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Biggert-Waters Flood Insurance Reform Act of 2012

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Floods are the most common natural disaster in the United States. In 1968, the U.S. Congress enacted the National Flood Insurance Program (NFIP), primarily because flood insurance was nearly unavailable from the private insurance markets following frequent widespread flooding along the Mississippi River in the early 1960s. The NFIP is an important component of the federal government's efforts to limit the damage and financial impact of floods. Although state insurance departments regulate most insurance, the NFIP is a federal program managed by the Federal Emergency Management Agency (FEMA). State insurance regulators collaborate with the NFIP and FEMA to ensure that consumers are sufficiently protected and informed.

Since 2008, the NFIP had been operating under numerous stopgap extensions (17) and shut down twice for several weeks. On July 6, 2012, President Barack Obama signed into law the Biggert-Waters Flood Insurance Reform Act of 2012, extending the NFIP for five years through Sept. 30, 2017. This long-term extension is critical to provide stability to the program, which protects more than 5.5 million consumers throughout the country. In addition to the five-year program reauthorization, the legislation includes many program reforms.

On Aug. 14, 2012, the NAIC's Center for Insurance Policy and Research (CIPR) held a summit on the recently enacted flood reauthorization bill and future challenges of the NFIP. Speakers from many different perspectives, including academia, state and federal governments, consumer groups and the industry, met to share their knowledge on flood insurance. This article will summarize some of the NFIP reforms, as well discuss key observations of the summit.

◆ NFIP Reforms

The Biggert-Waters Flood Insurance Reform Act of 2012 phases out subsidies for vacation and second homes, as well as businesses, severe repetitive loss properties or substantially improved/damaged properties. Under the new legislation, rates for these properties will increase by 25% per year until premiums meet the full actuarial cost, attempting to move the NFIP toward risk-based pricing. Properties not currently insured by the NFIP or any lapsed policy also will be subject to full actuarial rates.[1]

In determining chargeable premium rates, the reform requires the rates be adequate on the basis of actuarial principles to cover the average historical loss-year obligations incurred by the National Flood Insurance Fund and allows for the use of historical loss data, including catastrophic loss years.[2] However, the law does add the flexibility of installment payments for policyholders, whereas previously payments for NFIP policies required full payment of the insurance annually. The new legislation requires FEMA to develop an installment plan to allow policyholders that are not required to have their premium escrowed every month with their lender to pay their flood insurance premium in installments.[3]

The NFIP reform also requires a premium rate adjustment to any property located in an NFIP-participating area to accurately reflect the current risk of flood. The determination of this risk is made after the effective date of any revised or updated flood insurance rate map (FIRM). The legislation requires any increase in the risk premium be phased in over a five-year period at a rate of 20%. This differs from the previous NFIP program, which placed a 10% cap on an increase-of-risk premium. However, there are some properties located in areas that were not previously designated as a special flood area. At some point in the future, these locations may become designated as such areas. For such properties, the chargeable risk premium rate will be phased in over a five-year period at a rate of 20% following the effective date of the remapping.[4]

In addition to the premium rate adjustment reform, the legislation imposes minimum deductibles on flood claims. The minimum annual deductible for a pre-FIRM property is $1,500 if the property is insured for $100,000 or less, and $2,000 for a property insured for more than $100,000. The minimum annual deductible for post-FIRM properties is $1,000 for properties insured for $100,000 or less, and $1,250 for properties insured for more than $100,000.[5]

The law includes language, supported by the NAIC, requiring FEMA, at a state's request, to participate in state-sponsored non-binding mediation to resolve insurance claim disputes. Non-binding mediation has a proven record that will allow the NFIP, insurance companies and policyholders to settle claims quickly outside the expensive and time-consuming litigation process.

