construction, the reformed actuarial rate would be fully applicable. Notice that because buyers will recognize their higher flood insurance premiums, bids for risky property will be reduced. This eases the net financial burden on the buyer and sends the market signal that less value should be exposed to flood risk.

Existing policyholders could still be subject to rate increases, but these increases could be capped at a maximum, say 10 or 20 percent, per annum. Taken together, the policy of unsubsidized rates for new buyers and builders and a gradual phase-in for existing policies will arrest the growth in underfunding of the overall program, properly align incentives for future development and population location, and gradually bring the program into operational solvency.

Give more discretion to states. Participation in the flood insurance program is subject to community adherence to building standards and certain disaster readiness concerns. As mentioned above, the damage done by flooding is determined by nature, as well as private and public decisions. Portions of the program could be devolved to the states, such as gathering necessary data for updating of the flood maps, verification of coverage, etc.

Additionally, actual flood risk is affected by levees, dams, and other infrastructure that may more appropriately provided by state and local authorities. Under the NFIP, federal taxpayers pick up the bill, leaving states with insufficient incentive to provide this infrastructure.

In order to provide the proper incentives, the state-by-state difference between NFIP premiums actually paid and the appropriate premium amount could be calculated over a fixed, rolling time frame (for example, 10 years). This amount could then be offset (in whole or part) with reduced funding in the FEMA emergency grant formula. This effectively uses reduced subsidies in one kind of insurance – FEMA post-event disaster relief is a *de facto* insurance – to offset subsidies in another.[16]

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[15] For example, the group "Stop FEMA Now" and legislation introduced by Sen. Mary Landrieu (http://www.landrieu.senate.gov/?p=press_release&id=3751).

[16] Robert Litan, Sharing and Reducing the Financial Risks of Future 'Mega-Catastrophes,'" Issues in Economic Policy No. 4, Brookings Institution, March 2006, http://www.brookings.edu/~/media/research/files/papers/2006/3/business%20litan02/200603_iiep_litan.pdf.

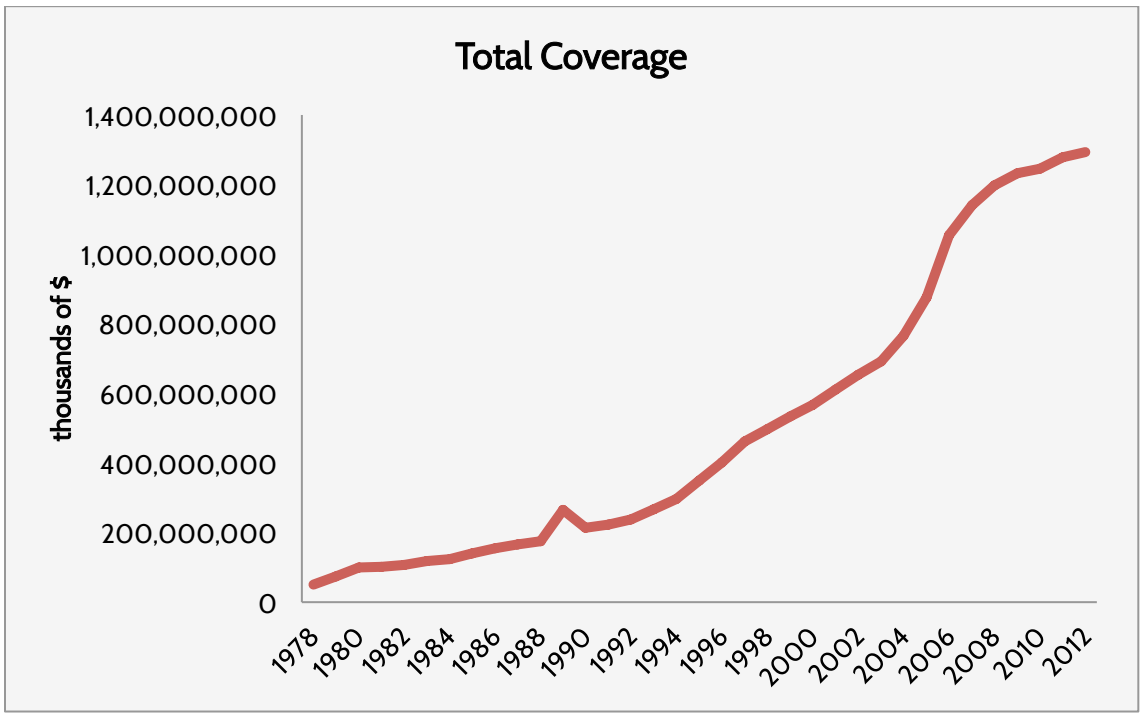
Means-test premium increases. Popular opposition to the reform stems from the saliency of rate increase shock. Although the reform allows for a gradual phase-in, even modest percentage increases in rates may be especially difficult for low-income or liquidity-constrained policyholders to afford. A more income-based phase-in could mollify much of the pushback. If income verification proves impractical, property value (if an owner-occupied first home) could be a useful proxy, with full rate increases for second or vacation homes.

