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U.S. Flood Insurance: A Looming Disaster

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IT HAS BEEN 45 YEARS SINCE THE U.S. CONGRESS passed the National Flood Insurance Act which created the National Flood Insurance Program. Since that time, the flood program has accumulated a deficit of roughly $24 billion, and that number is on an upwards trajectory as storms like Katrina and Sandy destroy highly populated areas and leave devastation in their wake.

Aside from the fact that it is run by the federal government, a number of deficiencies in its structure cause the National Flood Insurance Program to operate in a way that is not at all like an actual insurance program. A few of note are the absence of loss reserves, intentional subsidization of rates, and adverse selection caused by selective mandatory purchase requirements.

CHANGES ON THE HORIZON

In the recent bill passed by Congress to reform the flood program in 2012, there were a number of encouraging changes put in place. However, many of these changes have associated logistical issues. For instance, one of the most significant changes is to gradually remove subsidies on properties that are below actuarially indicated rates (some of which are as much as 60 percent below their indicated rates). Alongside this, there is a phase-in of a risk load which is intended to build up a loss reserve to account for catastrophic events.

While all of this is making the program sound more and more like an insurance program, one has to ask how long it will take to get to a financially stable place when the maximum rate increase on individual policies is 10 percent per year (25 percent for secondary homes, businesses, and homes with repeated severe losses). Doing a little back-of-the-envelope math gives us an estimate of no fewer than 30 years until we reach a $0 deficit and a fully funded loss reserve. Furthermore, this is assuming no occurrences of any event that exceeds the premium income (minus debt payments) each year.

A HISTORICAL PERSPECTIVE

The situation seems dire, so let's throw out all the numbers and reflect on why this program exists in the first place. Flood risk was historically understood by the insurance community to be an uninsurable hazard. The reason for this is because of the predictability of where flooding can occur and resulting adverse selection. Lawmakers turned their attention to this gap in coverage in response to a chain of Mississippi River flooding disasters and northeastern hurricanes in the 1920's and 1930's.

By the time 1968 came around, the federal government had paid out enough in after-the-fact disaster relief that they decided to set up an "insurance" program to prefund these payouts. Not only were these funds proactively addressing the issue, they were also being paid by those who actually would use the funds as opposed to collecting from every American taxpayer. Happily for those of us that live on a hill, the only people who are required to purchase these policies are those who have federally –backed mortgages in a flood zone.

WHERE IS THE INSURANCE INDUSTRY?

Now for the big question—why is the government better equipped than the insurance industry to provide this coverage? It's not. It is simply a losing game

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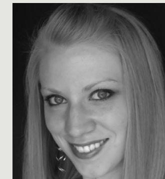
the way it was structured. The insurance industry has always known it, and the numbers are finally starting to show it.

It does not have to be a losing game. Predictability and adverse selection in flood risk are no different than predictability and adverse selection in earthquake or hurricane wind risk. The disciplines of risk management and reinsurance have both come light years from where they were in 1968. Notable developments that could be applied to flood insurance are probable maximum loss models and catastrophe bonds, among many others. But since flood was never written by insurers, risk managers have not been involved in developing diversification strategies. And since there is no allowance for a profit load on top of the federal policies and the underlying subsidization still remains largely intact, reinsurers have not developed vehicles that may be uniquely suited to handle the excess layers of catastrophic events.

It is not for lack of willingness that insurers and reinsurers alike are out of the business of flood insurance. In fact, as the NFIP deficit grows, there is a clear push to move the program in the direction of becoming a functioning insurance program, and the industry has been providing insight and feedback to foster this transformation. The problem is that the policies of Washington lawmakers will never be as well structured as the charter of an insurance company, no matter how much input they receive from industry experts.

THE RISKS OF THE STATUS QUO

A number of possible risks exist if U.S. flood insurance regulation is not completely deconstructed and rebuilt. The most immediate of these are the significant rate increases that existing policyholders will experience due to patchwork reform acts such as the recent legislation passed in 2012. The National Flood Insurance Program was not intended to be an insurance provider held to the same stringent solvency standards as the private sector is. As a result, a shift towards strategies used by the private sector to maintain financial stability will inevitably result in large rate increases. The only other option to achieve stability would be to mandate flood insurance at excessive rates for constituents who do not live in flood zones. However, even this is not currently an option as the reform act has a specific provision that requires rates to be actuarially sound. As policyholders begin to experience the rate increases, members of Congress as well as governors from various coastal states such as Florida, Louisiana, Mississippi, and even New Jersey are beginning to propose ways in which the premium increases can be mitigated. Doing this will only result in the program taking even longer to become financially solvent.



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A second very concerning risk is the possibility of another major catastrophic event in the near future. The national debt limit has nearly been reached. Another major event could cause payouts that would contribute to either requiring an increase on the national debt limit or a default on the national debt payments. The latter scenario is unlikely given the very strong political motivations to prevent it. However, it could be unavoidable depending on the size of a major catastrophe and cataclysmic for the U.S. economy.

A third risk is continued development in dangerous coastal and other flood-prone areas. The artificially suppressed premiums, lack of broader mandatory purchase requirements, and flood maps that are rarely updated all enable construction of new risks that will contribute to larger flood insurance debt in the future.

A CALL TO ACTION

The only solution to the flood insurance crisis is well-known…deregulation. Given the spotlight that is currently on the fragility of the flood program, a case can be made for a largely deregulated market similar to that of familiar non-admitted markets. The NFIP deficit currently makes up 4 percent of the national deficit. How

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many more disasters need to occur before lawmakers force the flood insurance problem onto the industry? Put in that situation, most countries around the globe leave the flood risk to go uninsured. The U.S. market would likely follow suit if the peril is handed off to the industry only to be subjected to the same stringent state regulations that are in place for standard homeowners insurance.

One of the forums most conducive to taking action would be within the various industry groups that often provide feedback as the National Flood Insurance Act continues to be reformed. Instead of reacting to individual sections of proposed law, we can instead bring proposed holistic market solutions to the table. As industry experts, we can illustrate that a macro level change is needed. Furthermore, if the federal law is dismantled, the regulation of flood insurance is then under the jurisdiction of the individual states per the McCarran-Ferguson Act. So engaging state officials now to evaluate local market concerns will also help to avoid unintended regulatory consequences. Being a proactive participant in the discussion is crucial so that an effective market structure can be developed. The reader is challenged to think critically and form their own ideas to help solve the problem. We should join forces and work together within the industry to devise a solution. With the flood deficit on the rise, now is the time for action. ■