

SUMMARY: The National Academies Affordability Study of March 2015

Rebecca Elliott

April 3, 2015

On March 26 of 2015, the National Academy of Sciences released the first of two reports on flood insurance affordability. This explainer summarizes the key takeaways from the first report, and provides a bit more background on its objectives and content.

Why was this study conducted?

The mandate for the study came out of the hotly debated Biggert-Waters Flood Insurance Reform and Modernization Act of 2012 (henceforth BW12), which required that the National Flood Insurance Program (NFIP) gradually shift all policies to risk-based rates. This amounted to the elimination of certain longstanding discounts within the NFIP, which have kept flood insurance premiums to “reasonable”—and therefore relatively affordable—rates.

When policymakers were debating various plans for flood insurance reform in 2010 and 2011, they knew that removing these discounts could potentially create a financial hardship for low- and middle-income homeowners in the flood zones, and for those newly “mapped in” to flood zones. Both categories of homeowners could see their rates rise rather dramatically. In the BW12 legislation, members of Congress added Section 100236, calling on FEMA to initiate an “affordability study” that would consider methods to “aid individuals to afford risk-based premiums under the National Flood Insurance Program through targeted assistance rather than generally subsidized rates, including means-tested vouchers.” The National Research Council of the National Academy of Sciences convened a Committee on the Affordability of National Flood Insurance Program Premiums, comprised of social scientists, flood experts, and statisticians.

Many have been eagerly awaiting the findings of the Committee because we have already gotten a glimpse of how changes to flood insurance can affect individuals and communities. BW12 did *not* indicate that the affordability study needed to be completed *before* FEMA could begin implementing rate increases. As a result, exactly what policymakers thought might happen, happened: homeowners started hearing about premium increases and there was national outcry surrounding issues of affordability and the continued economic vitality of affected communities. In response to this outcry, Congress intervened again, passing the Homeowner Flood Insurance Affordability Act of 2014 (HFIAA). The Act reinstated some discounts, and slowed down the increases for others. The HFIAA reiterated the mandate for the affordability study, and commits FEMA to creating an “affordability framework.”

What is in this report?

The 137-page report is quite comprehensive. The NFIP is a complex program with a complicated history, and the report clearly explains the reasons that we find ourselves in such a predicament with flood insurance at the present moment; it also offers some ways to think about paths forward. The first few chapters cover the history of premium setting prior to BW12 and how BW12 proposed to increase premiums. The report then goes into some of the issues surrounding “take up,” i.e. demand for flood insurance policies, and explores whether increasing premiums

will lead property owners to avoid or drop coverage. The authors then provide a detailed set of figures to capture the geographic distribution of flood insurance policies, to consider where the affordability problem will be experienced, and where it will be most pronounced. Finally, they turn squarely to the affordability question, with two final chapters that provide a framework for developing affordability options and identify some policy alternatives.

What are the key takeaways from the report?

1. *While there are different ways to measure the cost burden on property owners and renters from purchasing flood insurance, there is no objective threshold for “affordable” or “affordability,” and it does not mean the same thing as “reasonable.”* Decisions related to the affordability of flood insurance will inevitably be political ones, which imply judgment calls and tradeoffs. “Affordability” pertains to each policyholder’s ability to pay after considering wealth and income. A “reasonable” premium in regards to risk is not necessarily an “affordable” premium from the standpoint of a given property owner.
2. *The NFIP’s multiple, often competing, policy objectives have structured the present difficulty with flood insurance affordability.* For instance, the objective to have “risk-based” premiums that signal risk and earn enough to cover claims and expenses can be incompatible with the objective to ensure “reasonable” premiums for all (i.e. when the risk—and thus the premium—is quite high).
3. *We actually do not really know how removing discounts, as BW12 intended, will affect the overall financial health of a) affected policyholders, or b) the program as a whole.* Because FEMA does not have data on 1) how many properties are currently paying grandfathered rates, or 2) building elevations for pre-FIRM policies, we cannot really be sure how much higher risk-based premiums will be. It could be large increases, but we cannot say for certain.
4. *Because people are not really rational actors, we do not have a good understanding of how their demand for flood insurance does or will respond to increases in premiums.* The NFIP was designed to encourage policy take up via “reasonable” rates, but it is not clear that this is really doing the job. We need a multipart strategy to encourage the purchase of coverage.
5. *Changes to flood insurance policies will be realized nationwide, but their effects are geographically concentrated.* About 19 percent of policyholders are paying subsidized pre-FIRM rates *program-wide*. But pre-FIRM policies might apply to a large percentage of households in any *one* community—meaning the effects on those communities would be particularly dramatic. California, Texas, New York, and Florida have the largest populations, as well as large numbers of pre-FIRM subsidized policies.
6. *Affordability can be approached with capped premiums (i.e. keeping premiums below a certain percentage of coverage), income considerations (i.e. below a certain income threshold), or housing cost calculations (i.e. below a certain percentage of income spent on housing costs, including flood insurance).* Each approach would establish slightly different eligibility criteria for an affordability program.
7. *Policymakers also have to decide who will receive assistance, what type of assistance will be provided and how much, how it will be provided, who will pay for the assistance, and how it will be administered.* Will eligibility be based on being cost burdened by flood insurance, on loss of pre-FIRM premiums, on community characteristics, on requirement to purchase flood insurance, on mitigation efforts, or on some combination of these? Or on something else entirely? Will the program simply help property owners afford flood insurance, or can it also