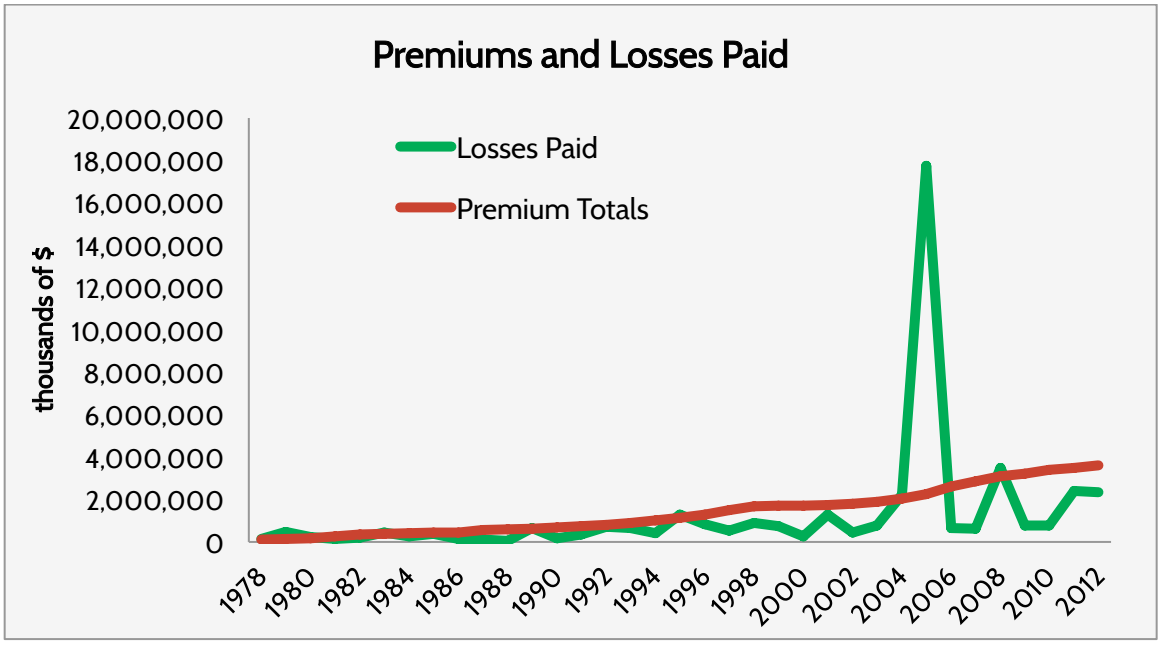
Mitigation credits. Expected program costs are affected when policyholders take steps toward risk mitigation. If premiums do not reflect the lower risks, homeowners may not undertake desired mitigation. NFIP could provide credits on rates or deductibles with proof of having taken some of these steps (the program already provides premium reduction credits for community-based activities).[17] These credits could also be income-scaled.

