

Special report: Irene wallops flood insurance program

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By Ben Berkowitz

NEW YORK (Reuters) - The only thing worse than getting flooded out of your home once is getting flooded out of it twice. Or, for that matter, over and over again.

Margaret Wert bought her Wayne, New Jersey house in 1999, relying on assurances from her realtor that any occasional flooding would only amount to an inch or two of water. A week after closing, Hurricane Floyd put four feet of water in her basement.

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Earlier this year, Wert, 45, got flooded again and received a payout of \$5,000 on her government flood insurance, which costs her \$1,200 a year. It wasn't enough to cover her bills, but it helped with the new stove, refrigerator and boiler.

But all of Margaret Wert's new appliances and much of her house are now ruined, after Hurricane Irene flooded broad swathes of New Jersey. This time, though, she has a message for the government insurance program.

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"If they don't buy me out and give me what I want, I am going to walk away, and they can keep it. I will tell the insurance company 'give the check to the bank.' You can do the repairs. You can live there in mold, you can live there in

smell, I am done."

In the United States, uniquely in the developed world, insuring homeowners against flood damage is the sole province of the federal government. The National Flood Insurance Program (NFIP), which is administered by the Federal Emergency Management Agency, is virtually the only place to get protection against the disasters of flood and storm surge.

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The problem is that the NFIP is a disaster itself, hanging on by a series of hard-fought annual extensions and the subject of a stalled reform bill in Congress. Only six years ago, taxpayers had to bail out the program after losses from Hurricane Katrina proved too much to handle.

But bailouts are not popular in Washington these days. With Congress locked in battle over the national deficit and recessionary fears looming, House Republicans are already warning that any extra money spent needs to be offset by cuts.

While Hurricane Irene was not as strong as Katrina, it has caused severe and widespread flooding in some of America's most populated - and most expensive - areas. The storm killed at least 38 people in 11 states, in addition to three who died in the Dominican Republic and one in Puerto Rico.

In New Jersey alone, Governor Chris Christie has estimated losses could be in the tens of billions of dollars. The state has nearly \$52 billion in flood insurance in force from the NFIP.

The question is whether the NFIP can handle it, and whether the losses it faces from Irene are enough to spur the U.S. Senate into passing a major reform bill that made it through the House of Representatives last month.

Moreover, if climate change believers in the insurance industry are right, and the environment is changing in unpredictable and severe ways, the flooding that results could worsen an already bad situation for the NFIP and for homeowners.

"What I do regret tremendously is because the federal government can undercut the private sector, it is now the only insurer in the floodplain management arena," said Joe Allbaugh, the former director of FEMA under President George W. Bush, who now runs his own disaster management company.

"It spends most of its time in the red. That's because it's another government program (where) the premiums that are charged are way under market value, in my opinion."

HISTORY

The NFIP dates to 1968, when Congress created it to help offset flood damage in quickly developing parts of the country, as well as to give communities an incentive to manage their flood risk more effectively.

From an insurance standpoint, the program is much like any other private-sector program: pay the government a certain amount and when a flood happens, receive coverage for repairs. As of June 30, the program had nearly 5.6 million policies in force with a total insured value of \$1.246 trillion.

But from a fiscal standpoint FEMA does not manage the NFIP like a traditional insurer. Most insurers use a measure of solvency that looks at their capital and reserves and their ability to pay claims. In particular, regulators require insurance companies to keep a statutory reserve of liquid assets to cover potential future losses.

FEMA, on the other hand, has said it manages the NFIP to generate enough premiums to cover expenses and losses for an average loss year, rather than keeping capital for the long term. Even former agency officials admit it charges rates that dramatically underprice the risks faced.

That is all well and good in a normal year and when business is good, but when a worse-than-average loss year happens, the consequences are disastrous.

After Katrina and Rita struck in 2005, the NFIP was more or less insolvent, without the capacity to pay the huge volume of claims those hurricanes created. Congress reacted by increasing the NFIP's borrowing ability from the U.S. Treasury more than 13-fold, to a level of nearly \$21 billion.