go towards supporting mitigation? Will assistance take the form of vouchers, grants, loans, discounts, tax credits/refunds, buyouts, or some combination? Will there be minimum and maximum amounts of assistance and how will the precise amount be determined? How will the cost of such a program be distributed across local, state, tribal, and federal entities, as well as supported by taxpayers versus policyholders? Will FEMA be solely in charge, and what will be the role of the Write-Your-Own (WYO) insurers? All of these decisions involve tradeoffs that must be weighed and resolved.

The report concludes with in-depth consideration of three broad policy options for providing assistance:

1. Direct financial assistance to homeowners, either for mitigation actions that reduce the cost of flood insurance (e.g. elevating a home), or for the costs of premiums directly.
2. NFIP program reforms, which could reduce the cost of flood insurance for all policyholders through changes to NFIP structure and requirements.
3. Community-based programs.

Direct financial assistance to homeowners could take a variety of forms, which the report discusses in turn. Existing mitigation grant programs could be reformed to prioritize helping the most cost burdened homeowners, perhaps by replacing the existing cost-benefit criterion with a means-tested one, or by identifying households that are losing pre-FIRM subsidies and facing an affordability challenge, or by reforming post-flood mitigation funding to establish lower premiums as soon as the mitigation project is *approved* (i.e. rather than having to wait for the project to be completed to start paying less for flood insurance). Mitigation loans could help low-income households afford the high upfront costs of undertaking mitigation and realize lower annual premiums thereafter. Means-tested vouchers could help homeowners pay their annual premiums, as well as offset payments for mitigation loans. Tax deductions or credits, as well as disaster savings accounts, would ease the cost burden, but only for those owing taxes; the financial benefits of these options are more substantial for higher income policyholders.

NFIP program reforms could reduce flood insurance premiums program-wide through expanding the range of mitigation measures (i.e. money-saving options beyond elevation), raising deductibles, designating the Treasury as a reinsurer during catastrophic loss years (i.e. preventing the NFIP from going into debt), enhancing the WYO agent advisory role (i.e. have agents assist homeowners with mitigation options), reducing the administrative costs of the program (i.e. the amount going to WYOs, which the authors seem skeptical can change very much), and eliminating the mandatory purchase requirement (the authors warn against this).

Community-based programs could lower costs for entire communities through enrollment in the Community Rating System (CRS), which offers premium discounts when the participating community implements floodplain management activities that exceed the NFIP minimum. Expanding the CRS would bring benefits to more policyholders. In the past, policymakers have also considered community-level insurance policies, which would automatically insure all community members and would be supported by special assessments on each covered property; FEMA is preparing a report on this option now.

The authors note that some of the above options could be combined in different ways.

What can we expect next?

Another report! The second report will propose analytical procedures with which FEMA might conduct an analysis of policy options. The report is expected sometime around September 2015.

It is important to note that these reports are proposals only, and are not explicitly connected to any existing mandates for implementation. For anything proposed in these reports to become a real program, Congress will likely have to take further action.