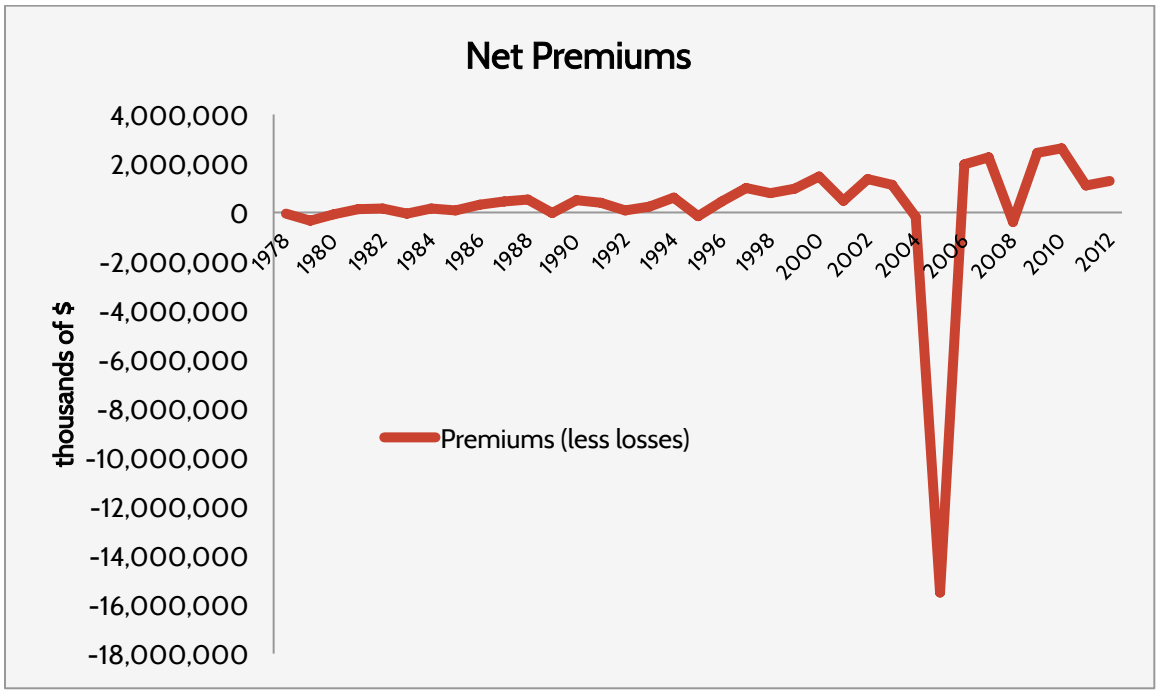
Thank you and I look forward to answering your questions.

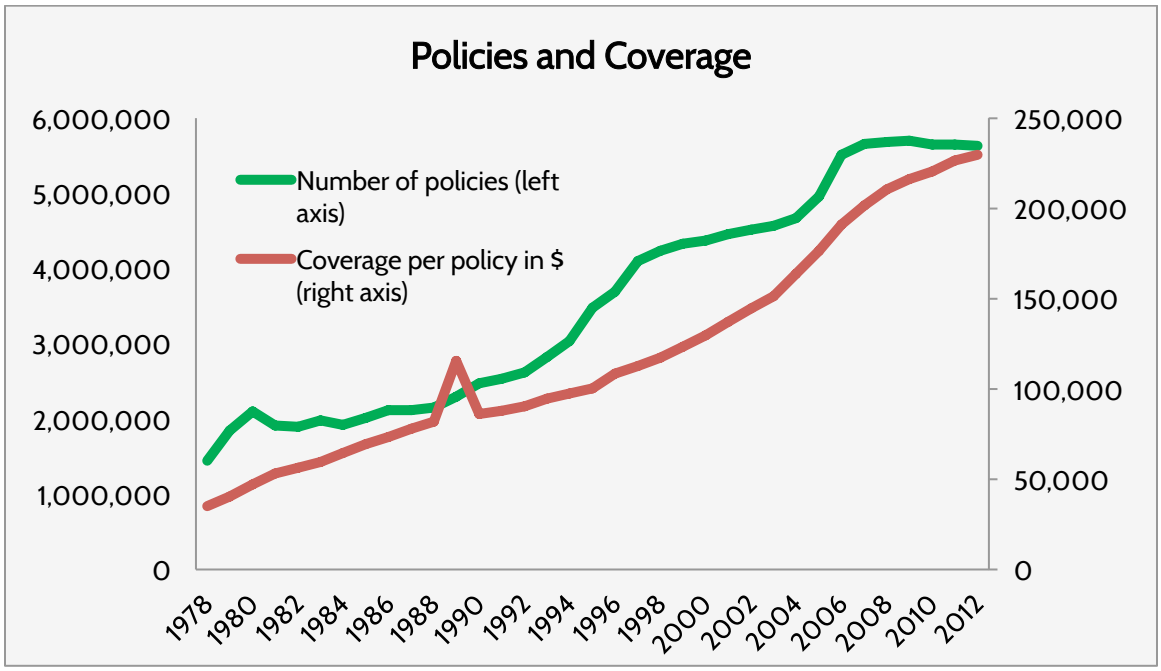
[17] "National Flood Insurance Program Community Rating System," Federal Emergency Management Agency, updated 11/05/2013, http://www.fema.gov/national-flood-insurance-program-community-rating-system.

