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The Heartland Institute

Senate Banking, Housing and Urban Affairs Committee

Subcommittee on Economic Policy

Hearing on Reauthorization of the National Flood Insurance Program

May 9, 2012

Chairman Tester, Ranking Member Vitter, and members of the Subcommittee,

We thank you for the opportunity to submit written testimony on reauthorizing the National Flood Insurance Program, and in particular, on S. 1940, the Flood Insurance Reform and Modernization Act of 2011, reported out of the Committee in September 2011.

The Heartland Institute is a 28-year-old national nonprofit education and research organization, headquartered in Chicago and dedicated to discovering, developing, and promoting free-market solutions to a range of social and economic problems. Heartland's Center on Finance, Insurance, and Real Estate long has advocated for substantive long-term reforms to NFIP[1], and we are pleased that both the U.S. House and Senate Banking Committee have approved meaningful, fiscally and environmentally responsible, and substantially similar legislation that would forward

[1] Eli Lehrer and Scott Richardson, "Solving the Flood/Wind Problem After Hurricane Losses: The Case for a Standardized Loss Allocation System" (Chicago: The Heartland Institute, 2011)

the goals of actuarial rates, effective enforcement of mandatory purchase and floodplain management requirements, modernized Flood Insurance Rate Maps, and a shift toward preparing for extreme tail risks through the build-up of catastrophe reserves.

However, the window to take-up the Committee's five-year NFIP reauthorization on the Senate floor is rapidly closing. Unless otherwise extended by Congress, statutory authority for NFIP is set to expire May 31, one day prior to the start of the 2012 hurricane season. Though the House and Senate flood insurance reform bills introduced in the 112th Congress are more similar than in other recent sessions, there remain some minor differences that will need to be settled before the legislation can be presented to the President. We are hopeful that this process can be completed in an expeditious manner before the program's scheduled expiration, but that will require immediate action on the part of Senate leadership.

Two-Year Extension Versus Long-Term Reform

The Federal Emergency Management Agency, which is responsible for administering NFIP, recently endorsed a plan for Congress to pass a two-year reauthorization of NFIP under its current structure, to grant additional time for debate on long-term changes to the program and to provide the housing market with additional certainty of the program's continuation over the near term. We are sympathetic to FEMA's concerns about the disruption that another lapse in NFIP authorization could cause. Since its last long-term authorization expired in September 2008, NFIP has been extended without any changes through a series of 12 short-term reauthorizations. It also has lapsed several times during that period due to congressional inaction, including four lapses for a total of 53 days in 2010 alone.

But we disagree strongly with FEMA that a two-year extension, which would push the reform debate into the 113th Congress, is desirable at this time. NFIP is not sustainable for an additional two years as it is currently constituted. The U.S. Government Accountability Office placed NFIP on its list of high-risk federal programs in March 2006, and it has remained there in each successive year.[2] The program is $17.775 billion in debt and can borrow only $3 billion more from the U.S. Treasury under its currently authorized borrowing authority. Given its debt load, NFIP continues to accrue nearly $1 billion in interest annually and the Congressional Budget Office projected in October 2011 that its current borrowing authority likely will be exhausted by or before 2014.[3]

Extending NFIP for an additional two years with no major changes would create a strong possibility that FEMA will either need to return to Congress to seek additional borrowing power or that the program will become insolvent. Political concerns could jeopardize congressional attempts to authorize additional debt for an already heavily indebted, high-risk program, while insolvency would be even more destabilizing to housing markets, given that the program is relied upon by 5.6 million policyholders with $1.25 trillion of coverage in-force. In order to ensure the program is placed on more sound fiscal footing, it is imperative that Congress approve a long-term reauthorization that includes significant reforms.

NFIP Debt and Borrowing Authority

For much of its history, the National Flood Insurance Program has been able to pay claims out of its operating revenues, and the program had no debt at all at the end of the 2004 Fiscal Year. In the ensuing nearly eight years, it has borrowed $19.6 billion from the U.S. Treasury, and repaid less than 10 percent of that total.[4] Following record losses stemming from the 2005 hurricane season, Congress voted three times between September 2005 and March 2006 to raise the cap on FEMA's authority to borrow money from the U.S. Treasury, previously just $1.0 billion, until it ultimately reached its current level of $20.775 billion.

Catastrophic flood loss events have driven the program's growing debt over this period. In fact, NFIP has paid out more in claims than it received in policyholder premiums in three of the past

[2] United States Government Accountability Office, NATIONAL FLOOD INSURANCE PROGRAM: Continued Actions Needed to Address Financial and Operational Issues, (Washington: GPO, 2010)
[3] Congressional Budget Office, Congressional Budget Office Cost Estimate: Flood Insurance Reform and Modernization Act of 2011, (Washington: GPO, 2011)
[4] Congressional Research Service, National Flood Insurance Program: Background, Challenges, and Financial Status, (Washington: GPO, 2011)

eight calendar years. In 2004, NFIP collected $2.04 billion in premiums and made $2.23 billion of payments to policyholders; in 2005, it collected $2.24 billion in premiums and made $17.71 billion of payments to policyholders; and in 2008, it collected $3.07 billion in premiums and made $3.45 billion of payments to policyholders.

