

Conceptual Framework-- FEMA Risk Rating 2.0 Needs to Pass the Rational Explanation Test

Principle: Americans believe that when their government makes decisions or establishes policies such actions should make sense and that the government has an obligation to share the thinking and information that supports the decisions or policies. Policies and decisions should be supported by facts and reasonably related to the stated objectives.

Applied to Risk Rating 2.0. Under RR 2.0, which is scheduled to begin on October 1, 2021, FEMA has established the objective of charging flood insurance premiums that more accurately reflect the expected flood damages of each policyholder. They speak of this objective in other terms too such as communicating flood risks to policyholders. The principle applied to this problem would mean that each policyholder would be given a complete, transparent, and accurate explanation of how his premium is estimated to capture his individual expected flood losses in a given insurance year. Flood insurance premiums should pass this *rational explanation test* with full transparency.

What does the rational explanation test mean in the context of NFIP premiums?

- Each policyholder should have access to the flood frequencies or probabilities that are assumed by FEMA in computing her flood insurance premium. There can be no understanding of how the computed premium is reasonably connected to the objective of making the premium a more accurate expression of flood risk unless the policyholder can understand what the flood frequencies for his property are assumed to be and how these probabilities determine his premiums.
- The policyholder should also be presented with data sufficient to determine how much of his proposed premium depends on *observed* flood risk and how much of the premium reflects events, probabilities, and consequences *assumed* to be valid by FEMA but are not fully reflected in the observed record of flood events, probabilities, and consequences. The best way to help policyholders understand the reasonableness of the premium computation is to first compute a premium based upon the observed flood history. Next, FEMA could perform a full accounting of the assumed changes in flood frequencies. Then a proposed premium could be computed and transparently compared to the premium that would apply based on the observed flood history. This comparison would help disclose whether or not the proposed premium is reasonable. All data used in computations should be freely available to the policyholder and the proposed premium should be reproducible if the policyholder is given the data and assumptions used by FEMA. There should be no reliance on proprietary data or methods.

Does FEMA adhere to the principle of rational explanation for RR 2.0?

- FEMA has not met the minimum standards of transparency necessary to assure a policyholder or a taxpayer of the reasonableness of their computation of flood insurance premiums.
- FEMA has placed the computation of flood insurance premiums in the hands of outsiders using obscure models and methods

- FEMA has declined to provide the policyholder with a reproducible flood insurance premium
- FEMA has declined to provide to the policyholder the flood frequencies that are used to compute a policyholder's premium
- FEMA has declined to share with the policyholder a premium based on observation as well as the proposed premium and explain how assumed events, consequences, and probabilities not reflected in observed flood history determine the proposed premium
- FEMA has declined to share the statistical analysis underlying so-called rating factors estimated using statistical methods and the associated confidence intervals or error bands

What are the traditional institutional means that the U.S. uses to ensure that decisions like flood insurance premiums satisfy the “rational explanation” test and protect policyholders?

- **Rulemaking under the Administrative Procedures Act (APA):** FEMA could establish flood insurance premiums using rulemaking. This is the widely accepted method for making government decisions to meet a rational explanation test. The APA provides for transparent public review and comment on proposed agency actions and review of agency proposals by other agencies, including the Office of Information and Regulatory Affairs (OIRA) at the Office of Management and Budget (OMB). FEMA has declined to use this tool even in light of the fact that the APA includes setting prices among the government actions that are considered to be “rulemaking.” FEMA’s omission is difficult to fathom or justify in a context where FEMA proposes to radically change the manner in which flood insurance premiums are computed.
- **Information quality safeguards established by OMB in pursuit of the Data Quality Act.** NFIP is a program that meets the criteria for rigorous data quality standards. In proposing new premiums, FEMA has failed to have its models reviewed by an independent review panel, failed to make the computation of the premiums reproducible, and has employed private contractors to do government functions using propriety information – a process that denies the policyholder any opportunity to review the proposed premiums for reasonableness.
- **Premium Appeals.** In the current implementation of pricing under the NFIP, premiums are computed by reference to flood zones on flood insurance rate maps (FIRMS). Premiums are more or less uniform within flood zones. Communities may appeal the flood zones on these maps, and these appeals are equivalent to appealing the premiums to be charged. Under Risk Rating 2.0, computation of a flood insurance premium is severed from the identification of flood hazard on the FIRM. The FIRM is no longer a “rate map.” The FIRM is merely an indicator of floodplain management, including whether the mandatory flood insurance requirement is to be imposed. Risk Rating 2.0 has eliminated the appeal of premiums. FEMA has not provided a new and viable premium appeal process. This is a serious deficiency that Congress should remedy if Risk Rating 2.0 is to go forward.

- **Public Service Commission Price Regulation.** The foregoing institutions are available now and are in disuse by FEMA in implementing Risk Rating 2.0. This alternative would establish a commission to regulate flood insurance premiums much in the same way that a public service commission regulates utility prices, or a state insurance commission regulates casualty insurance premiums. Congress should consider establishing a commission of state insurance commissioners to review flood insurance premiums proposed by FEMA and recommend whether Congress should approve the rates. We would not dream of a powerful utility company setting water or electrical rates unless approved by a public service commission. The same standard ought to apply to flood insurance premiums.

Conclusion: In implementing the first broad revision of flood insurance premium calculation in over fifty years, FEMA is acting with disregard for the public's rights to understand and be able to reproduce the premiums proposed to be charged. The unprecedented overhaul now being contemplated by FEMA through Risk Rating 2.0 should be delayed allowing for full transparency and participation by the public. Doing otherwise risks precipitous declines in residential and commercial property values and resale, reduction in overall taxable market value, and reduction in local government services or increased tax rates. These potential harms are expected nationwide both in leveed and non-leveed areas and FEMA has produced insufficient underlying data to justify the proposal. Risk Rating 2.0 should be delayed while FEMA remedies these omissions and Congress acts to provide additional safeguards and oversight of NFIP premium setting.