Flood Insurance

THE TOPIC

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Because of frequent flooding of the Mississippi River during the 1960s and the rising cost of taxpayer funded disaster relief for flood victims, in 1968 Congress created the National Flood Insurance Program (NFIP). It has three mandates: to provide residential and commercial insurance coverage for flood damage, to improve floodplain management and to develop maps of flood hazard zones. Flood damage to vehicles is covered under the comprehensive section of an auto insurance policy but there is no coverage for flooding in standard homeowners, renters or in most commercial property insurance policies. Coverage is available in a separate policy from the NFIP and from a few private insurers. Despite efforts to publicize this, many people exposed to the risk of floods still fail to purchase flood insurance.

The widespread flooding associated with Hurricane Katrina in 2005 set in motion a debate about how to improve the federal program. Likewise, the Mississippi floods of 2011 and Hurricane Irene, both of which caused widespread physical and economic damage, much of it uninsured, are prompting a reexamination of how the risk of flooding is handled, from the building of levees and other artificial barriers to the federal flood insurance program, including the possibility of some form of privatization. Meanwhile, the last Congress balked at significant change, choosing instead frequent short-term reauthorizations in lieu of long-term reform. Efforts to revamp the program are continuing.

RECENT DEVELOPMENTS

- **Long Term Reform:** On June 29, 2012, a month before the latest short-term extension was due to expire, Congress passed legislation reauthorizing the NFIP until September 30, 2017. The measure was folded into HR 4348, the Surface Transportation Extension Act of 2012, which extends the highway program for two years and also retains the current interest rate on student loans for one year.

- The legislation was a compromise between a bill approved by the full House and a somewhat different proposal passed by the Senate Banking Committee in 2011. Among other things, it allows the Federal Emergency Management Agency (FEMA) to raise rates more steeply than the current 10 percent, to a maximum of 20 percent annually, and mandates that rates for second homes, properties that have had repetitive flood claims and commercial properties rise 20 percent over the next five years, starting July 1, 2012, thus phasing out subsidies on some 30 percent of properties. It also affirms FEMA's authority to purchase reinsurance from the private market and requires FEMA and the Government Accountability Office (GAO) to assess the capacity of the private reinsurance, capital and financial markets to assume a portion of the program's risk. The reforms are expected to generate an additional $2.7 billion over the next 10 years, according to the Congressional Budget Office.

- Also included was a provision negotiated by Sen. Roger Wicker, R.-Miss, to help settle disputes over the extent of wind versus water damage when the structure is a total loss and reduced to a slab. The Wicker provision would use data from federal agencies such as the National Oceanic and Atmospheric Administration to help allocate total losses between the two perils or causes of loss after a major storm.

- Not included was a proposal to expand the NIFP to offer coverage for additional living expenses to help compensate policyholders who are forced to move out of their homes when a structure is flooded and business interruption insurance coverage for businesses whose operations are curtailed or suspended due to flooding. The GAO will study the impact of adding such coverage's.

- **Policies in Force:** While the number of flood policies in force is growing, a significant portion of the population at risk of flooding still is not insured for flood damage, as the flooding in the Midwest in the spring of 2008 and after Hurricane Ike revealed. The latest available data show that in 2010, there were more than 5.7 million policies in force, compared with 5.0 million in 2005, the year of Hurricane Katrina, and 4.3 million in 1999. Premiums grew to $3.4.billion in 2010 from $2.2 billion in 2005. In 2010, 27,923 claims were paid, even though no major hurricane struck the U.S. mainland, compared with 212,518 in 2005, and the cost of claims was $718 million, compared with $17.7 billion in 2005.

BACKGROUND

The National Flood Insurance Program: Before Congress passed the National Flood Insurance Act in 1968 after frequent widespread flooding along the Mississippi River, the national response to flood disasters had been to build dams, levees and other structures to hold back flood waters, a policy that may have encouraged building in flood zones.

