Reforming the National Flood Insurance Program after 35 Years of Failure

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Executive Summary
Three-and-a-half decades after it emerged in its modern form, the National Flood Insurance Program (NFIP) remains deeply dysfunctional. Although modestly successful in improving the quality of land use planning in the United States—at least relative to what came before—the program has enormous weaknesses. In particular, it has cost taxpayers billions of dollars despite promises that it would sustain itself, encouraged some development in environmentally sensitive flood plain areas that would not have occurred absent the program, and has impeded the development of superior, private sector models to deal with flood risk.

Legislation recently approved by the House of Representatives and the Senate would resolve some of the program’s most obvious absurdities and reduce its liabilities slightly, but will not solve its fundamental, underlying problems. Rather than continued “baby steps,” NFIP needs drastic reform. This paper considers a variety of incremental steps and argues that four major steps hold promise for moving beyond the program.

Land Buy-outs. In certain cases, government, private industry, or a combination of the two might buy land currently occupied by NFIP-insured properties and convert it to more flood-resistant uses—for example, golf courses, public parks, and other public areas. Although attractive for some parcels of land, and an important component of any “exit strategy” for NFIP, land buyouts cannot, alone, solve the program’s problems.

Partial Privatization of Flood Mapping. Rather than stick with NFIP’s “one size fits all” mapping system—an approach that guarantees that maps will have flaws—the government should move towards a private mapping system by allowing insurers to base flood insurance rates on any approved map they can chart. Insurers could devise different sets of maps and set rates based on them.

Sale of the Program’s Assets. A large portion of the National Flood Insurance Program’s policies have some value on the private market. Divided up into portfolios, many could find buyers at auction. Such a sale would reduce the government’s role in flood insurance provision by a good deal, but would deprive the government of a revenue source to subsidize many of its worst risks.

Tax Credits and Program Termination. Following a sale of the bulk of the NFIP’s policies, a tax credit or grant program could serve to phase out NFIP altogether. People currently within the NFIP would either receive a one-time grant correlated to the decline in the value of their property resulting from the NFIP’s termination or more modest ongoing but time-limited subsidies. Thus, the government’s liability for the program would end.

The National Flood Insurance Program is broken and needs serious change. In the long term, it needs to go.
Introduction

The capacity to conceive a common good as one’s own and to regulate the exercise of one’s powers by reference to a good which others recognize, carries with it the consciousness that powers should be so exercised; which means that there should be rights, that powers should be regulated by mutual recognition. -T.H. Green, Lectures on the Principle of Political Obligation.¹

America’s National Flood Insurance Program (NFIP) has existed in its current form for 35 years. By the end of 1973, a majority of America’s seriously-flood prone communities had joined NFIP and the program’s supposed veil of protection covered an increasing number of homes. Building continued on the nation’s floodplains, and private insurers—so far as most consumers knew—appeared to run the program.² This paper describes how the flood insurance has evolved during this period, outlines the social consequences of this evolution, and considers options for rethinking the program. It describes the outlines of the federal flood insurance program as it exists today and the world it has created. It also describes how the program has changed and evolved since 1973, and examines a variety of reform proposals currently before Congress, including a proposal to expand the program to cover wind damage. Finally, it presents an outline for reforming the program.

To accomplish its goals as set out by Congress, the National Flood Insurance Program needs sweeping, fundamental reform oriented towards turning practically all of its functions over to the private market. This transition cannot and should not take place all at once. However, with the proper institutional framework, the nation could carry out this transition effectively.

How NFIP Works

One sentence can well describe the basics of the National Flood Insurance Program: The federal government funds the program in full and the private sector runs most of its important aspects.

When it comes to flooding, the National Flood Insurance Program covers most of what a standard homeowners’ insurance policy covers. The policy language, in fact, closely mirrors most homeowners’ insurance policies except that only water damage is covered. The program covers
structural damage, ventilation systems, debris cleanup, and flooring.³ This particular type of insurance comes almost entirely from the federal government—only one private company, AIG, sells it at all. Both NFIP and non-NFIP insurance can cover the contents of one’s home against flood. Several companies also sell renters’ insurance, which provides coverage against flood.⁴

Nearly all National Flood Insurance Program policies flow through the Write Your Own (WYO) program.⁵ A memo outlining the program for insurance companies describes it best:

As consideration for their sale and administration of Federal flood insurance in their own name, WYO Companies retain from premiums various expense allowances and receive reimbursements as set forth in the arrangement, but take no insurance risk. Funds received from policyholders above the approved expense allowance are Federal funds, and WYO Companies serve as fiscal agents of the United States.⁶

In other words, private companies corral in policyholders and service claims but the government takes on the actual insurance risk. At least in theory, NFIP itself rather than the U.S. Treasury bears the risk: NFIP can borrow from the Treasury up to a ceiling set by Congress but needs to pay back the money with interest. Companies get miniscule amounts of money for administering claims. These payments are enough to get them to participate, but hardly turns the program into a significant profit center for any insurer.⁷ Nonetheless, while a few insurance companies may sustain minor accounting losses as a result of the program, the presence of a 100-percent federal backstop means that no insurance company will ever go broke supporting the program.

Many insurers have criticized the program and suggested improvements, but no movement within the industry exists to repeal or privatize it. In fact, the government program came into existence before any private company sold flood insurance on a large scale, so the industry has never had anything with which to compare it (though lack of experience need not preclude future interest).

