

Managing the Unmanageable: The Future of the NFIP and the Private Flood Insurance Market



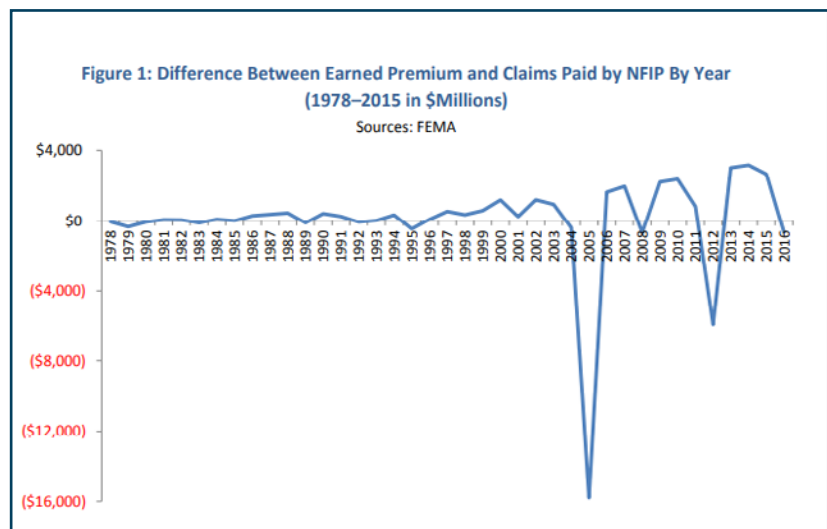
By Fred E. Karlinsky, Richard J. Fidej, Benjamin J. Zellner, Christian Brito

Floods are the most common natural disaster in the United States. Flood risk affects all 50 states; 4.2 million homes representing \$1.1 trillion in property exposure are at risk of flooding from hurricane storm surge, including \$793 billion in Atlantic coast exposure and \$354 billion in Gulf coast exposure. Further, the risk is expected to grow due to climate change and more people living near the coast.

The insurance industry has historically struggled to cover flood risk. Private industry largely withdrew from the flood insurance market in the aftermath of several severe flood events along the Mississippi River in the 1920's, and massive uninsured losses resulting from major floods in the 1960's highlighted the magnitude of the problem.

In response, Congress created the National Flood Insurance Program (NFIP) in 1968. The program, which is administered by the Federal Emergency Management Agency, provides federally subsidized flood insurance to homeowners and businesses in flood zones. All properties located in 100-year flood plains, known as Special Flood Hazard Areas (SFHAs), must have flood insurance if there is a mortgage or loan from a federally backed lender. Communities in SFHAs must participate in the NFIP and implement certain measures to mitigate flood damage. While the insurance is purchased through private insurers, the federal government backs the policies and is ultimately financially responsible for covered losses.

The NFIP was expected to largely pay for itself through premiums collected, and it was anticipated that mitigation measures would allow private insurers to re-enter the market. Unfortunately, that vision failed to materialize. Over time the NFIP suffered significant losses, which spiked over the past decade due to Hurricane Katrina,



Superstorm Sandy and other major storms. Indeed, nine out of the ten costliest events for the NFIP occurred since 2000. The 2017 hurricane season has proven to be one of the most damaging on record. Three major storms struck the U.S., causing an estimated \$200 billion in damage.¹ Much of the damage was caused by floods, particularly in and around Houston, where Hurricane Harvey slowly moved over the area.

These losses caused the NFIP to borrow more and more money from the U.S. Treasury. Prior to the 2017 hurricane season, the NFIP's debt to the Treasury Department was around \$25 billion. The 2017 hurricane season led to over \$8 billion in losses incurred by the NFIP, and it became clear that the program would be unable to pay all claims, as its cash on hand, reinsurance and remaining borrowing authority were well below the estimated losses.

The problem was partially addressed by enactment of a disaster relief bill that, among other things, forgave \$16 billion of the NFIP's debt, thus permitting it to borrow additional amounts to pay claims. However, the long-term problem of the NFIP's financial position remains unresolved.



