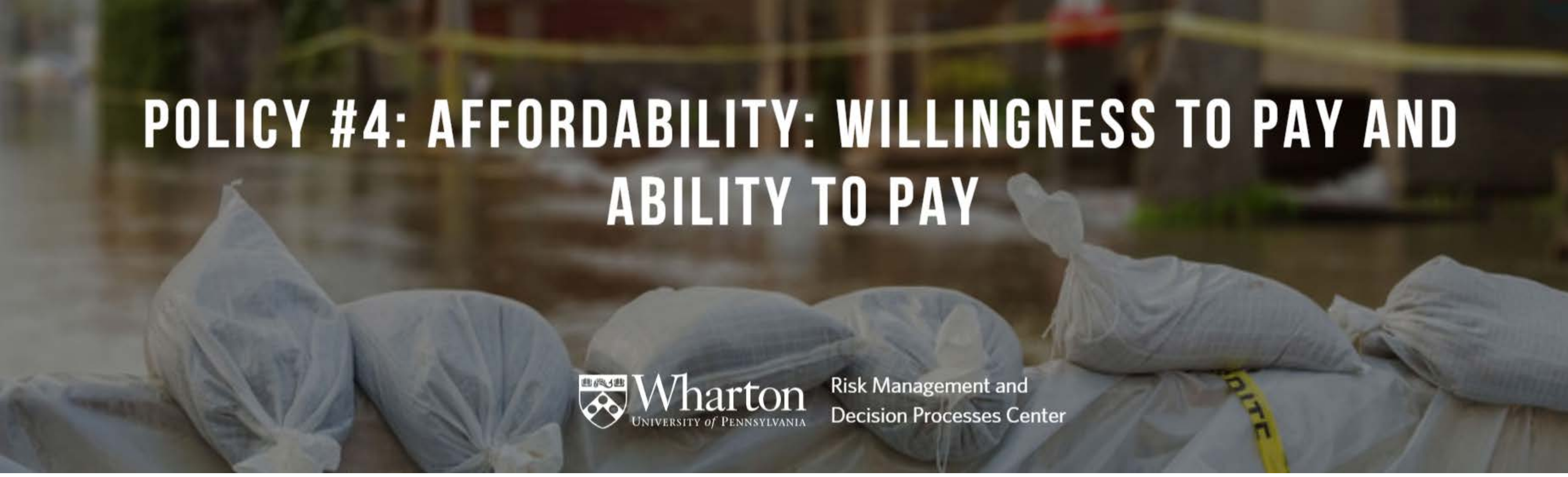
POLICY #4: AFFORDABILITY: WILLINGNESS TO PAY AND ABILITY TO PAY



The cost of flood insurance may be a deterrent to purchase. There are two separate, but sometimes conflated, policy questions related to price and the flood insurance coverage gap. First, does paying the flood insurance premium create financial hardship for a household, as a property owner or as a renter? This is the concern about property owners' and renters' *ability to pay* a flood insurance premium. Second, do property owners or renters believe that flood insurance is worth the premium charged by the insurer? This question focuses attention on property owners' and renters' *willingness to pay* to pay for coverage. Differentiating these concepts is important as policy responses differ.

Discussion Question 1: Should the focus on closing the insurance coverage gap be on low and moderate income (LMI) property owners and renters? Why or why not?

The ability to pay concern often is expressed in tandem with concerns about increasing flood insurance premiums, especially for those facing the mandatory purchase requirement. Multiple reports have now been written on this topic.[1] This summer, FEMA published "A Flood Insurance Affordability Framework for the NFIP."[2] The framework report finds that there are 5.1 million households – owners and renters – in the nation's SFHAs but only 1.8 million of them have an NFIP policy. Of note, is that LMI households are less likely to have an NFIP flood policy. The 1.8 million households in an SFHA <u>with</u> a policy have a median household income of $77,000 per year. The 3.3 million <u>without</u> a policy have a median household income of $40,000, or about ½ of those with a policy. The report also found that 60% of the 3.3 million <u>without</u> an NFIP policy are low or moderate income households as defined by the Department of Housing and Urban Development. Whether this low LMI household take up rate is the result of a limited ability to pay, or unwillingness to pay, cannot be determined. However, it is the case that asset poor LMI households are least able to recover after a flood, or take pre-flood risk reduction actions.

Discussion Question 2: What funding strategy for an LMI assistance program is most practical and most likely to be authorized and funded?

