Flood Insurance Reform Means Higher Premiums

By Charles E. Gilliland and Harrison Hunt

The Biggert-Waters Reform Act, also known as the Flood Insurance Reform Act of 2012, attempts to end subsidies for flood insurance premiums offered through the National Flood Insurance Program (NFIP). NFIP has been hemorrhaging money for the past 45 years, and there has been serious concern about the long-term viability of the program. After catastrophic losses from hurricanes Katrina and Sandy, nearly all hope for a seamless recovery has been lost.

As of July 2013, NFIP was $24 billion in debt and borrowing money from the Treasury to pay claims. The act seeks to address this shortfall by increasing premiums to compensate for the risk associated with each property, ending the longstanding subsidies. Ending subsidies could affect substantial numbers of property owners by saddling them with much higher premiums. The act does authorize extension of the massively indebted program, but subsidies for 438,000 policies would end. The act further specifies a schedule for eliminating the remaining 715,000 subsidized policies altogether.

A July 2013 U.S. Government Accountability Office (GAO) Report to Congressional committees on flood insurance concluded that the Federal Emergency Management Agency (FEMA) needed more information on subsidized properties to accurately assess the impact of the act. GAO estimated that about 1.1 million of the 5.5 million NFIP policies involved discounted rates that failed to reflect the full actual risk of flooding. Furthermore, a large portion of the discounted properties were located in high-risk areas. These owners could suffer a significant financial hardship as FEMA implements the act. The problem is magnified for many of these owners because NFIP is essentially the sole flood insurance provider for much of the nation.

Beginning in 1968, NFIP subsidies were intended to encourage municipalities and cities to opt in to the program. After communities joined the program, property owners faced a federally mandated obligation to purchase an NFIP policy. The implementation of NFIP made up for the lack of private flood insurance, which occurred because of the difficulty of quantifying flood risks. Participation in NFIP required communities to create new floodplain management regulations designed to mitigate flood risks and better understand the floodplain for the soon-to-be insured properties.

The subsidies dispelled fears that the new mandatory flood insurance policies would place undue hardships on owners of the properties most at risk, instead allowing them to adjust to
the new costs over time. Intended as a temporary arrangement, subsidies have survived unchanged for decades with later policies being grandfathered at the subsidized rates. As FEMA’s Multi-Hazard Flood Map Modernization Program brings new floodmaps online, and as NFIP approaches bankruptcy, it has become necessary to align premiums for these highly subsidized policies with the actual risk of flood damage.

The structural obstacles that pushed NFIP into a $24 billion deficit are glaring. One of the issues that magnified NFIP losses was the grandfathering of subsidized premiums. Simply put, so subsidies have survived unchanged for decades with later policies being grandfathered at the subsidized rates. As FEMA’s Multi-Hazard Flood Map Modernization Program brings new floodmaps online, and as NFIP approaches bankruptcy, it has become necessary to align premiums for these highly subsidized policies with the actual risk of flood damage.

The structural obstacles that pushed NFIP into a $24 billion deficit are glaring. One of the issues that magnified NFIP losses was the grandfathering of subsidized premiums. Simply put, so long as there have been no substantial improvements or damage to the property, subsidized policies can stay in force indefinitely, even transferring to new owners when the property is sold. Some of the original policies, with premiums set before adequate floodplain data was available, have persisted for decades as subsequent policies are grandfathered in and maintained. For policies based on accurate maps, where a policy owner can prove the property was built to code at the time of construction, subsidized low rates can be locked in indefinitely. This applies even if the floodplain map has changed and identifies the property as riskier than before.

Because FEMA did not periodically re-evaluate floodplain maps, many are outdated and no longer accurately assess flood risk for many properties. According to a 2005 study by the Department of Homeland Security, more than 70 percent of FEMA’s maps are more than ten years old. In addition, many of the maps were drawn by hand. Updating these maps also requires obtaining new elevation information. A 2010 Senate study revealed that the information contained in the National Elevation Dataset is 40 years old on average. These circumstances led GAO to conclude that elevation/base flood information currently remains unknown for 97 percent of NFIP’s subsidized properties.