¹ Karma Allen & Maia Davis, Hurricanes Harvey and Irma May Have Caused up to \$200 Billion in Damage, Comparable to Katrina, ABC NEWS (Sept. 11, 2017, 8:09 PM), <http://abcn.ws/2jihHxB>

The growing financial strain on the program has spurred efforts to make it more financially sound. The last major enacted reform was the Biggert-Waters Flood Insurance Reform Act of 2012, sometimes called BW-12. That law made various reforms to improve the program's financial position, the most notable of which were significant rate increases and the removal of various subsidies to homeowners in flood-prone areas. These reforms proved politically unpopular due to the extremely large rate increases homeowners experienced, and the loss of subsidies made it difficult, if not impossible, for some people to insure their home or business.

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Higher flood insurance rates also affected local housing markets, as some prospective buyers realized they would be unable to afford the flood insurance premiums on a property. The backlash led Congress to repeal many of the provisions of BW-12 in 2014 by passage of the Homeowners Flood Insurance Affordability Act, which reinstated some of the subsidies and capped rate increases. Some insureds also received refunds for higher rates that they had paid under BW-12. The partial repeal of BW-12 may have satisfied some homeowners, but the financial viability of the program remained an open issue.

Although Congress unwound many of the reforms implemented by BW-12, significant provisions of the law remain in effect. BW-12 contains provisions that opened up the residential flood insurance market to private homeowners insurers by directing federal mortgage lenders to accept loans secured by mortgages on properties in flood zones if the property is covered by an NFIP-compliant policy issued by a private insurer.

Such private policies must be at least as broad as the coverage in the standard NFIP policy form, and must offer limits of \$250,000 or the balance of the loan, whichever is less. The private policy must also have comparable deductibles, exclusions and conditions. Some ambiguities remain in the law, but BW-12 nevertheless remains a significant step toward increased participation by private insurance companies in the flood insurance market.

The size of the flood insurance market in the U.S. has further helped spur interest in expanding the private flood insurance market. Roughly \$4.3 billion in total premiums was generated in 2016 from more than 5 million policies issued by the NFIP. Even at this volume, only about 20 to 30 percent of homeowners who should purchase flood insurance do so. Hurricane Harvey demonstrated the magnitude of this issue, as an estimated 70 percent of flood damage caused by that storm is not covered by insurance.²

A piece of these losses will ultimately be borne by the property owners themselves or various governmental disaster relief programs. In 2017, President Trump signed a \$36.5 billion disaster relief package designed to aid victims of the 2017 hurricanes (although some of this amount will also go to victims of the 2017 California wildfires).³ That amount was in addition to tens of billions in funds previously appropriated for disaster relief and included \$16 billion to address the financially strapped NFIP.

This is a potentially very large market available for private companies to enter, as well as an incentive for the federal government to encourage development of a private market. Private insurers' interest in the flood market has also been spurred on by advances in catastrophe modeling, which have allowed insurers to better underwrite and price flood risks. More sophisticated catastrophe models, as well as access to more historical loss data, more accurate measurements of property elevations and other underwriting information, have increased the private market's confidence in its ability to cover flood risk and, consequently, calls for changes in the law to make the private market more viable.

While the private flood insurance market has grown in recent years, it remains a small player in covering flood risk in the U.S. Detailed statistics on the existing private market are not available, but it is estimated to be only a fraction of the size of the NFIP. Most private flood policies are issued by surplus lines carriers, not admitted carriers, although there is significant interest from admitted insurers looking

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² Harvey Residential Insured and Uninsured Flood Loss \$25-\$37 Billion: Corelogic, REUTERS, Sept. 1, 2017, <http://reut.rs/2ySfBai>
³ <https://www.nbcсандiego.com/news/politics/House-GOP-Pushing-Disaster-Relief-for-Hurricanes-Fires-465066293.html>

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to take advantage of this market. There are, of course, many significant issues that need to be addressed for growth in the private market to accelerate, including legislative obstacles. While BW-12 instructs federal mortgage lenders to accept mortgages on properties with private flood policies, federal banking and housing agencies may still impose their own solvency requirements on the insurance companies issuing the policies.

