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Flood Insurance Issues

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THE TOPIC

Flooding is the most common and costly natural disaster in the United States, causing an average of $50 billion in economic losses each year. Most U.S. natural disasters declared by the president involve flooding.

There is no coverage for flooding in standard homeowners or renters policies or in most commercial property insurance policies. Coverage is available in a separate policy from the National Flood Insurance Program (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, the Mississippi floods of 2011 and Hurricane Irene and superstorm Sandy in 2012 set in motion a debate about how to improve the federal program.

RECENT DEVELOPMENTS

- **Superstorm Sandy Claim Disputes:** Beginning in late 2014 some New York and New Jersey homeowners alleged they were underpaid in the settlement of their flood insurance claims after 2012 superstorm Sandy.
- According to the homeowners, initial engineering reports linked home damage to the surging storm waters but were later modified to blame pre-existing structural problems, resulting in lower claims payments.
- The Federal Emergency Management Agency (FEMA), which oversees the flood insurance program, ordered all private insurers to turn over claims records in which they retained an engineering firm, approximately 16,000 of 144,000 claims. FEMA also launched a Sandy Claims Review, inviting all 144,000 claimants to have their claim revisited. About 800, or about one-half of 1 percent, accepted the offer as of late May 2015.
- In May New York Senator Charles Schumer urged FEMA to scrap the Write Your Own program, in which private insurers processes flood insurance policies and claims but FEMA's National Flood Insurance Program (NFIP) assumes the insurance risk. Write Your Own companies process more than 80 percent of all NFIP policies.
- Some insurers and engineering firms face class actions that allege racketeering, and New York's attorney general opened a criminal investigation.
- A Senate report issued in June 2015 said the process for reviewing claims disputes had many flaws but there was no evidence of insurers' systematically underpaying flood victims. The report also found that claims that had been re-inspected by a second adjuster had "low overall error rates" and that private insurers settling claims through the Write Your Own program were less likely to underpay claims than the federal government, which settled claims for the program's Direct business.
- **National Flood Insurance Reform:** In March 2014 Congress rescinded many of the rate increases called for by The Biggert-Waters Flood Insurance Reform Act, passed two years earlier. The original act sought to make the federal flood insurance program more financially self-sufficient by eliminating rate subsidies that many property owners in high-risk areas receive.
- The new law reduces some rate increases already implemented, prevents some future increases and puts a surcharge on all policyholders. The measure also authorizes funds for the National Academy of Sciences to complete an affordability study.
- The 2014 law prevents any policyholder from seeing an annual rate increase exceeding 18 percent. It calls on the flood program's administrator, the Federal Emergency Management Agency (FEMA), to "strive" to prevent coverage from costing more than 1 percent of the amount covered. In other words, if the policy offered $100,000 of coverage, the premium would not exceed $1,000.
- The 18 percent cap will result in refunds in some cases. Refunds began in October 2014. FEMA has a fact sheet on who is eligible for refunds.
- The law also reinstates a practice known as grandfathering, meaning that properties re-categorized as being at a higher risk of flooding under FEMA's revised maps would not be subject to large increases.
- It also ends a provision in Biggert-Waters that removed a subsidy once a home was sold. People who purchased homes after Biggert-Waters became law will receive a refund. Many lawmakers in coastal states were concerned that the higher cost of flood insurance would have a negative impact on the real estate industry.
- The subsidy will now be covered by a $25 surcharge on homeowners flood policies and a $250 surcharge on insurance for nonresidential properties and secondary (vacation) homes.
- According to data from FEMA, most current flood insurance policyholders (81 percent, or 4.5 million) pay rates based on the true risk of flood damage and so were not affected by Biggert-Waters or the subsequent rollback. Properties most affected by the rate hikes were in high-risk flood zones; were built before communities adopted their first Flood Insurance Rate Map; were second homes; or are second homes that have not been elevated. Others affected include businesses and those who live in homes that have been repeatedly flooded.
- More detail appears in the "2014 Changes" section below.
- In June 2014 Florida enacted a law that encourages private companies to offer flood insurance. The legislation permits four types of flood coverage – a standard policy, which resembles National Flood Insurance Program coverage, and three enhanced policies. To encourage market growth, the law allows insurers to file their own rates until October 1, 2019. After that, rates will be subject to regulatory approval.
- **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. The latest available data show that in 2013, there were nearly 5.6 million policies in force,

compared with 5.0 million in 2005, the year of Hurricanes Katrina and Rita. Premiums grew to $3.5.billion in 2013, from $2.0 billion in 2005. In 2013, 16,864 claims were paid, compared with 148,448 claims in 2012 and 213,290 in 2005. The cost of claims was $441 million in 2013, compared with $8.8 billion in 2012 and $17.8 billion in 2005.