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[1] Biggert-Waters Flood Insurance Reform Act of 2012, H.R. 4348, S. 100205.
[2] Biggert-Waters Flood Insurance Reform Act of 2012, H.R. 4348, S. 100211.
[3] Biggert-Waters Flood Insurance Reform Act of 2012, H.R. 4348, S. 100205.
[4] Biggert-Waters Flood Insurance Reform Act of 2012, H.R. 4348, S. 100207.
[5] Biggert-Waters Flood Insurance Reform Act of 2012, H.R. 4348, S. 100210.

Additionally, the new legislation requires FEMA to establish a reserve fund to help meet future obligations of the NFIP in higher-than-average loss years. The reserve fund will phase in a reserve ratio or balance equal to 1% of the sum of the total potential loss exposure of all outstanding flood insurance policies in force during the prior fiscal year. Furthermore, the legislation authorizes FEMA to establish, increase or decrease the amount of aggregate annual insurance premiums to be collected to maintain the reserve ratio and to place an amount not less than 7.5% of the reserve ratio into the fund until it is fully capitalized. If the NFIP is not able to make the minimum contribution, it must report this to Congress. The reserve fund will be phased in at the beginning of the 2013 fiscal year.[6]

Establishing a reserve fund is important in light of the fact the NFIP has been operating under a deficit for a number of years. This deficit can be attributed primarily to the 2005 hurricane season (Hurricanes Katrina, Rita and Wilma), a time in which the NFIP had to borrow approximately $17 billion from the U.S. Treasury. The legislation includes a provision requiring FEMA to repay the flood insurance debt incurred to date. FEMA is charged with creating a debt repayment schedule and reporting its progress every six months. FEMA is also required to submit a report to Congress on the options available to the agency for eliminating the debt within 10 years.[7]

Another section of the legislation establishes a Technical Mapping Advisory Council to address map modernization issues. The council is to include representatives from FEMA, various federal agencies, state and local governments, as well as experts from private stakeholder groups. This council is responsible for suggesting improvements regarding accuracy, general quality, ease of use, and distribution and dissemination of flood insurance rate maps. Recommending mapping standards and guidelines for improving these maps are also included in the scope of this legislation. The council will also be required to provide standards for data accuracy, data quality, data currency and data eligibility, in addition to maintaining and recommending maintenance of flood insurance rate maps and flood insurance risk identification on an ongoing basis.[8] Annual progress reports to Congress are required.

In line with the Technical Mapping Advisory Council, the National Flood-Mapping Program is to be established by FEMA to review, update and maintain flood insurance rate maps, including all areas within the 100-year and 500-year floodplains and residual risk areas. Additionally, FEMA is charged with enhancing communication and outreach to the states, local communities and property owners regarding mapping changes and mandatory purchase requirements. This program establishes a process for local communities to request a remapping based on the standards recommended by the technical mapping advisory council.[9]

The new law requires a number of reports and studies on a broad range of issues aimed at greater accountability, oversight and transparency. The U.S. Treasury Department's Federal Insurance Office (FIO) is required to conduct a study on the current state of the market for natural catastrophe insurance and report to Congress no later than one year after the enactment of the bill. FEMA has been charged with an annual report regarding the NFIP financial conditions and a study of participation and affordability issues.

Another report that is of particular interest requires FEMA and the U.S. Government Accountability Office (GAO) to assess options for privatizing the NFIP. The legislation requires reporting on reinsurance assessment, by assessing the capacity of the private reinsurance, capital and financial markets to assist communities, on a voluntary basis, in managing the full range of financial risks associated with flooding by requesting proposals to assume a portion of the insurance risk of the NFIP.[10] The GAO is also charged with conducting a study regarding business interruption and additional living expenses coverage, as well as investigation of reinsurance/privatization initiatives. The law contains definitive deadlines for select provisions that the NFIP must adhere to, and although FEMA will be working with Congress, it might be a challenge to meet all of the deadlines.[11]

◆ CIPR FLOOD INSURANCE REFORM SUMMIT

The CIPR Flood Insurance Reform Summit was hosted by Mississippi Insurance Commissioner Michael Chaney, chair of the NAIC's Property and Casualty Insurance (C) Committee. Speakers included Edward Connor, deputy associate administrator for federal insurance, Department of Homeland Security, FEMA; Howard Kunreuther, professor of operations and information management and co-director of the Risk Man-