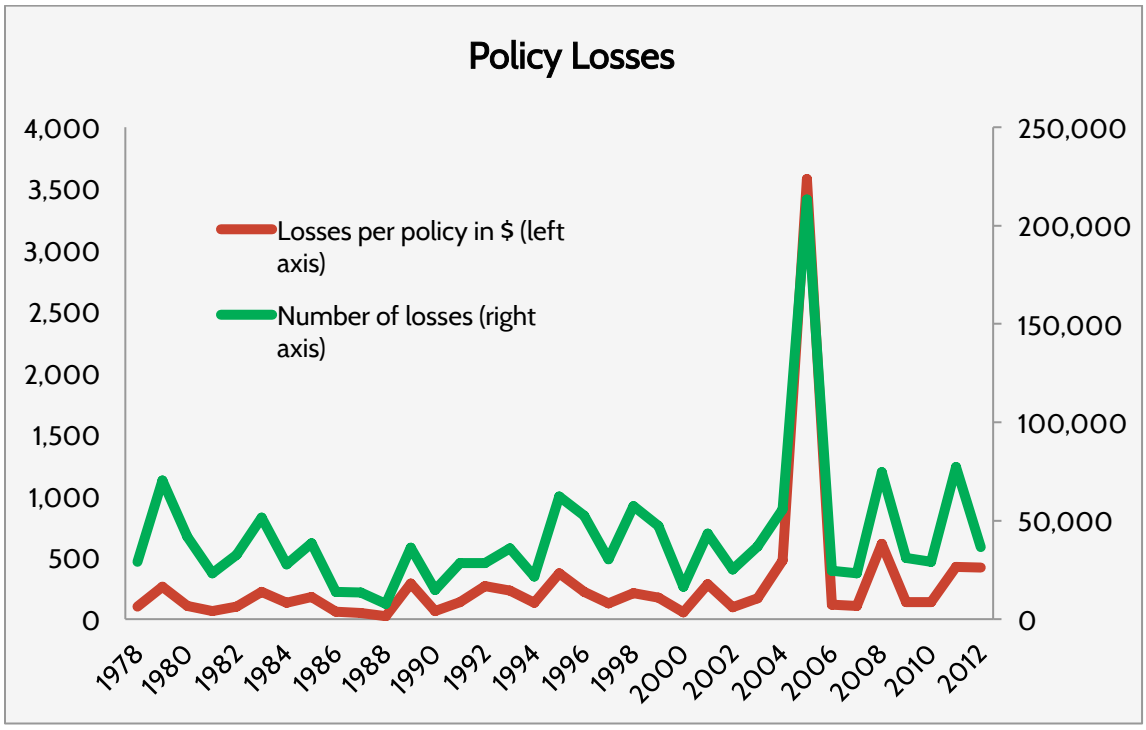
Appendix


Total Coverage
thousands of $
1,400,000,000
1,200,000,000
1,000,000,000
800,000,000
600,000,000
400,000,000
200,000,000
0
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012


Premiums and Losses Paid
thousands of $
20,000,000
18,000,000
16,000,000
14,000,000
12,000,000
10,000,000
8,000,000
6,000,000
4,000,000
2,000,000
0
Losses Paid
Premium Totals
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012


Net Premiums
4,000,000
2,000,000
0
-2,000,000
-4,000,000
-6,000,000
-8,000,000
-10,000,000
-12,000,000
-14,000,000
-16,000,000
-18,000,000
thousands of $
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
Premiums (less losses)


Policies and Coverage
6,000,000
5,000,000
4,000,000
3,000,000
2,000,000
1,000,000
0
250,000
200,000
150,000
100,000
50,000
0
Number of policies (left axis)
Coverage per policy in $ (right axis)
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012


Policy Losses
4,000
3,500
3,000
2,500
2,000
1,500
1,000
500
0
250,000
200,000
150,000
100,000
50,000
0
Losses per policy in $ (left axis)
Number of losses (right axis)
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012