That debt burden is, by all accounts, unsustainable. The Government Accountability Office, in a late-2006 report, said FEMA would never be able to pay off the NFIP's debts given the level of business it was doing at the time.

While Irene was no Katrina, it comes on top of serious Midwestern flooding that the program has already had to deal with this year. Some people believe NFIP will stretch its debt boundaries and may well end up needing more assistance.

"It may be a little bit too soon to tell but it's certainly not going to be a very good year for the NFIP and we've not finished the year yet," said Robert Hartwig, an economist and the president of the Insurance Information Institute.

Hartwig said a private insurance market for flood coverage is absolutely possible, with plenty of insurers and reinsurers willing to get into the business -- but only if the NFIP raises its rates and if insurers get assurances

from state regulators that they will be able to do the same.

But failing those changes, the NFIP will remain the only game in town. If its already unsustainable indebtedness gets any bigger, that leaves two potential solutions to the problem: make the program bigger or forgive the debt.

SMALL AND STAYING THAT WAY

The flood program would seem to have ample room to grow, given that fewer than one in 20 American households have a policy.

It is also cheap for most people. The former FEMA director Allbaugh calls it one of the best buys for taxpayers, and with average annual premiums of less than \$500, it's hard to argue.

And yet take-up is and has been anemic. Many people who buy flood insurance do so only because their mortgage lender requires them to do so as a condition of their loan. Many of them, insurance agents say, take the first opportunity they can to let the policy lapse.

"We are seeing a definite uptick in policies that are being non-renewed because people just can't afford it," said Patty Templeton-Jones, vice president of operations and principal NFIP coordinator at Fidelity National Indemnity Insurance Co., which is the largest writer of flood insurance policies in the United States. The NFIP largely uses private insurance companies to write and administer policies on its behalf, paying them a fee for the service.

Templeton-Jones said there is no question that Fidelity National and other flood insurance writers will see business pick up in the near term, but there is also little doubt that many of those new customers will let their policies go in

two to three years, absent another disaster in their area.

Therein lies the problem, for the government and for communities that are already financially strapped: people just do not see the point of a flood policy.

Among them are Kevin Putnam's parents. Their Brattleboro, Vermont house is now full of water, thanks to Hurricane Irene, and the potentially crushing burden of rebuilding could be stuck on their shoulders. "They have been here 50 years and this is the first time this has happened," Putnam said. "The premium just isn't worth it."

Take that sentiment, multiply it across an entire town, and the result is nothing less than financial disaster.

"It's a small state and we're overwhelmed," Brattleboro, Vermont town manager Barbara Sondag said. The state suffered its worst flooding in 80 years, with some 260 roads damaged or washed away entirely in the storm.

According to NFIP data as of June 30, Vermont ranks 47th of the 50 states in the number of flood policies in force, with just 1.5 percent of households covered.

In Brattleboro there are all of 99 policies on the books for a town of more than 12,000 people. Insurers like Fidelity National say there are some limited FEMA loans those people may be able to apply for, and even more limited (in size and availability) grants. But by and large, they are on their own.

REFORM BATTLE

If FEMA can not find a way to generate more revenue, then the only other hope for dealing with its debt is political reform. As with anything else in Washington, that is easier said than done.

In July, the U.S. House of Representatives, in a rare display of overwhelming bipartisan unity, passed an NFIP reform bill on a 406-22 vote.

The U.S. Senate, faced with the September 30 end of the current legislative session, will almost certainly not even bring that bill, or its own differing version, to a vote.

The House bill would make changes to requirements for mandatory flood purchase, as well as long-sought reforms to both the terms and rates of flood policies.

The Senate, on the other hand, is focused on its own measure, modeled on one that passed in 2008 but went nowhere thereafter. One of the cornerstones of that bill, unusually enough in the current deficit-cutting environment, is forgiveness: writing off the NFIP's unsustainable debt entirely and essentially starting the program over from scratch.