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[6] Biggert-Waters Flood Insurance Reform Act of 2012, H.R. 4348, S. 1310A.
[7] Biggert-Waters Flood Insurance Reform Act of 2012, H.R. 4348, S. 100213.
[8] Biggert-Waters Flood Insurance Reform Act of 2012, H.R. 4348, S. 100215.
[9] Biggert-Waters Flood Insurance Reform Act of 2012, H.R. 4348, S. 100216.
[10] Biggert-Waters Flood Insurance Reform Act of 2012, H.R. 4348, S. 100232.
[11] Biggert-Waters Flood Insurance Reform Act of 2012, H.R. 4348, S. 100233.

agement and Decision Processes Center, Wharton School of Business, University of Pennsylvania; Jeff Czajkowski, Travelers research fellow and Willis Re research fellow, Risk Management and Decision Processes Center, Wharton School of Business, University of Pennsylvania; Peter Kochenburger, director of graduate programs and associate clinical professor of law, University of Connecticut School of Law; Sonja Larkin-Thorne, NAIC funded consumer representative; Patty Templeton-Jones, chief operating officer, Fidelity National Insurance Services; Jennifer Rath, chair, Insurance Institute for Business and Home Safety (IBHS) Flood Committee; and Stuart Mathewson, Chair of the Flood Insurance Subcommittee and Co-chair of the Extreme Events Committee of the American Academy of Actuaries.

Providing the federal viewpoint, Connor summarized the newly passed reauthorization of the NFIP and focused on mandated rate increases. Connor stressed that, while these increases are necessary, they might be a shock to policyholders. Communication of the rate increases should be clear, provided in advance and as frequently as possible to alert the public and allow consumers time to adjust to the coming changes.

Connor also remarked on the provision that requires FEMA to establish a reserve fund to help meet the future obligations of the NFIP. Connor noted that this would be difficult to work on until the NFIP debt, currently estimated at more than $17 billion, is retired. The NFIP had been self-sustaining, to the extent that, if the program borrowed money from the U.S. Treasury, it was able to repay that debt. However, the 2005 hurricane season pushed NFIP's debt to $20 billion. The NFIP was able to pay back $4.3 billion of the debt in interest and principal by renegotiating the interest rate with the Treasury and because of recent mild hurricane seasons. With revenue of $3.4 billion, Connor said the NFIP would need to be without flood losses for 35 years to repay the current debt.

Providing an academic viewpoint, Kunreuther proposed that, rather than subsidizing premiums and increasing rates by 25% until premiums meet the full actuarial cost, the NFIP should immediately implement actuarially sound rates and offer a voucher so the consumer can see what the actual rate should be. This way, rates would immediately reflect risk, the vouchers would only go to those needing special treatment and homeowners would know their premiums would be stable. Another recommendation was to tie flood policies to the property, not the individual, possibly assessed through property taxes, although practical application might be difficult.

A January 2012 white paper drafted by the Wharton Risk Center, CoreLogic and SwissRe was also discussed by Czajkowski. The paper attempted to quantify what private insurance rates would look like and how risk-based premiums would be affected by mitigation efforts. The study found that NFIP premiums both underpriced and overpriced risks and that private market participation could increase take-up rates.

NAIC funded consumer representatives reflected that the new NFIP modernization act had many positives, and although it will be a hard message to convey, it is not anti-consumer to allow the program to charge actuarially sound rates. Kochenburger praised the updating of the flood maps and focus on mitigation; however, he said there was not enough focus on consumer education to inform homeowners. Larkin-Thorne noted that many lenders use the CoreLogic models to rate flood risk, which includes everything within a flood prone area, and so the cost of a NFIP policy can increase disproportionately if, for example, only 10% of a property is a flood hazard. Larkin-Thorne also stressed that flooding is not just a coastal problem, but a national problem. She noted that, even in the Midwest, 10% of homes are in floodplains.