**Biggert-Waters Reform**

The Biggert-Waters Reform Act has several proposed avenues for restoring NFIP solvency. The thrust of the proposal is to eliminate endless grandfathering, update floodplain maps to more accurately assess risk, and gradually align current subsidized rates with actuarially defined rates attuned to true flood risk. The act specifies the following list of properties slated to have subsidies eliminated:

- any residential property that is not a primary residence;
- any severe repetitive-loss property;
- any property that has incurred flood-related damage in which the cumulative amounts of payments under this title equaled or exceeded the fair market value of such property;
- any business property, and
- any property that has experienced or sustained substantial damage exceeding 50 percent of the fair market value or substantial improvement exceeding 30 percent of the fair market value.

Rate increases for these properties would be phased in over several years, rising by 25 percent each year. Other properties for which the owner has voluntarily allowed an NFIP policy to lapse or refused to accept mitigation assistance after a major disaster would also face elimination of subsidies.

Clearly, a substantial number of property owners face escalated premiums as the act goes into effect.

NFIP involves two types of policies, subsidized and full-risk. Full-risk properties have appropriately priced premiums that reflect the risk associated with the insured property. Premiums for subsidized policies are lower, sometimes substantially lower, than their risk profile would justify. The reform visions repricing some subsidized premiums but, because of the long history of subsidies and grandfathering, insuring agencies don’t have the information needed to adjust premiums without re-evaluating each individual property.

For example, the owner of one property with a history of flooding paid a subsidized premium of $1,500 per year. Under the act, that premium is scheduled to increase $24,000 annually. The subsidized premium ensured that the property owner remained unaware of the actual flood risk associated with the property. The GAO insists that FEMA generally lacks the data needed to ascertain the proper full-risk premium at the elevated risk levels and also lacks a plan for obtaining the needed information.

This dearth of information and vague wording of the act led GAO to state that the NFIP plan is essentially just waiting for property owners to volunteer to pay for a new Elevation Certificate. The certificate is designed to help evaluate the likelihood that a property may flood by providing detailed data on property elevations relative to flood plains. An application for an Elevation Certificate requires owners to submit a property description and its situation in relation to adjacent grade elevations. The information would have to be signed and sealed by a qualified surveyor, engineer or architect. Obtaining an Elevation Certificate would likely represent a significant expense for property owners.

Because the NFIP plan assumes that property owners will bear the expense of obtaining a new certificate, it runs a risk of adverse selection. Specifically, owners most willing to pay for the evaluation are more likely to be confident that their property faces little flooding risk, qualifying them for lower rates. Owners of properties located in high flood-risk areas will be less likely to volunteer to pay for a certificate that would likely raise their NFIP premiums.

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The lack of specific property data and up-to-date flood maps makes it impossible to assess the actual impact of changes imposed by the act. However, older properties might face substantial increases. Specifically, FEMA uses flood insurance rate maps [FIRM] to assess flood risk associated with a particular property, but structures built before the FIRM guidelines went into effect generally involve an elevated level of risk. These structures were built before a community opted in to NFIP [early to mid-'60s], and are, therefore, probably not compliant with the localized floodplain building codes. The effects of repealing subsidies might hit these properties particularly hard. In addition, repetitive-loss properties, which represent 1.3 percent of all NFIP policies, will account for 15 to 20 percent of future losses, according to recent estimates.

NFIP has not increased rates on properties that have had repeated claims. Private insurers routinely raise rates on such properties, which will likely face increased premiums under the act. Finally, language in the act specifies use of losses from catastrophic years in calculating averages for setting premiums. That provision virtually ensures that average rates will rise.

Responding to concerns about increased premiums inspired by the act, a push has emerged to delay the effects of the legislated premium increases. Known as the Homeowner Flood Insurance Affordability Act, Senate Bill 1846 would delay premium increases for four years, or six months after FEMA proposes policy changes and regulations to address affordability issues. The Congressional Budget Office estimates that the latter would occur during calendar year 2018. It would also delay increases for properties sold after July 6, 2012, the effective date of the act. The bill would not block rate increases for most business properties, second homes or repeat flood properties. Rates on those properties are currently scheduled to increase by 25 percent per year until they reach full cost.

Reaction to this legislation has been strong. Keep an eye on Congress for revisions, delays or other changes to this law. 💤

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**THE TAKEAWAY**

The National Flood Insurance Program is more than $24 billion in debt in large part because of government subsidies paid to property owners to help pay premiums. The Biggert-Waters Reform Act seeks to end the subsidies and base premiums on risk assessments that reflect the actual risk of flooding. Premiums would rise significantly for substantial numbers of program participants.
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