



214 Massachusetts Ave. N.E Washington D.C. 20002 (202) 546-4400 www.heritage.org

CONGRESSIONAL TESTIMONY

Fixing the National Flood Insurance Program

**Testimony before
Committee on Banking, Housing
and Urban Affairs
United States Senate**

February 2, 2006

**David C. John
Senior Research Fellow
Thomas A. Roe Institute for Economic Policy Studies
The Heritage Foundation**

My name is David John. I am Senior Research Fellow at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

The catastrophic losses that the National Flood Insurance Program (NFIP) faces in the wake of this year's hurricane season prove that it is time for Congress to fix the program once and for all. The solution is to take steps to make NFIP actuarially sound. Such changes may not be popular among those who live in flood plains or along the coast, but they are the only responsible way to shore up the program and protect taxpayers.

According to David Maurstad, Acting Insurance Administrator for the Federal Emergency Management Agency (FEMA), claims due to Katrina and Rita could exceed \$22 billion, or about one-and-a-half times the \$15 billion NFIP paid out in claims between its creation in 1968 through 2004. Maurstad's estimate amounts to more than 11 times the almost \$2 billion NFIP paid for flood insurance claims stemming from the hurricanes that hit Florida and other areas in 2004.

So far, Congress' reaction to these losses has rightly focused on ensuring that the program has the money to pay claims against it. In September, NFIP's authority to borrow from the Treasury was raised from \$1.5 billion to \$3.5 billion. November saw a further increase to \$18.5 billion. Last week, Mr. Maurstad told this committee that NFIP will need to borrow \$5.6 billion more just to cover claims and expenses through the end of FY06. Interestingly, it appears from his testimony that \$670 million of the roughly \$25 billion that NFIP expects to borrow from the Treasury will go back to that agency in the form of interest payments.

In theory, NFIP will repay these loans from its premium income, but if interest alone eats up almost 35 percent of NFIP's annual income of roughly \$2 billion, the only way that repayment is possible will be if premium income is greatly increased and average claims remain at the pre-Katrina level. Since NFIP is expected to repay the loans, pay its administrative expenses, and meet average year losses from that \$2.0 billion, realistically, the only way to get these loans off of NFIP's books will be for Congress eventually to forgive them.

Unfortunately, the demands on NFIP are not likely to decline. While losses from a single storm like Hurricane Katrina may be exceptional, scientists expect hurricane activity to build in coming years. As millions of Americans continue to relocate to flood-prone areas and property values in those areas continue to rise, NFIP can expect to face much higher levels of annual claims than it has in the past. Unless premium income grows at least as fast, the program's request for increased borrowing authority is likely to be an annual event rather than an exception caused by a catastrophe.

Another challenge to the program's finances would develop if Congress increases the level of flood insurance coverage available on a single structure and its contents.

Realistically, Congress is quite likely to do just that. Such an increase would reflect rising property values, but it is questionable if premium income on the increased insurance will cover the higher losses.

The net result of these factors is an NFIP that is a permanent borrower, and represents a constant drain on taxpayers. The only way to avoid constant deficits and increased borrowing is to reform the program. The current request for additional borrowing authority is an excellent opportunity to make substantial changes that will reduce the likelihood of continued NFIP bailouts.

Four Necessary Steps to Avoid Future Bailouts

1. **Eliminate the current subsidy for older structures and require coverage for the replacement value of the property.** The only way to avoid still more congressional bailouts of NFIP is to make the program actuarially sound and to target it towards people who actually live or work full-time in covered structures. Today's NFIP subsidizes about one-fourth of the structures that it covers. About 76 percent of policyholders pay risk-based premiums that include the possibility of a catastrophic loss. However, structures that existed before the surrounding community joined NFIP—24 percent of the total—receive flood insurance at subsidized rates that imply a substantially lower risk of flooding than actually exists. The Government Accountability Office (GAO) estimates that some premiums are only 35 to 40 percent of what they would be without the subsidy. The total value of this subsidy is an estimated \$1.3 billion annually. In addition to making NFIP's finances shaky, the subsidy discourages private insurance companies from competing with the federal program. Finally, the program assumes that flood control measures such as levies and dykes will protect the properties near them, regardless of whether they are adequate and in good repair.

NFIP should eliminate the subsidy for older structures because its continued existence is a danger to the program. In order to minimize the impact on home and business owners, the subsidy could be phased out over several years. To some extent, the higher premiums will make it more attractive to replace older structures that are prone to higher flood losses with new buildings that incorporate architectural features that would minimize such damage.