In practice, nearly every American who purchases a home in a flood-prone area needs to secure flood insurance. The massive government-sponsored enterprise lenders—particularly the massive Freddie Mac and Fannie Mae—also require participation in the program
for any loan they securitize, which historically has included nearly all loans under $417,000. Federal law, furthermore, mandates federally regulated institutions serving people in high flood risk zones to require their borrowers to secure flood insurance. State-regulated banks, in theory, do not have to enforce the mandate but nearly all do. The mandate, however, applies to lenders, not individuals. So, while no federal law requires individuals to obtain flood insurance or imposes direct penalties on individuals who do not have it, it is nearly impossible to get a loan for a house in a flood-prone area without securing flood insurance.

The ability to purchase flood insurance technically depends on municipalities opting in. In practice, however, every locality that could opt into flood insurance has already done so. To opt into flood insurance, a community must impose a zoning code that meets National Flood Insurance Program standards. Any locality with zoning power—towns, cities, counties, townships, special districts, and others—can participate. Many Americans live in areas with more than one participant, such as a participant city within a participant county. In a few cases—particularly in areas with lax or non-existent zoning codes—or where the Bureau of Land Management rather than local officials make many land use decisions—voters have formed special districts largely to participate in the National Flood Insurance Program.

Three factors determine rates that the National Flood Insurance Program charges to individuals. These are the community rating system, Flood Insurance Rate Maps, and individual property characteristics.

- **Community rating system.** While all communities must meet certain minimum requirements—essentially forbidding new development in areas that hydrologists believe certain to flood very frequently unless property owners secure private flood insurance—NFIP offers a complex “community rating system” that offers incentives in the form of lower rates to places that adopt more stringent building codes and do more to encourage mitigation.

- **Flood Insurance Rate Maps.** The National Flood Insurance Program develops Flood Insurance Rate Maps (FIRMs) to map out probabilistic

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The National Flood Insurance Program is a government program administered by private companies.

determinations of areas likely to flood and then use that information as a major factor in setting rates. Although FIRMs improve upon and have almost entirely replaced the older flood hazard boundary maps and “maximum probable flood” predictions that previously dominated the process, they remain flawed in many respects and a project to modernize them has fallen years behind schedule.13

- **Individual property characteristics.** NFIP has something it calls an individual underwriting process for each policy, but it hardly appears worthy of the name. In Northern Virginia, the author found out that his insurance company, USAA, asked only three underwriting questions to determine flood risk while it asked over 40 questions (including subquestions) to set his fire, theft, and windstorm rates.14 Selina Crane, a Wachovia Vice President who oversees parts of the company’s insurance business in Florida, acknowledges that, “it’s not really underwriting at all.”15 NFIP’s process does not use credit scores and does not take claims history into account (although, as discussed below, that may change).16 NFIP, in short, is much less sensitive to differences in construction than private insurance companies, and even some public agencies that write property insurance.17

To summarize, the National Flood Insurance Program is a government program administered by private companies. Its rates have a high degree of sensitivity to local laws and building codes and far less to actual personal behavior and risk. Although it takes assessed home value and a few basic characteristics into account, it fundamentally functions on the basis of modified community rating rather than on any individualized risk assessment. It is fair to say that NFIP uses a form of modified community rating to determine rates.

This structure has significant implications for proposals to restructure or expand the program. The total premium collected, in theory, could prove actuarially adequate. Nothing about this structure makes the
program fundamentally unsustainable. But, by definition, collecting actuarially adequate premiums under this structure in the aggregate will result in some property owners paying premiums that insurance price regulators might rule “excessive”—or even “unconscionable”—and others paying individual premiums well below actuarial adequacy.

**How the Program Evolved**

Like many large government programs, the National Flood Insurance Program did not spring fully formed from any legislative effort but, rather, evolved piecemeal from a variety of policy changes over a period of years. This section reviews changes in the National Flood Insurance Program from 1973, how it impacted America’s built landscape, and how it moved in various directions (sometimes further, sometimes closer) from its supposed goals of making the United States more secure against floods. This incremental evolution had several features:

- Continued erosion of premiums intended to get more people into the program coupled with the program’s long term financial deterioration;
- A general rule—irregularly enforced—that new construction would be permitted mostly in the “100 year flood plain” (areas likely to flood every 100 years or less often);
- Increasingly stringent enforcement of purchase requirements;
- Increased efforts to use the program to modify zoning codes; and
- A gradual increase in the number of “conforming” (theoretically actuarially adequate) properties.

Following a series of cuts intended to reduce rates and encourage more participation the National Flood Insurance Program continued to reduce its rates, thus increasing enrollment while simultaneously eroding its fiscal stability. The NFIP cut premiums in 1974, in 1975 (through rewriting regulations), and again in 1977. This served to erode any risk-based character the program may have had. By April of 1982, almost 65 percent of program enrollees were receiving a subsidy on their premiums. In short, the premium cuts attracted people who took greater risks. At the same time, the number of communities participating in the program
increased from about 3,000 in 1973 to nearly 20,000 by the mid 1980s. The result was clear: The program made things worse. A report to the Ford Administration noted “a lack of action to enact State or local land use ordinances that would minimize the effects of flooding.” Nonetheless, premiums only fell between 1973 and 1981. As a result, the program began accumulating large deficits, and by 1997 the deficit reached nearly $1 billion. By 2000, larger participation, better management, and higher premiums had eliminated the deficit—but not for long. Today, the deficit stands at about $18 billion—a sum both houses of Congress have voted to forgive, and which NFIP officials have said publicly they expect to see grow once again.