BACKGROUND

The National Flood Insurance Program: Before Congress passed the National Flood Insurance Act in 1968, 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 taxpayer 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 floodplain management regulations for their floodplain areas as set out by NFIP. More than 20,000 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 mud flows 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 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. Regulators can now fine banks that consistently fail 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, 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 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 b 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 re-examine 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 SFHAs. 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 from 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.

2014 CHANGES

Legislative changes in 2014 undid much of a 2012 attempt to put the NFIP on a sounder financial footing. Congress passed the Biggert-Waters Flood Insurance Reform Act of 2012 as part of a bill reauthorizing the NFIP. It attempted to make rates charged accurately reflect the true flood risk of each property, thus making the program actuarially sound.

The 2012 law put a 5 percent surcharge on all but the lowest-risk policies to create a reserve fund to cushion against future losses. But the most controversial measure intended to drastically reduce the discount received by insurers of older properties in high-risk areas, a discount generally called a subsidy.

Starting in October 2013, three formerly subsidized groups saw the phase-out begin:

- Businesses.
- Non-primary residences (typically vacation homes).
- Structures with severe repeated flood losses.

Rates for these groups were scheduled to increase 25 percent per year until actuarially sound rates were reached. Other subsidized policyholders would keep their subsidies until the property was sold, the policy lapsed, a new policy was purchased or the property suffered "severe, repeated flood losses where the owner refuses an offer to mitigate."

The plan was unpopular, particularly in the Southeast, where many subsidized policies existed. Congress responded with the 2014 rollback.

The new law repealed and modified parts of Biggert-Waters, as well as making additional changes to the flood insurance program. Other parts of Biggert-Waters remained unchanged.

Refunds: Refunds applied to policyholders in high-risk areas who were required to pay full-risk rates after they purchased a new policy on or after July 6, 2012. Policyholders who renewed after March 21, 2014, and received an increase of more than 18 percent may also be eligible for a refund.

Policyholders who received typical annual rate increases in 2013 or 2014 or paid the Biggert-Waters surcharge that created a reserve fund would see refunds only if their policy renewed after March 21, 2014, and their total increase (premium plus reserve fund) exceeded 18 percent.

FEMA noted that "only a small percentage of the overall NFIP policy base" was eligible for a refund. Refunds began in October 2014.

Subsidies: The new law stipulated that subsidized policies would receive gradual rate increases. Most of these properties must receive 5 percent annual increases until they are charged the full risk rate. In most cases, rate increases are capped at 18 percent per year. Exceptions include:

- Older business properties paying subsidized rates.
- Older non-primary vacation homes paying subsidized rates.
- Frequently flooded properties paying subsidized rates.
- Buildings that have been substantially damaged or improved that were built before the local adoption of a Flood Insurance Rate Map (FIRM).

While FEMA developed guidelines on rates, purchasers of subsidized properties were allowed to assume the prior owner's policy and rates. Lapsed policies receiving pre-FIRM subsidized rates were reinstated with pre-FIRM rates until FEMA developed rates as mandated by the 2014 act.

Surcharges: The 2014 act created surcharges to help fund the subsidized policies. A policy for a primary residence was assessed $25. Other properties were assessed $250. All policies are scheduled to pay the fees until the pre-FIRM subsidies are eliminated.

Grandfathering: Often when the lines on flood maps were redrawn, some properties ended up in higher risk zones than before, but they continued to pay lower rates. The Biggert-Waters Act required 20 percent annual rate increases until these grandfathered properties were assessed full-risk rates. Under the 2014 act, homes and businesses that were built to code, then remapped into a higher risk area will not receive a rate increase. Properties moving into Special Flood Hazard Areas would pay the subsidized premium in the first year, then the rate increases assessed on all such properties would be between 5 percent and 15 percent annually, with no single property receiving more than an 18 percent increase.

Other changes:

- FEMA is required to perform an affordability study, and it must address flood insurance affordability issues within 18 months of that study's completion.
- FEMA was also instructed to begin offering monthly installment payments for policies and make available policies with deductibles up to $10,000.
- FEMA is required to consider in its rates steps that owners have undertaken to mitigate flooding.
- New flood maps must be certified as following a technically sound scientific and engineering methodology.