Even in years in which the program's pure loss ratio has been less than 100 percent, it incurs significant administrative costs through its Write Your Own program, under which private insurers are paid to market NFIP policies and adjust claims following a loss event. The GAO estimates that payments to WYO insurers, which are based on payment methodologies established in 1983, typically consume between one-third and two-thirds of the program's annual premiums.[5]

The program's string of record losses began with Hurricane Ivan in 2004, which prompted $1.58 billion in flood insurance claims. Claims from the 2005 hurricane season, the bulk of which were paid in Fiscal Year 2006, included the largest single loss event in NFIP history, $16.17 billion for Hurricane Katrina. NFIP also paid out $470.7 million in losses from Hurricane Rita and $363.8 million of losses from Hurricane Wilma.

Since 2005, the program has been hit further by floods in Pennsylvania, New York, and New Jersey in June 2006 that caused $227.5 million in losses; an April 2007 Nor'Easter that produced $225.6 million in losses; and the strike of Hurricane Ike in September 2008, which produced $2.63 billion in losses, the second-largest flood loss event in U.S. history. The program was spared comparably large losses from significant floods in the Midwest in 2008 and in New England in 2010 largely because take-up in those regions was relatively low.

Implementing Actuarial Rates and Establishing Catastrophe Reserves

Based on CBO's most recent projections, given annual interest payments of $900 million and annual premiums of roughly $3.1 billion, it is unlikely that NFIP will be able to repay its debt

[5] United States Government Accountability Office, NATIONAL FLOOD INSURANCE PROGRAM: FEMA's Management and Oversight of Payments for Insurance Company Services Should Be Improved, (Washington: GPO, 2007)

within the next decade. Even in Fiscal Years 2010 and 2011, when claims were significantly lower than premiums, the program was able to pay down just $500 million and $750 million of debt, respectively. While the reforms proposed in S. 1940 and H.R. 1309 do not solve this problem, they do make significant contributions toward moving the program in a fiscally sound direction and mitigate against the risk that NFIP's financial condition will deteriorate even further.

Since the introduction of Flood Insurance Rate Maps in the early-to-mid 1970s, NFIP has maintained two separate sets of rate-paying customers. For those whose properties were built after completion of a community's rate map, the program charges full actuarially indicated rates. But for those who own properties which predate rate maps, estimated to be roughly 20 percent of all NFIP policyholders, the program charges subsidized rates that FEMA estimates are only 35 percent to 45 percent of the full-risk cost. NFIP also experiences disproportionate losses from so-called "repetitive loss properties." Although estimated to constitute just 1 percent of the total policies in-force, RLPs have accounted for more than one-third of all claims paid. Moreover, FEMA estimates that roughly 90 percent of RLPs are pre-FIRM properties that pay subsidized premiums.

Under both S. 1940 and H.R. 1309, subsidized premium rates would be phased out for all severe repetitive loss properties, second homes and vacation homes, commercial properties, and any property that has suffered damage exceeding 50 percent of its fair market value or that has undergone improvements of more than 30 percent of its fair market value. The Senate bill would raise the maximum risk premium increase for these properties from the current 10 percent to 15 percent, while the House bill would raise the maximum increase to 20 percent. The Senate bill also schedules a three-year phase-in of NFIP premiums for properties newly included in Special Flood Hazard Areas due to rate map revisions, while the House bill calls for a five-year phase-in.

According to CBO's projections, implementation of the Senate bill's provisions for phasing out subsidized premiums would increase federal revenues by $4.565 billion over the next decade, forming the bulk of a projected $4.665 increase in NFIP's net income. This would not resolve the program's fiscal problems, but it would mark a significant turn toward sustainability.

In addition to phasing out subsidized premiums for many pre-FIRM policies, S. 1940 also projects to raise $775 million over the next decade through additional premiums that would be charged to capitalize a reserve fund. Unlike private insurers, which charge rates that are designed to build a capital surplus and which typically cede risks of catastrophic losses to reinsurers, NFIP operates strictly on a cash-flow basis, and borrows money to cover expenses in years of extreme loss.

The Senate bill would begin to change this structure, first by charging premiums to capitalize a reserve fund and also by granting FEMA statutory authority to explore the use of private reinsurance and alternative risk transfer mechanisms such as catastrophe bonds to limit its exposure to catastrophic flood events. Taking these actions would not only better protect taxpayers from being forced to foot the bill for flood risks, but would encourage greater private sector participation in the flood insurance market, which could eventually set the stage for privatizing part or all of NFIP's operations. Reinsurers and catastrophe bonds already provide private sector capacity for flood risks in many other nations where such risks are privately insured.

Conclusion

In 1966, when Congress was initially deliberating on what would become the National Flood Insurance Program, the Presidential Task Force on Federal Flood Control Policy warned that creating a federal program that provided "insurance in which premiums are not proportionate to risk would be to invite economic waste of great magnitude."[6] That prediction has, unfortunately, come to pass.

Over much of its history, the National Flood Insurance Program has subsidized irresponsible floodplain development at taxpayers' expense. Today, more than half of the U.S. population

[6] United States Task Force on Federal Flood Control Policy, A Unified National Program for Managing Flood Losses, (Washington: GPO, 1966)

lives in coastal watershed and river floodplains.[7] Indeed, according to NFIP's own statistics, 90 percent of all presidentially declared national disasters in the United States involve flooding.

The federal government should not encourage the choice to live in harm's way, nor should it subsidize development in environmentally sensitive wetlands and floodplains. The National Flood Insurance Program needs significant reform today.

Respectfully Submitted,

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[7] United States Commission on Ocean Policy, An Ocean Blueprint for the 21st Century, (Washington: GPO, 2004)