Although a variety of mechanisms have existed to enforce participation in the National Flood Insurance Program, the program has never succeeded in attracting anything close to universal participation. The program’s administrators and its critics in Congress knew about participation problems from NFIP’s earliest days—the first formal report from the then-General Accounting Office (now Government Accountability Office) about NFIP focused on lack of participation and community compliance with the program. Research by the author and the American Institutes for Research indicates that at least 11 reports between 1973 and 2007 looked at participation. And, although the program did experience significant growth (and an increase in financial stability during the 1990s), it has never achieved anything close to total compliance with its mandates and seems unlikely to do so in the future.

Since purchase of flood insurance became mandatory in some areas in 1973, efforts to encourage participation in the program have occurred in at least three phases: one focused on communities, another focused on lenders, and the third focused on individuals.

The initial 1968 legislation establishing the program imposed enormous community-wide sanctions: Localities not mandating the purchase of flood insurance would find themselves deprived of all federal aid. The program simply did not catch on: Fewer than 200 communities signed up and, when major storms hit, nobody had coverage. The approach of denying aid itself quickly fell by the wayside—so few people purchased flood insurance between 1968 and 1973 that there is no record of anybody having been denied disaster assistance.

Congress then tried a new approach, focused on lenders, with the 1973 flood insurance law. Through banking regulations and pressure on
government supported enterprises, federal law, theoretically, required purchase of flood insurance for almost everyone in a flood zone from roughly 1980 onwards. Yet enforcement was spotty: The National Flood Insurance Program—contained within the Federal Emergency Management Agency (FEMA)—sold the insurance while the Federal Reserve theoretically enforced purchase requirements. However, neither really did its job on a national scale. For the most part, enforcement fell to localities. In its first comprehensive enforcement review, GAO found that some states and banks enforced laws quite tightly and others not at all. For example, nearly everyone in Florida and Massachusetts purchased flood insurance while nearly 80 percent of Texans and about a quarter of Mainers eligible for the program did not. Although state oversight of lenders clearly has something to do with the disparities—Texas’s state banking regulators simply did not make Texas lenders require purchase of flood insurance—neither the GAO nor anyone since has identified exactly why such large differences emerged.

Finally, since the Clinton Administration, and continuing today, the NFIP has imposed a *de facto* personal mandate, albeit a reasonably weak one: Freddie Mac and Fannie Mae, starting in 1994, adopted a policy of never securitizing loans for people without flood insurance. That, coupled with stricter enforcement of state oversight rules and a new federal oversight process for any property that the federal government touched amounted to a *de facto* mandate for individual purchasers in NFIP participant communities. Very wealthy people capable of securing flood insurance through a Lloyd’s syndicate—and, in the 2000s, through AIG—could purchase property without flood insurance. In practice, no mechanism monitored continued presence of flood insurance. Unlike previous efforts, however, these met some success. While GAO found itself still unable to determine exactly how many people bought flood insurance, by all accounts participation had increased a great deal since the early 1990s. In 1999, the NFIP—for the first and only time in its history—became debt-free. For a time, the individual mandate appeared to work in increasing participation and the program’s own stability.

At the same time, the NFIP and its masters at FEMA embarked on a concerted effort to reduce the scale and quantity of subsidy attached to the program largely by encouraging localities to tighten their own zoning codes. FEMA also encouraged mitigation through the community rating system and the short-lived Project: Impact, which was intended to avert...
disasters before they happened—in one case, the agency moved an entire town.\textsuperscript{34} Although FEMA never dictated the absolute particulars of local zoning codes, the large carrot of better lower premiums encourage most localities to enact them.

The number of people receiving subsidies under the program declined a good deal: Rates went up even as participation became essentially mandatory.\textsuperscript{35} In the early 1980s, nearly 80 percent of properties received subsidies, by 2006, in theory, only about 18 percent were subsidized at all.\textsuperscript{36} There are significant questions, however, regarding the soundness of this structure.

The maps used to determine flood rates are outdated, so whatever the NFIP’s official statistics, it appears highly likely that the actual numbers are wrong. One analysis in the St. Petersburg, Florida, area found that over 5,000 properties were paying the wrong rates. Similar, more recent findings tell a similar story for Washington, D.C.’s central business district.\textsuperscript{37} Still, on balance, the program has steadily increased the percentage and number of properties paying rates that theoretically approach market levels.

Losses, however, continued to mount. Between 2001 and 2008, the program’s debt soared to its current figure of nearly $18 billion, which made it essentially bankrupt in the wake of hurricanes Katrina and Rita. A Congressional Research Service report put it best:

FEMA is unlikely to repay the funds borrowed to pay 2005 hurricane-related claims [those from Katrina and Rita] within the next 10 years. Even if FEMA increased flood insurance rates up to the maximum amount allowed by law [10 percent per year], the program would still not have sufficient funds to cover future obligations for policyholder claims, operating expenses, and interest on debt stemming from the 2005 hurricane season.\textsuperscript{38}

Although many issues remain outstanding, both the House and the Senate have passed legislation to forgive the entire debt (as of this writing, a final proposal is destined for a House-Senate conference). This situation led to a series of reforms culminating in what could become the most significant reform of the flood insurance program since 1973: the Flood Insurance Modernization Act legislation, which both

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houses of Congress have passed (as discussed below, the specific proposals differ a good deal). Before considering this legislation, it is necessary to survey the National Flood Insurance Program’s actual consequences.