- Policyholders who successfully appeal FEMA's rate increases will be reimbursed for the cost of the appeal.
- The law creates a flood insurance advocate, who will educate policyholders about flood risks.

FLOOD COVERAGE IN OTHER COUNTRIES

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.

In other developed countries, there are two basic methods of providing flood insurance. 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 and Italy.

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.

In 2014 the United Kingdom launched Flood Re, a not-for-profit reinsurance organization to take on flood risks that primary insurers do not want. If an insurer calculates that the flood risk of a particular policy exceeds the flood premium, it will cede that risk to Flood Re. The insurer will pay the claim, then seek reimbursement from Flood Re.

In all likelihood, Flood Re's losses and expenses will exceed its premium. Additional funding will come from a levy raised from insurers by market share.

NATIONAL FLOOD INSURANCE PROGRAM, 1980-2014

		Losses paid	
Year	Policies in force at year-end	Number	Amount ($000)
1980	2,103,851	41,918	$230,414
1985	2,016,785	38,676	368,239
1990	2,477,861	14,766	167,897
1995	3,476,829	62,441	1,295,578
2000	4,369,087	16,362	251,721
2005	4,962,011	213,515	17,768,904
2007	5,655,919	23,183	614,007
2008	5,684,275	74,852	3,487,554
2009	5,700,235	31,027	780,115
2010	5,645,436	29,152	774,689
2011	5,646,144	78,057	2,427,308
2012	5,620,017	149,808	9,061,580
2013	5,568,642	18,046	488,815
2014	5,350,887	12,105	351,446

Source: U.S. Department of Homeland Security, Federal Emergency Management Agency.

- In 2013, the average amount of flood coverage was $233,237 and the average premium was $632.
- The average flood claim in 2013 was $26,165, down from $59,189 in 2012, the year of superstorm Sandy.
- NFIP premiums written rose slightly from $3.3 billion in 2012 to $3.5 billion in 2013.
- As of June, the federal government had declared 10 major flood disasters in 2014, compared with 42 in all of 2013.

TOP 10 MOST SIGNIFICANT FLOOD EVENTS BY NATIONAL FLOOD INSURANCE PROGRAM PAYOUTS (1)

Rank	Date	Event	Location	Number of paid losses	Amount paid ($ millions)	Average paid loss
1	Aug. 2005	Hurricane Katrina	AL, FL, GA, LA, MS, TN	167,970	$16,317	$97,140
2	Oct. 2012	Superstorm Sandy	CT, DC, DE, MA, MD, ME, NC, NH, NJ, NY, OH, PA, RI, VA, VT, WV	129,360	7,996	61,809
3	Sep. 2008	Hurricane Ike	AR, IL, IN, KY, LA, MO, OH, PA, TX	46,593	2,690	57,730
4	Sep. 2004	Hurricane Ivan	AL, DE, FL, GA, LA, MD, MS, NJ, NY, NC, OH, PA, TN, VA, WV	28,294	1,612	56,977
5	Aug. 2011	Hurricane Irene	CT, DC, DE, MA, MD, ME, NC, NH, NJ, NY, PA, RI, VA, VT	44,244	1,338	30,242
6	Jun. 2001	Tropical Storm Allison	FL, LA, MS, NJ, PA, TX	30,786	1,107	35,958
7	May 1995	Louisiana Flood	LA	31,343	585	18,667
8	Aug. 2012	Tropical Storm Isaac	AL, FL, LA, MS	11,995	549	45,780
9	Sep. 2003	Hurricane Isabel	DE, MD, NJ, NY, NC, PA, VA, WV	19,938	500	25,091
10	Sep. 2005	Hurricane Rita	AL, AR, FL, LA, MS, TN, TX	9,528	475	49,820

(1) Includes events from 1978 to August 31, 2015, as of October 15, 2015. Defined by the National Flood Insurance Program as an event that produces at least 1,500 paid losses. Stated in dollars when occurred.

Source: U.S. Department of Homeland Security, Federal Emergency Management Agency; U.S. Department of Commerce, National Oceanic and Atmospheric Administration, National Hurricane Center.

KEY SOURCES OF ADDITIONAL INFORMATION

Federal Emergency Management Agency: Homeowner Flood Insurance Affordability Act: Overview

Center for Insurance Policy and Research, National Association of Insurance Commissioners: Homeowner Flood Insurance Affordability Act of 2014: Section by Section Summary