The National Flood Insurance Act created the National Flood Insurance Program (NFIP), which was designed to stem the rising cost of tax-payer funded relief for flood victims and the increasing amount of damage caused by floods. The NFIP has three components: to provide flood insurance, floodplain management and flood hazard mapping. Federal flood insurance is only available where local governments have adopted adequate flood plain management regulations for their floodplain areas as set out by NFIP. About 20,400 communities across the country participate in the program. NFIP coverage is also available outside of the high-hazard areas.

The law was amended in 1969 to provide coverage for mudslides and again in 1973. Until then, the purchase of flood insurance had been voluntary, with only about one million policies in force. The 1973 amendment put constraints on the use of federal funds in high-risk floodplains, a measure that was expected to lead to almost universal flood coverage in these zones. The law prohibits lenders that are federally regulated, supervised or insured by federal agencies from lending money on a property in a floodplain zone when a community is participating in the NFIP, unless the property is covered by flood insurance. The requirement for flood insurance also applies to buildings that receive financial assistance from federal agencies such as the Veterans Administration. However, because the initial mortgage on the property is frequently sold by the originating bank to another entity, enforcement of this law has been poor.

Legislation was enacted in 1994 to tighten enforcement of flood insurance requirements. Regulators can now fine banks with a pattern of failure to enforce the law and lenders can purchase flood insurance on behalf of homeowners who fail to buy it themselves, then bill them for coverage. The law includes a provision that denies federal disaster aid to people who have been flooded twice and have failed to purchase insurance after the first flood.

Buildings constructed in a floodplain after a community has met regulations must conform to elevation requirements. When repair, reconstruction or improvement to an older building equals or exceeds 50 percent of its market value, the structure must be updated to conform to current building codes. A 2007 NFIP study on the benefits of elevating buildings showed that due to significantly lower premiums homeowners can usually recover the higher construction costs in less than five years for homes built in a “velocity” zone, where the structure is likely to be subject to wave damage, and in five to 15 years in a standard flood zone. The Federal Emergency Management Agency (FEMA) estimates that buildings constructed to NFIP standards suffer about 80 percent less damage annually that those not built in compliance.

How It Works: The NFIP is administered by FEMA, now part of the Department of Homeland Security. Flood insurance was initially only available through insurance agents who dealt directly with the federal program. The "direct" policy program has been supplemented since 1983 with a private/public cooperative arrangement, known as "Write Your Own," through which a pool of insurance companies issue policies and adjust flood claims on behalf of the federal government under their own names, charging the same premium as the direct program. Participating insurers receive an expense allowance for policies written and claims processed. The federal government retains responsibility for underwriting losses. Today, most policies are issued through the Write-Your-Own program but some non-federally backed coverage is available from the private market.

The NFIP is expected to be self-supporting (i.e., premiums are set at an actuarially sound level) in an average loss year, as reflected in past experience. In an extraordinary year, as Hurricane Katrina demonstrated, losses can greatly exceed premiums, leaving the NFIP with a huge debt to the U.S. Treasury that it is unlikely to be able to pay back. Hurricane Katrina losses and the percentage of flood damage that was uninsured led to calls for a revamping of the entire flood program.

Flood adjusters must be trained and certified to work on NFIP claims. NFIP general adjusters typically reexamine a sample of flood settlements. Insurers that fail to meet NFIP requirements must correct problems; otherwise they can be dropped from the program.

As with other types of insurance, rates for flood insurance are based on the degree of risk. FEMA assesses flood risk for all the participating communities, resulting in the publication of thousands of individual flood rate maps. High-risk areas are known as Special Flood Hazard Areas or SFHAs.

Flood plain maps are redrawn periodically, removing some properties previously designated as high hazard and adding new ones. New technology enables flood mitigation programs to more accurately pinpoint areas vulnerable to flooding. As development in and around flood plains increases, run off patterns can change, causing flooding in areas that were formerly not considered high risk and vice versa.