The affordability framework report describes alternative criteria for determining eligibility for financial assistance with insurance purchase and mitigation costs and presents assistance program design options. The common characteristic among the options is that a purchaser of insurance pays for coverage or mitigation up to some means-tested threshold. From the perspective of the eligible purchasers, they receive a premium discount if you tell them what the risk-based premium is. The NFIP now offers other premium discounts, such as for CRS participation or for grandfathering and the discount is, in effect, a subsidy that must be paid for. If FEMA ran the affordability program, funding could come from increasing NFIP premiums across the board (a cross subsidy), or from a direct treasury transfer to the NFIP (or occasional loan forgiveness). If another agency ran the program, it would require a direct treasury payment to that agency for the administrative costs of the program and for the subsidy payments. Other policy options include a tax credit approach or encouraging non-Federal entities to help support an affordability program (one House reform bill assigns this responsibility to the states).

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[1] For example: National Research Council (2015). Affordability of National Flood Insurance Premiums: Report 1. Washington, DC, National Academies Press; Dixon, L., N. Clancy, B. M. Miller, S. Hoegberg, M. Lewis, M., B. Bender, S. Ebinger, M. Hodges, G. M. Syck, C. Nagy and S. R. Choquette (2017). The Cost and Affordability of Flood Insurance in New York City: Economic Impacts of Rising Premiums and Policy Options for One- to Four-Family Homes. Santa Monica, CA, RAND Corporation.

[2] FEMA (2018). An Affordability Framework for the National Flood Insurance Program. Washington, DC, Department of Homeland Security, Federal Emergency Management Agency.

The question remains of how much an assistance program would help increase demand for flood coverage. To do so it may need to include policyholders outside the SFHA. There may be limited administration and Congressional interest in creating a new freestanding entitlement program, with uncertain future budget exposure if eligibility for the discount is extended beyond those who currently have a policy. On the other hand, if assistance is limited to current policy holders this may have less impact on closing the flood insurance gap.

Discussion Question 3: What is the relative importance of the insurance premium on people's willingness to purchase insurance?

As noted above, many households that could afford to buy flood insurance don't see the value in it; they think it is "not worth it" given other ways the same amount of money might be used. One often cited reason households are not willing to buy flood insurance, even if they might afford some coverage, is that they feel the price is "too high." In fact, the possibility of lower premiums is a central argument made by advocates for encouraging the private sector to compete with the NFIP. There is limited research evidence reporting on how the level of premiums, or how changes in premiums, affect purchase decisions. What has been noted is that the number of properties with an NFIP policy declined after BW and HFIAA increased premiums, suggesting that price matters, but whether this price effect is the result of willingness to pay or ability to pay remains an open question. Also, we know that private insurers have targeted their policy marketing to areas where they feel they can charge a premium that is lower than that charged by the NFIP, suggesting that they believe that price matters to the purchase decision.

While lower prices might encourage households to buy a policy, the decision of whether to buy flood insurance coverage may depend on more than its price. Other breakout sessions at this workshop will explore some of the possible reasons. One session will discuss the possibility that some believe flood already is covered in their homeowners policy – over 40% in one III survey believe that. Another will consider how "rules of thumb", or heuristics, result in inaccurate perceptions of the likelihood or consequences of a flood. Another will consider whether confusion about the coverage offered by the NFIP policy makes it unattractive to purchasers and difficult for agents to market. Other possible reasons people don't buy flood insurance are:

- People self-insure. Self-insurance can be a substitute for those who are not asset poor. A property owner or renter can knowingly and rationally choose self-insurance as a resiliency strategy, if they have an understanding of the need to deplete savings accounts, cash in equities, take out a loan, or cut back on other expenditures to pay for rebuilding.
- People prefer to use money for investment. Using money for making an investment with expected payback rather than purchasing insurance - a risk transfer service - may be a rational choice, if the difference in the products is understood.
- Public policies cause residual risk to be underestimated and dampen demand. A 1% return frequency was chosen so that there would be regulatory and administrative clarity about where mandatory purchase would be required and where NFIP required land use regulations would apply. However, property owners, renters and local governments ignore the residual risk beyond the SFHA, and do not purchase insurance. Similarly, the residual risk behind levees is often assumed to be zero, discouraging purchase of flood insurance.
- Misperceptions of post flood disaster aid limit insurance demand. People at-risk may not realize that federal disaster aid for households only averages around a few thousand dollars and are only to make a home safe, not bring it back to pre-disaster conditions. And the first line of federal assistance for families is actually a loan. To rebuild back in the manner many LMI households would want, they need an insurance policy.

Discussion Question 4: What are two or three policies or programs that would increase willingness to buy insurance and what would be the barriers to implementing those polices or programs?