"There is no solution that doesn't gore somebody's ox," said Drew Sachs, vice president of disaster services at Witt Associates and an eight-year FEMA veteran himself.

But the man who ran the flood program during the Katrina bailout, and who spent 25 years running his own insurance agency, said the solution should be obvious.

"The debt should have been forgiven five years ago. The debt was an obligation of the federal government. The program did exactly what it was designed to do," said David Maurstad, who was administrator of the NFIP from 2004 to 2008.

Maurstad, who is now the national director of water policy and planning for infrastructure services company Atkins North America, said it made little

sense for the government to bail out insurers like AIG during the financial crisis and yet leave its own insurance program with an unsustainable debt.

Yet neither chamber is even close to agreeing with the other, which means that sometime before September 30, Congress is likely to do what it has done annually in recent years -- pass a one-year reauthorization for the NFIP that solves nothing but lets the program stay in business.

"Irene will highlight the need for renewal (of the NFIP), but it will not remove the obstacles to passage," said Robert Gordon, senior vice president for policy at the Property Casualty Insurers Association of America.

The other complication is immediate cost. If NFIP does need more money, House Republicans quickly made clear those funds would have to be at the expense of something else.

"We'll find other places to save so that we can fund this kind of role that the federal government needs to play," House Majority Leader Eric Cantor told Fox News this week. "In instances like this, yes, there's a federal role, yes, we can find the money. We're just going to need to make sure there are savings elsewhere to continue to do so."

LEGAL FIGHT AHEAD

People who were flooded have 30 days from the storm's impact to file claims. When they get paid, though, will depend in large part on whether the NFIP accepts their claims or not.

(For answers on insurance coverage questions, see: "Are you covered?" - link.reuters.com/hag53s)

One of the problems that is likely to emerge in "Irene country" is one that people in Texas, Louisiana and Florida already know all too well -- the legal

conundrum of wind versus flood.

Simply put, in many cases an insurer will tell a homeowner their damage was caused by flood, and to call FEMA. In some cases, FEMA will tell the same homeowner that no, their damage was caused by wind, and instruct them to call the company that provides their homeowners' insurance.

Enter the lawyers.

"There's a big issue under homeowners' insurance, and I would say maybe the most common issue, would be causation," said Robert Berg, an insurance litigator and partner at Michelman & Robinson in San Francisco.

"It's a problem with the legal process. If you have somebody at your house and they're doing work, a contractor will say 'It's not my fault, it's the other contractor's fault.' It's the same thing."

Berg and other attorneys say the legal issue of causation is, especially after Hurricane Katrina, fairly well defined in the more traditionally hurricane-prone parts of the country.

But in the northeast, where for some places a hurricane is a once-a-century event, the case law does not yet exist.

"Because there hasn't been as much litigation in the Mid-Atlantic and Northeast as there has been down south, it's hard to say," said Barry Buchman, an insurance litigator with Gilbert LLP in Washington.

Michelman & Robinson's Berg said in a situation like this, the law may well be written on the fly.

"If it's really horrific and you get enough attorneys involved, then they'll think of ways to create coverage," he said.

STRUGGLING TO SURVIVE

While politicians and lawyers battle over who pays, it's the homeowners who suffer.

According to catastrophe modeling company Eqecat, Irene was an unusually wide, wet and slow storm, which made for ideal flooding conditions in parts of the northeast that had already experienced one of the wettest Augests ever.

For people who live in New Jersey and suffered flooding damage earlier this year, having to suffer it again - and deal with insurance claims all over again - may be too much to handle.

Jonathan McNamara of Fairfield, New Jersey, said his parents just got their insurance checks a week ago for flooding from March, and now their home is flooded again.

"They have given us money but getting it is a whole other story," said McNamara, 22, who lives with his parents. "It's very time consuming and a very frustrating process."

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