**The Consequences**

The National Flood Insurance Program has not worked. In its current form, it has three major flaws:

1. It is not financially self-sustaining;
2. It encourages at least some development in flood plains that would not otherwise occur. Much of this development takes place in particularly environmentally sensitive areas;
3. It impedes the development of better models for predicting flood risk.

The NFIP, first and most importantly, imposes a significant hidden cost on American taxpayers. Its current debt—all of it accumulated since 1999—stands at $18 billion. That is about the same as the total budget for farm price support programs (although, in fairness, it only fractionally increases the national debt). If forgiven, these funds will represent a blatant use of public funds for purely private purposes. The money will come from taxpayers as a whole to be redistributed to people who choose to live in areas with greater flood risks. Moreover, given that coastal areas that face the greatest risk of flood are generally wealthier than the country as a whole, this is a blatant act of wealth redistribution to the already wealthy.\(^{39}\)

Worse, this wealth redistribution creates perverse incentives. All insurance creates moral hazard, and flood insurance is no exception. When homeowners’ insurance makes it possible for people to plant large trees around their houses or automobile insurance makes the risks of high speed highways worthwhile, the moral hazard benefits society, by allowing us to have, respectively, nicer homes and faster transportation. However, when the moral hazard subsidizes development and the attending wealth redistribution from the risk-averse to the risk-prone, it becomes very difficult to develop a public policy justification for it. Although participation in NFIP requires bans on the most obviously unwise construction (and encourages communities to ban other types of construction), it also encourages at least some floodplain construction that would not happen absent the program.\(^{39}\)
A study from the National Wildlife Federation describes the dimensions of this problem. Many properties, including some supposedly located in “safe” areas, have sustained loss after loss with almost no end in sight. David Conrad, the report’s author, put it well in a conversation with the author: “Even if it were enforced properly, the “100 year flood plain” standard would mean that a home would have about a one-in-four chance of flooding in the course of a mortgage.”

Finally, the National Flood Insurance Program’s very existence has impeded the development of better models for rating flood risk. The current system imposes one way of thinking on the entire flood program. The hard work of scientific tests on how floods are mapped simply has not been done, and one program dictating all flood mapping makes it much harder to get this work done. As long as only one approach—limited through yearly appropriations—exists at any one time, the prospects for a breakthrough in flood mapping seem very limited.

The Flood Insurance Modernization Act: Analysis

The legislation passed by both houses of Congress would make some positive yet ultimately minor and cosmetic reforms to the program, while also creating massive new burdens for taxpayers. In addition to forgiving NFIP’s debt as discussed above, both houses have voted to tighten program eligibility around the edges. The House has also passed legislation to create both a massive new wind insurance program and a federal backstop, both of which would surely result in even larger future debts. The Senate has rejected both of these measures.

Similarities between the House and Senate proposals—almost sure to become law—all move the program modestly in the right direction. Both houses of Congress have passed legislation which would result in a sizeable increase in premiums for properties that are not primary residences, strengthen mandatory purchase requirements, and encourage people to secure both flood and wind coverage. Both houses would also phase out subsidies for second homes and for people who have lost their homes time and again to floods—known as “repetitive loss properties.” These measures would improve the program’s financial state, but they are both quite limited. In particular, premiums will rise by 15 percent a year (under normal circumstances, they may not rise more than 10 percent a year) on second homes and repetitive loss properties, until they reach
The increased premiums apply only to newly purchased properties, second homes, and homes that have been destroyed at least twice.

Although this may correct some obvious absurdities in the program as it currently exists, the measure is unlikely to have a major impact on the program. Many people will purchase one flood-prone property precisely because they have a primary residence that is not near the water. Thus, people who want to avoid paying higher flood insurance premiums will likely simply declare that their flood-prone house is their primary residence. NFIP could try to disprove such claims, but this will be almost impossible to enforce. If people who want flood insurance obtain new drivers’ licenses and voter registrations at their second homes, they would likely satisfy all legal requirements for residency.

NFIP will not likely have the resources to investigate this practice. Efforts to move repetitive loss properties toward actuarially adequate rates also appear likely to have little consequence. Although no formal, uniform policy exists for doing so, existing community rating system guidelines mean that most communities make rebuilding these properties very difficult—exceptions are in communities with very permissive zoning codes—while the Clinton-era Project: Impact bought out many such homes. Because so many programs advance the same fundamental goals, new guidelines are likely to have only a modest impact. At the margin, these reforms will remove subsidies from people who should never have gotten them in the first place. These types of reforms make up all of the Senate bill and all of the common ground between the House and Senate bills. They will not fix NFIP.

Indeed, the House-passed flood insurance legislation contains two major flaws. It would add an enormous (and undetermined) wind-storm liability to the program and an equally large open-ended catastrophe liability.

Quite simply, the House bill envisions a massive expansion of the National Flood Insurance Program through the addition of a new national wind insurance program, which the legislation calls “multi-peril” coverage. While this program looks better than NFIP on its surface, it would likely impose a significant additional liability on taxpayers.

In defending the proposed program, the House Bill’s proponents point to its rather unambiguous language in saying that the program will
charge actuarially adequate rates—in other words, premiums high enough so that taxpayers do not pay a dime:

(5) ACTUARIAL RATES- Multiperil [wind] coverage pursuant to this subsection shall be made available for purchase for a property only at chargeable risk premium rates that, based on consideration of the risks involved and accepted actuarial principles, and including operating costs and allowance and administrative expenses, are required in order to make such coverage available on an actuarial basis for the type and class of properties covered.47

Although the requirement seems unambiguous (and, will probably mean that fewer people get subsidies than do under NFIP), it is unlikely to eliminate all subsidies for at least three reasons:

1. The necessary uncertainty of the rate setting process;
2. The lack of any other controls on the program; and
3. The political nature of the program itself.