State insurance regulators and the industry oppose the imposition of federal requirements on carriers. The industry does not want to have to comply with two sets of standards. Another fundamental issue is that the subsidized rates offered by the NFIP make it difficult for private insurers to compete. The BW-12 reforms would have made private insurance more competitive by making NFIP rates more reflective of the risk covered (actuarially sound rates). However, the repeal of most rate increases and reinstatement of subsidies has left this problem unsolved.

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Rate increases have proved politically unpopular in the past, and they may continue to be in the wake of the 2017 hurricane season.

Despite difficulties, several proposals were advanced in Congress in 2017. The most consequential is likely the Private Flood Insurance Market Development Act of 2017, H.R. 1422, sponsored by Republican U.S. Rep. Dennis Ross of Florida. The bill clarifies that policies issued by insurance companies, including both admitted and surplus lines carriers, that are licensed or otherwise approved to engage in insurance in the state where the property is located are acceptable for federal mortgage lenders. The National Association of Insurance Commissioners has voiced support for similar bills in the past, and for federal legislative confirmation that state insurance regulators will have the same authority to regulate private flood insurance products as they do to regulate other insurance products — an issue that BW-12 does not clarify. The bill enjoys bipartisan support in the House of Representatives and was unanimously passed out of the Committee on Financial Services in July. An identical bill was introduced in the



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Senate and referred to the Committee on Banking Housing, and Urban Affairs, but to date has not moved.

The momentum toward adoption of pro-private market reforms to the NFIP seems to have been slowed by the impact of Hurricanes Harvey, Irma and Maria in 2017, which may have reduced the public's and legislators' appetites for a reduction in the federal government's subsidization of flood insurance. In July 2017, 26 Republican representatives from districts with significant flood risks sent a letter to Republican House leadership indicating that they could not support the reform bills that had been passed out of the Financial Services Committee. Some Democrats have also voiced skepticism at attempts to reduce the NFIP's subsidies.

An opportunity for reform remains, however, as the NFIP is currently set to expire on Nov. 30, 2018, meaning that Congress must take some action with regard to the program. The original expiration date, which was Sept. 30, 2017, has already been extended several times due to the turmoil created by the 2017 storms and focus on tax reform, but reauthorization remains on Congress's immediate agenda. Opposition to efforts to encourage a private market often revolves around the potential effect on the NFIP. Opponents of privatization efforts voice concerns that the private market will cherry-pick the best risks and leave policies in the NFIP that will not be affordable without large subsidies. This would create a sort of death spiral for the NFIP, which would basically become a flood insurance subsidization program and likely create new political problems concerning the fairness of such a program.

Some have expressed support for such a development and say it would permit Congress to better address the long-term problem of people building in areas that are highly prone to flooding. Another obstacle to increased private sector involvement is that agents currently receive a higher commission for policies placed with the NFIP than they do for more standard property coverage in the private market. This creates a significant incentive for agents to place

policies with the NFIP. It is an issue that will need to be addressed for the private market to become more viable.

How private flood insurance will be handled with regard to state guarantee funds is another unresolved issue. As a federal program, the federal government ultimately pays for claims on NFIP policies, so state guarantee funds are currently not tapped to pay flood-related claims. As the private flood market grows, the question of whether the states' guarantee funds will protect policyholders whose flood insurer has become insolvent will become more pressing. There is currently a debate over whether states should start imposing guarantee fund assessments to private flood policies or if they should simply declare that their guarantee funds will not cover flood insurance policies. This is an issue for each individual state to decide. But if the private market grows significantly, the pressure will build for a state backstop for insolvencies.

The fate of the NFIP and the potential for growth of the private flood insurance market remain murky. What is clear, however, is that the private market will not expand significantly without major reforms to the NFIP. There seems to be a consensus that some reforms are necessary, but whether changes will promote the private sector or only solidify the NFIP's role as the nation's flood insurance provider is unclear. The only certainty is that more storms will come, and the cost of the damage must be paid. 🌊

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