Larkin-Thorne went on to say that she feels privatization is not the answer. She strongly encouraged empowering local governments to mitigate losses, even to the extent of allowing the states to reclaim high-hazard lands instead of allowing homeowners to continually rebuild and suffer losses. Long-term stability is critical, and Larkin-Thorne encouraged the use of guaranty funds and reinsurance to stabilize the NFIP. She concluded with a reminder of the importance of consumer education and agreed with the Wharton Risk Center's suggestion on multi-year policies, tied to property taxes.

The final session was devoted to industry insight. Templeton-Jones spoke from a perspective of a monoline flood insurer; she recognized that, without rate increases, while burdensome on consumers, the health of the NFIP and real estate are at risk. One of the challenges with the NFIP reform law will be to improve communication with the public, especially related to rate increases and flood maps. She also stressed the importance of cooperation between agencies, companies and regulators to make the program a success.

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Rath offered a perspective from companies that offer flood as an ancillary line. Rath noted that most companies that would have the capital and resources to enter the private market already write the NFIP business and sign a "non-compete" clause to not offer a private policy. Out of more than 2,000 property/casualty insurers,[12] there are only 85 write your own (WYO) companies writing coverage due to the complexity, lack of data and low-frequency/high-severity risk of the line. Companies want to have the law of large numbers apply in order to have a good, viable rate, and would need a large amount of capital when insuring such a catastrophic risk. Another challenge she mentioned was a company's inability to set building codes, as FEMA can, to help mitigate losses. Even if privatization occurs, FEMA and NFIP would still be needed as an insurer of last resort for the pool of high-hazard risks.

Finally, Mathewson stressed the actuarial principle that a rate should reflect the hazard of the insured risk. Rates are also required to be reasonable, not unfairly discriminatory and actuarially sound. He supported removal of subsidies and mentioned that, currently, NFIP excludes catastrophic event years like 2005 in its rate experience, which, if they were added, would double the rates. Mathewson agreed that some privatization would be beneficial and would bring more coverage, more data and more premiums into the program, and encouraged the use of reinsurance. He also reflected that, without debt forgiveness, building a reserve fund is not practical.

◆ SUMMARY

In light of the reforms provided by the Biggert-Waters Flood Insurance Act of 2012, there are many challenges that exist as these changes are implemented. While premium rate reforms are necessary, policyholders will likely be surprised by the premium increases. The Wharton Risk Center has suggested implementing actuarially sound rates immediately and offsetting the increased cost to consumers by using a temporary voucher system. This approach would provide consumers with the actual rate increase information immediately, while offsetting the financial impact of the increase over a period of time. Regardless, clear and frequent communication between FEMA and flood insurance policyholders in advance of these changes is key in allowing consumers time to adjust. For many consumers, their home is the single-largest investment they will make in their lifetime. It is imperative for the consumer to understand the importance of purchasing flood insurance to protect their home in the event of a flood. It is also necessary to relay information regarding flood insurance to residents of inland, as well as coastal, states.

Repayment of the current debt, as well as establishing a reserve fund, could prove to be a difficult task. However, long-term stability of the NFIP is critical to the success of the flood insurance program. The use of reinsurance may contribute to making these reforms successful. Once the studies required by the legislation are complete, there will be some indication as to whether reinsurance and possible privatization of the NFIP would be beneficial. There is much work to be done to implement the reform of the NFIP, and it will take some time to put these reforms into practice.

More information on the Biggert-Waters Flood Insurance Reform Act of 2012 can be found at the U.S. Library of Congress, by searching for the bill summary for H.R. 4348.[13] In addition, an NAIC executive summary can be found on the CIPR website.[14]

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[12] NAIC, *Insurance Department Resources Report* (2011), 37.
[13] http://thomas.loc.gov/home/thomas.php
[14] www.naic.org/documents/cipr_events_2012_cipr_summit_overview.pdf

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