People tend to underestimate the risk of flooding. The highest-risk areas (Zone A) have an annual flood risk of 1 percent and a 26 percent chance of flooding over the lifetime of a 30-year mortgage, compared with a 9 percent risk of fire over the same period. In addition, people who live in areas adjacent to high-risk zones may still be exposed to floods on occasion. Ninety percent of all natural disasters in this country involve flooding, the NFIP says. Since the inception of the federal program, some 25 to 30 percent of all paid losses were for damage in areas not officially designated at the time of loss as special flood hazard areas. NFIP coverage is available outside high-risk zones at a lower premium.

Flood insurance covers direct physical losses by flood and losses resulting from flood-related erosion caused by heavy or prolonged rain, coastal storm surge, snow melt, blocked storm drainage systems, levee dam failure or other similar causes. To be considered a flood, waters must cover at least two acres or affect two properties. Homes are covered for up to $250,000 on a replacement cost basis and the contents for up to $100,000 on an actual cash value basis. Replacement cost coverage pays to rebuild the structure as it was before the damage. Actual cash value is replacement cost minus the depreciation in value that occurs over time. (Excess flood insurance is available in all risk zones from some private insurers for NFIP policyholders who want additional coverage or where the homeowner's community does not participate in the NFIP.) Coverage for the contents of basements is limited. Coverage limits for commercial property are $500,000 for the structure and another $500,000 for its contents.

To prevent people putting off the purchase of coverage until waters are rising and flooding is inevitable, policyholders must wait 30 days before their policy takes effect. In 1993, 7,800 policies purchased at the last minute resulted in $48 million in claims against only $625,000 in premiums.

Proposals for Change: The NFIP has four major goals: to decrease the risk of flood losses; reduce the costs and consequences of flooding; reduce the demand for federal assistance; and preserve and restore beneficial floodplain functions. In a final report published in 2006 by the American Institutes for Research (AIR), which conducted an evaluation of the federal flood insurance program, AIR said that although much had been accomplished, the program fell short of meeting its goals in part because the NFIP did not have the ability to guide development away from floodplains and cannot restore beneficial floodplain functions once they have been impaired. In addition, AIR said, many people still are not covered or not adequately covered for flood damage. AIR also noted that the NFIP was hampered in reaching its goals by insufficient Congressional funding, lack of pertinent data, misperceptions about the nature of the program and the breakdown in coordination among its three major sectors.

A report published by FEMA in 2007 suggests that development patterns should be changed to protect environmentally sensitive areas and that communities in the flood program should be encouraged or required to ban development in these locations.

Another criticism of the NFIP is that it does not charge enough for coverage. Among the reasons for the premium shortfall is that the cost of coverage on dwellings that were built before floodplain management regulations were established in their communities is subsidized. As a result, the premiums paid for flood coverage by the owners of these properties reflect only 30 to 40 percent of the true risk of loss.

Lawmakers considering legislation to renew authorization of NFIP have proposed many changes that would have increased the NFIP's future income, including making owners of property subject to repetitive flooding pay premiums that more closely reflect the true cost of their losses and gradually eliminating the flood insurance subsidy for vacation and second homes. In addition, they would have allowed higher premium increases to make the program eventually self-sustaining.

Flood Coverage in Other Countries: There are two basic methods of providing flood insurance in developed countries. Under the first, the optional system, insurers extend their standard policy to include supplemental coverage for flood damage on payment of additional premium. The coverage tends to be expensive due to the fact that only those most likely to be flooded, and therefore to file claims, purchase it, a situation known in the insurance industry as adverse selection. Among the countries with optional coverage are Germany, Italy and the Netherlands. The other method is "bundling." Under this system, flood coverage is combined with coverage for other perils such as fire and windstorm, thus spreading the risk of flood losses across a large geographical area and greatly increasing the percentage of the population covered for flood damage. Countries that have adopted this method include the United Kingdom, Spain and Japan. In addition, in some countries such as France and Spain there are government compensation programs for major disasters, including flooding, that take effect when the cost of a disaster reaches a certain level. The system in the United States is unique in that the government underwrites the coverage and private insurers act as administrators bearing no actual flood risk.

Reference

"Flood Insurance." *Insurance Information Institute*. National Flood Insurance Program, n.d. Web. 25 Oct 2012. http://www.iii.org/issues_updates/flood-insurance.html