Uncertainty of the rate setting process. First, the rare and severe nature of serious storms will make it nearly impossible for the program’s administrators to establish actuarially adequate rates. As a result of Florida’s severe hurricane lashing in the mid-2000s, just about every major insurer sustained significant underwriting losses—paying about $1.05 in claims for each dollar of policy collected—and one major insurer, Poe National, became insolvent.48 Despite legal mandates under state guarantee fund laws that private insurers charge actuarially adequate rates, almost none managed to do so. Except for the grossest generalizations, no one can adequately predict exactly which areas will sustain hurricane strikes and which will not. Private insurers, by virtue of their status as separate commercial entities, can develop contrasting models and create risk pools that let them pool “risky” and “safe” policies together, thus managing risk more broadly. A single risk pool, by definition, puts all its eggs in one basket. No legislation can change this danger in having a single pool.

Lack of other controls on the program. Just as importantly, only weak controls exist to keep the program honest and actuarially sound. The new wind insurance program—as part of the National Flood Insurance
Program—will have the same indefinitely expandable borrowing authority from the Treasury (it would be capped, as is the current flood program’s authority). The legislation would not even segregate flood and wind-related borrowing.\(^49\) It does contain one limitation on borrowing that may prove toothless. It requires the fund to stop issuing flood insurance if it were to borrow to pay wind-related claims.\(^50\) Yet so long as the program’s overall debt declines—which it always does in years when the nation avoids major disasters—the flood program’s overseers can say they are paying back the wind-related claims.\(^51\)

**Political nature of the program.** Finally, the program’s susceptibility to political influence will probably undermine any safeguard anyhow. For example, if the program ever did face a legal mandate to stop selling wind insurance, it would probably do so immediately after a Katrina-like storm that would greatly increase the demand for wind coverage. Moreover, the program will almost certainly crowd out at least some private insurance, so its very existence would decrease the availability of private wind insurance, at least at the margins. Some companies, seeing the federal government provide wind insurance in some places, might simply decline to expand into the wind insurance market in those regions. Thus, if the program ever were to stop writing coverage, it would do so at a time when many people would most need it. Were that to happen, consider the following scenario.

Citizens go to their elected representatives and demand that the program be issuing new policies. Congress then modifies the legislation to allow the program to write new policies, something it would find difficult to resist at such a time. This would lead to further growth in the new flood/wind program’s overall debt, and thus grow the national debt.

Although legislation contains language to hire new staff and speed up FEMA’s effort to modernize flood insurance rate maps, which is dangerously behind schedule, to actually do so will require appropriations. In recent years, Congress has underfunded FEMA’s authorizations for flood map modernization, while the Government Accountability Office found that the program lacked clear indicators of progress and clear objectives.\(^52\) Simply throwing more money at the problem—even if the money comes—may not improve the program’s ability to set actuarially adequate rates for many properties.
In short, the National Flood Insurance Program has severe problems that cannot be remedied within its current framework. Expanding the seriously broken program into wind insurance would be a serious mistake.

**National Backstopping**

In addition, the House has passed—and the Senate rejected—a proposal to create a national backstop: a government-run reinsurance fund that would displace a part of the private reinsurance industry.\(^\text{53}\) This would represent a mistake as serious as creating national wind insurance. Both House and Senate proposals would create a “national catastrophe consortium” that would offer loans from the United States Treasury to states against catastrophic losses. Although technically “private,” the consortium would have a board made up entirely of representatives appointed by state governments (with the secretaries of Commerce and Homeland Security serving as ex officio members in the programs’ first stages and the Secretary of the Treasury serving as the chair).\(^\text{54}\) The consortium could sell any sort of catastrophic risk coverage including a backstop for private flood insurance. The idea has three major problems.

First, the proposed program has all of the disadvantages of NFIP. Like NFIP, it would disproportionately benefit the well-off and encourage development in environmentally sensitive areas. Like NFIP, likewise, it would almost certainly benefit the wealthy—those who live near coasts—more than others.

Second, it would guarantee the continuation of financially unsound programs operated at the state level. Florida alone has set itself up for potential liabilities of $36 billion)—twice as large as those of the National Flood Insurance Program.\(^\text{55}\) By offering coverage at lower-than-adequate rates on insurance, Florida actually increases its chance of getting a federal bailout. (The Consortium’s assistance kicks in automatically when damages equal more than 150 percent of collected premiums.) This makes lower-than-adequate premiums actually desirable from the state’s point of view.

Finally, the program would benefit some states a great deal and others not at all. Florida would get have an opportunity for at least $36 billion in federal help while a state where current private insurance programs cover all or almost all disasters—say Illinois or Vermont—would
have almost no chance of ever getting aid.\textsuperscript{56} Thus, the consortium serves as mechanism for continued subsidies.

**Other Prospects for Reform**

The Flood Insurance Reform and Modernization Act, as passed by the House, has serious flaws from the standpoint of restoring market discipline to America’s flood insurance system. The Senate version of the bill—which excludes the wind and catastrophe fund provisions—takes baby steps in the right direction.