In addition, many NFIP policies only cover the remaining balance on a structure's mortgage, not the cost of actually replacing it. This protects the lender but can leave homeowners with a ruined property that they cannot afford to rebuild. Flood insurance should also cover the cost of replacing the structure, rather than just the cost of repaying its mortgage. Although this would increase premiums, insuring for replacement value will make it more likely that homes and businesses will be able to rebuild, rather than relocate.

2. **Require flood insurance where storm surges are possible – including areas behind a levee or other flood control measures.** Currently, NFIP coverage is

required only where there is a one-percent chance of a flood and not in low-lying areas where surges are likely following major storms. A significant number of property owners affected by Hurricane Katrina suffered water damage despite the fact that their structures were outside of the 100-year floodplain where flood insurance is required by law. The most famous of these areas are the neighborhoods in New Orleans that were located behind a levee. Realistically, any flood control measure can be expected to only protect against events of a certain size. This means that there is some residual risk of flooding in areas that are behind levees, downstream of a dam, or in a coastal area that could see a major hurricane. The ability to predict where a flood will hit is more of an art than a science.

Flood insurance should be required in all areas where a flood or storm surge is likely if a weather event reaches catastrophic levels. Especially with serious hurricanes more likely to occur in the future, it makes little sense to continue to leave structures at risk of storm-surge damage or near levees that could fail outside the system. NFIP should also assess the possibility that flood control measures in an area are likely to fail or are inadequate when determining premiums. In addition to making actuarial sense, this step would help to better inform homeowners of the risk of flood damage that they actually face.

- 3. Strengthen mitigation programs to reduce repeat losses.** According to GAO, structures with repeat losses represented almost a third of all claims paid between 1978 and March 2004. Roughly 2,400 structures in Alabama and Mississippi that were damaged by Hurricane Katrina had suffered losses before, as had roughly 20,000 structures in Louisiana. If a property is responsible two or more claims of over \$1,000 each in 10 years, NFIP can offer to move, raise, flood-proof, or even buy the property to reduce the overall cost to the program. Unfortunately, these actions are often delayed or avoided altogether.

Congress should pressure NFIP to step up mitigation efforts by setting explicit goals for the agency and establishing regular reports by an outside agency on its progress that are examined at regular oversight hearings. In most cases, retrofitting structures to reduce flood damage will save NFIP the cost of expensive repairs and the structure's owner the disruption caused by flood damage.

- 4. Assess higher premiums for vacation homes and second homes:** Currently, NFIP charges the same rates for both vacation homes and owner-occupied structures. However, the number of homes built on coastal barrier islands continues to grow very rapidly, with a significant proportion of these homes being expensive vacation homes that are rented out for most of the year. One way to raise NFIP's income would be to charge owners of these homes higher premiums. Initially, second or vacation homes could be charged 15 to 20 percent more than owner-occupied structures, but over time, this surcharge could be increased even higher. The higher cost would be largely borne by increased rental fees, while the

additional money could be used for a variety of purposes, ranging from repaying the loans to the Treasury, financing additional mitigation efforts, or even slightly subsidizing the flood insurance premiums of lower income homeowners.

Conclusion

Especially in coastal areas, artificially low flood insurance premiums are subsidies that encourage people to live where natural disasters are more likely to occur. While people should be allowed to live where they please, they should also bear the risk that their choice may subject them to storms, floods, tornados, and other natural disasters. Hurricane Katrina caused what eventually will be recognized as a massive bailout of NFIP, and current weather and population trends make future bailouts likely. Rather than wait around for the next bailout, Congress should make NFIP actuarially sound. These steps necessary to this end will not be popular with many people who live in a flood plain or on the coast, but they are responsible ways to prevent pouring still more scarce tax dollars into the program.

The Heritage Foundation is a public policy, research, and educational organization operating under Section 501(C)(3). It is privately supported, and receives no funds from any government at any level, nor does it perform any government or other contract work.

The Heritage Foundation is the most broadly supported think tank in the United States. During 2004, it had more than 200,000 individual, foundation, and corporate supporters representing every state in the U.S. Its 2004 income came from the following sources:

Individuals	56%
Foundations	24%
Corporations	4%
Investment Income	11%
Publication Sales and Other	5%

The top five corporate givers provided The Heritage Foundation with 2% of its 2004 income. The Heritage Foundation's books are audited annually by the national accounting firm of Deloitte & Touche. A list of major donors is available from The Heritage Foundation upon request.

Members of The Heritage Foundation staff testify as individuals discussing their own independent research. The views expressed are their own, and do not reflect an institutional position for The Heritage Foundation or its board of trustees.