Ending the program immediately, while desirable in the very long term, is not politically viable. The program’s long-term existence has created a reliant constituency of homeowners, developers, communities, and insurers. Moreover, given that the program’s existence has retarded all but the most trivial development of private flood insurance, a total end to the program, without a phase-out period, would result in an end to all development—and theoretical default on the terms of many mortgages—in all flood prone areas. Government needs to get out of the way, but the transaction costs of doing things immediately are very high; the costs of phasing out over a period of time are much lower.

The next few pages explore several efforts to change the flood program: land buyouts, enforced mandatory purchase of flood insurance in high-risk areas, flood map improvement, auctioning off “conforming” flood insurance policies, and tax benefits for flood insurance incumbents—particularly oriented towards mitigation—coupled with a withdrawal of flood insurance and elimination of the program. All of these efforts can play a role in helping restore a private market for flood insurance. A combination of them could create a successful “exit strategy” away from the current system.

**Land Buyouts**

An enormous percentage of the National Flood Insurance Program’s losses come from what are known as repetitive loss properties. The National Wildlife Federation study cited earlier shows the dimensions of the program’s perverse incentive structure: Dozens upon dozens of properties have been rebuilt time and again using NFIP funds. The study found that at least 5,000 flood damaged properties had claims exceeding their value.\textsuperscript{57} Although these properties composed less than 1 percent of those covered
under NFIP, they represented 20 percent of all claims. Seriously outdated flood maps—which remain deeply flawed despite a massive effort to modernize them—make it nearly impossible to determine in advance which properties are most likely to suffer repetitive losses.

To deal with this problem, NWF recommends voluntary property buyouts. When a property likely to suffer repetitive loss is bought out, it typically reverts to a more flood resistant use, such as a park, wilderness area, wildlife refuge, or golf course. The federal government then would no longer provide these areas with flood insurance and thus disaster relief. The Clinton Administration found more widespread use of buyouts—often to good effect for both the NFIP and the environment. However, property buyouts have virtually ceased under the Bush Administration.

While land buybacks have benefits, they cannot solve flood insurances woes by themselves. Their expense, the difficulty of finding use for the land purchased, and their continuing nature make them, at best, a partial solution, for three reasons.

First, land buybacks can be very expensive. Many houses protected under NFIP—particularly in waterfront locations—have higher values than the land on which they sit. NFIP would find it hard to save money by purchasing land.

Second, land purchased under a buyback program loses a lot of value. Its development costs will almost always be quite high and, without subsidized flood insurance, its value will actually decline. A certain percentage of the land may make for good jogging trails, golf courses, parks, or simple wilderness. But there is a limit to the usefulness of such strategies.

Finally, a land buyback program—almost by definition—has no “exit strategy.” Almost inevitably, the land purchased under such a program would remain in government hands almost indefinitely. Some of it might be preserved to protect especially beautiful areas or specific types of wildlife, but much of it will have little use either for people or for natural preservation purposes. What, for instance, is the value of preserving a vacant lot on which a subdivision used to stand?

**Enforced Mandatory Purchase**

Current law makes it *de facto* mandatory for anybody who takes out a mortgage in a flood-prone area to purchase flood insurance. In general,
however, lenders do not force borrowers to maintain flood insurance after taking out a loan. Several lenders have proposed enforcing the purchase of flood insurance in flood-prone coastal areas. In his seminal work on flood plain management, Gilbert F. White suggests that the existence of a verification mechanism would be a key part of an effective flood insurance system. However, there is little reason to think that it would solve all the problems of flood insurance on its own.

The lack of enforceability makes flood insurance ineffective. As long as people in flood-prone areas who do not purchase flood insurance continue to receive government relief and rebuilding assistance no matter what they do, zoning and mitigation requirements attached to flood insurance will continue to prove extremely difficult to enforce. If an effective mechanism existed to enforce flood insurance purchase, insurers, lenders, and governments would have a significantly greater incentive to enforce mitigation measures attached to flood insurance. In that case, people who chose to live in flood-prone areas would, pay at least some of the costs implicit in their choice of residential locale.

However, the logic of expanding participation has two major problems. The current program does not work and the mechanisms to enforce participation remain unclear at this time.

First, simply expanding participation without fixing the program would not fundamentally improve its performance, since the problems of moral hazard and market distortions caused by non-actuarial rates would remain in place.

Second, no one has yet proposed a workable mechanism for effectively enforcing expanded participation.

**Flood Map Improvements**

The Flood Insurance Rate Maps process, as it currently exists, seems beyond redemption. Despite millions of dollars spent, efforts to modernize maps remain far behind schedule and even modernized maps do not always contain all the information that insurers would need to set risk-based rates. The problem, as discussed above, is not poor management per se—although that is a problem—but, rather, the program’s very nature. By using only one approach throughout the country, any flaw in the current FIRMS system gets magnified dozens of times. Without the discipline of market forces, diverse underwriting standards, and the benefits of
competition, really good flood maps do not seem likely. A single auto insurer, no matter how well run, would make similar mistakes. Any system for setting insurance rates, almost by definition, will have some flaws somewhere.

Short of massive wholesale reform of the entire program, incremental steps are still possible. Rather than simply grant contracts to create FIRMs, therefore, the National Flood Insurance Program should let insurers themselves establish rates within well-defined geographic areas, using almost any data they choose. Methodologies used for determining rates would remain proprietary trade secrets if companies chose to protect them. Once several systems existed, companies operating under File and Use guidelines (they would have to file flood maps with an authority, which might be a mutually run private consortium, and could use them unless they were disapproved) could implement other rating methodologies. This would lead to a market of sorts—although not a truly free market, as subsidies and inadequate premiums would remain in place for flood insurance rates.

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Auction of Conforming Policies
The lack of adequate information to determine whether any NFIP rates truly achieve standards of actuarial adequacy makes it impossible to auction off even a portion of NFIP policies. While some policies in some locations might prove saleable on an individual basis, the low quality of existing maps makes it impossible to consider even a partial privatization as a short-term solution. No private insurer would buy NFIP policies without knowing what it is buying.

Nonetheless, a program to improve maps could make a certain number of policies—those with actuarially adequate rates known as “conforming policies”—possible to privatize. To make privatization feasible, the national flood program would divvy up all policies into geographically dispersed portfolios that would have value on the open market. Each portfolio would contain policies from all regions of the country with a significant number of flood policies. To make this possible, a certain percentage of non-conforming properties would need to remain entirely in federal hands to be directly subsidized by the Treasury. Companies purchasing portfolios would have transferable but initially exclusive rights to write rate-regulated—but not overtly price-controlled—
policies under a “write your own” system and would face a mandate to continue offering mutually agreed upon coverage at agreed upon rates within the areas they purchase. Insurers could also sell unprofitable policies by offering money to other companies to take on liabilities for their own policies. After a period of time, NFIP could eventually establish open competition. Companies would then become free to set flood rates subject to either existing state laws or a new federal regulatory system. Consumers would gain the freedom to shop around the entire country for flood insurance. The resulting system would include all policies that pay actuarially adequate rates—at least 80 percent of current flood policies—and perhaps a good deal more.

Such a strategy, however, would have a downside. Private insurers would likely prove unwilling to assume a certain number of policies and these policies, which, without the backing of actuarially adequate policies, would cost far more per capita than the current program. Yet this might not impose such an enormous liability. Given that the current program already needs an $18 billion bailout, an expenditure of $1 billion a year could be sustainable. As an alternative, Congress might simply hand the program over to the states to run as they find most suitable to their particular circumstances.

**Tax Credits**

Wholesale compensated termination of the program appears to be the most attractive option for dealing with policies that could not be privatized. As noted, the program’s very long existence has created a constituency for its continuation, so ending the program quickly would be politically difficult. A few different types of tax credits might be in order.

First, legislation already before the United States Senate would create mitigation tax credits. This proposal deserves serious consideration for its potential to phase out flood insurance. The bill, the Property Mitigation Assistance Act of 2007, would take good first steps towards building an effective national mitigation strategy. It would authorize modest loans and grants to homeowners, which would include a mandatory state match—to further strengthen their homes. It would also provide incentives for states to introduce stronger disaster resistance guidelines similar to those envisioned under a national wind insurance program but without a firm mandate or an insurance accompaniment. States wanting to

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participate in the grant program would simply have to draw up guidelines for mitigation. Finally, the program would focus on low and moderate income homeowners. Only homeowners with incomes less than 50 percent of the median in the areas where they live would get the maximum possible subsidies.

However, a true phase-out of the program might require an even more extensive effort to compensate people currently involved in the flood insurance system. Essentially, the federal government would announce the termination of NFIP as of a certain date and encourage all beneficiaries to find private insurance (those with mortgages would have to find a private alternative). Those unable to find private insurance would then have two choices:

First, those choosing to sell their houses within a certain number of years of the program’s termination would receive a grant or a refundable tax credit pegged to an estimate of the lost value of their home.

Second, those choosing to stay in their homes would receive grants or refundable tax credits which they could use to mitigate against disasters, offset the purchase of insurance in the residual market, or use towards the down payment on a new house following the inevitable destruction of their flood-prone one. Few, if any would end up without coverage, as many companies writing voluntary flood insurance would find ways to cover people currently lacking it. Thus, tax credits could free the nation from the current National Flood Insurance Program and allow the free market to provide the best possible coverage.

Conclusion
The National Flood Insurance Program, as it has existed since its creation in 1973 and evolved to the present day appears beyond remedy. Congress could best serve the public interest and the common good through a program of phased privatization that would end with the full transfer of the program’s functions to the private market. The program, despite some managerial improvements, still fails to accomplish its stated goals. Although its management has been less than stellar, the program’s fundamental construction—rather than mismanagement—has proven its fatal flaw.
The program creates moral hazard, impedes the development of better flood maps, and imposes significant costs on taxpayers. No amount of public sector managerial expertise can make this a viable, wise, or productive expenditure of public funds. Privatizing the program will take work and require a number of different phases.

The ever-growing burden of the National Flood Insurance Program imposes a significant ongoing burden on the U.S. Treasury. The program does not accomplish its goals. It damages the environment and encourages undesirable development. It should go.

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Notes

2. See Eli Lehrer, “Water Marauders: How the Federal Government Retarded the Development of Private Flood Insurance,” Issue Analysis, Competitive Enterprise Institute, 2007. This previous paper outlines how the flood program came into existence and how initially sensible regulations that took risk into account quickly gave way to a series of actions that made it increasingly difficult to relate national flood insurance premiums to risk.
4. Non-NFIP contents coverage is typically purchased as renters’ insurance.
5. Although 44 CFR subchapter B outlines a “direct program” for selling flood insurance, no such program currently exists in most of the country with one minor exception. (A small number of policyholders living on coastal barrier islands who purchased their houses and obtained policies before 1982).
10. The National Flood Insurance Program reports that slightly over 22,000 communities participated in the program during 2006. While total liabilities assumed by the program have grown significantly over that time period, the number of communities participating has remained more or less level since 1999. See National Flood Insurance Program: “Total Coverage by Calendar Year,” http://www.fema.gov/business/nfip/statistics/cy2006cov.shtm.
11. Although its purposes extend beyond NFIP participation, Clark County, Nevada—the entity that provides most government services to people with Las Vegas mailing addresses—has run its own flood control district since 1985. See: Clark County Regional Flood Control District, http://www.ccfcd.org/.
13. For a summary of the number problems see: FEMA, “Flood Map Modernization: Mid-Course Adjustment,” http://www.fema.gov/plan/prevent/fhm/mm_mca.shtm
16. A spate of claims in a certain area may stimulate a decision to revise FIRMs and thus increase rates. But individual claims history, at the moment, plays no role.
17. Florida Citizens Property Insurance Corporation is an example of a public agency that uses an industry standard process for determining risk. However, Florida Citizens does not price actuarially adequate rates, even though it uses complete underwriting criteria. Also, the community rating discounts (which can go up to 70 percent) slash premiums enormously in areas that NFIP judges to have “good” building codes and take effective mitigation measures. This may serve to make up for some portion of the loss of risk data implicit in NFIP’s simple rating mechanism.
18. Even when political considerations are taken into account, it is not impossible to do this. Switzerland’s health insurers, for example, community-rate policies but have no price controls.
The law containing the mandates is the Flood Disaster Protection Act of 1973 (PL 93-234).

The law mandating it (part of PL 90-48) took effect in 1977 with enforcement beginning in 1978. A variety of waivers (granted community by community, however, meant that it took a few years for even nominal enforcement to begin on anything resembling a national scale).


American Institutes for Research, p. 57.

Freddie, Fannie, and all wholly private companies that create and market mortgage-backed securities retain the ability to push debt obligations back onto the originator when a property goes into default because of the owners’ failure to secure flood insurance. This does not seem to be widely used, however.


American Institutes for Research, 75.


See American Institutes for Research, pp. 75-79 for a history of the rate increases.


It was passed by the House in late 2007, but did not gain significant support in the Senate during 2007. It was up for further discussion in 2008.


H.R. 3121, Sec 4.

Since one highly flood-prone state, Florida, has no state income tax, people might even benefit financially from doing this.

Witt and Morgan, pp. 55-78.

The wind insurance bill in toto is incorporated throughout H.R. 3121. The original legislative text is H.R. 920 (2007).

For simplicity, all subsequent citations are to H.R. 920.

H.R. 920 (2)(c)(5).

Robert Hartwig, “Natural Disaster Risk and Insurance: Where do We go From Here?” (Powerpoint Presentation), Insurance Information Institute, 2007.

Doing so might be difficult in any case since the program would not sell “naked” wind coverage but, instead, require anyone desiring wind coverage to purchase flood coverage as well.

H.R. 3121, Section 7(8)

Likewise, since there is often bona fide difficulty in determining the difference between flood and wind claims, it is likely that local administrators could pressure insurance adjusters to attribute damage to flood rather than wind. However, since the program would pay the bills either way, such determinations probably will not attract too much attention.


Part of the House-passed bill (H.R. 3355) and, in the Senate, proposed as S. 2310.

H.R. 3355, Section 105


A separate program, Terrorism Risk Insurance provides insurance against terrorist attack.


From 2002 on, the Bush Administration’s budget requests never included a land buyback line item. FEMA regional directors, NFIP itself, and the FEMA mitigation directorate, however, retained some ability to do buybacks on an atomized level. For a sample FEMA budget during this period see, FEMA, “$6.4 Billion FEMA Budget Sought,” http://www.fema.gov/news/newsrelease.fema?id=4282.


Insurance Information Institute. “Compulsory Auto Insurance/Uninsured Motorists,” http://www.iii.org/media/hottopics/insurance/compulsory/. Automobile insurance purchase has proven easier to enforce since it tends to get more use and because all drivers must have licenses. Although 47 states require automobile insurance and 23 have state reporting and enforcement systems, the Insurance Information Institute finds that participation remains uneven.


The flood insurers, in other words, would administer WYO themselves and, from a consumers’ perspective, the policy would not change.

S. 2328.
About the Author

Eli Lehrer is a Senior Fellow at the Competitive Enterprise Institute, where he directs CEI’s studies of insurance markets. Prior to joining CEI, Lehrer worked as speechwriter to United States Senate Majority Leader Bill Frist (R.-Tenn.). He has previously worked as a manager in the Unisys Corporation’s Homeland Security Practice, as Senior Editor of The American Enterprise magazine, and as a fellow for the Heritage Foundation.

He has spoken at Yale and George Washington universities and testified before Congress. He holds a B.A. (Cum Laude) from Cornell University and a M.A. (with honors) from The Johns Hopkins University, where his work focused on the Federal Emergency Management Agency and Flood Insurance. His work has appeared in the New York Times, Washington Post, USA Today, Washington Times, Weekly Standard, National Review, The Public Interest, Salon.com, and dozens of other publications. Lehrer lives in Oak Hill, Virginia, with his wife Kari and son Andrew.
The Competitive Enterprise Institute is a non-profit public policy organization dedicated to the principles of free enterprise and limited government. We believe that consumers are best helped not by government regulation but by being allowed to make their own choices in a free marketplace. Since its founding in 1984, CEI has grown into an influential Washington institution.

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