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FLOOD INSURANCE REFORM AND MODERNIZATION ACT OF 2006

JUNE 28, 2006.—Ordered to be printed

Mr. SHELBY, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

R E P O R T

together with

ADDITIONAL VIEWS

[To accompany S. 3589]

The Committee on Banking, Housing, and Urban Affairs, having had under consideration an original bill (S. 3589) to amend the National Flood Insurance Act of 1968, to restore the financial solvency of the flood insurance fund, and for other purposes, having considered the same, reports favorably thereon and recommends that the bill do pass.

INTRODUCTION

On May 25, 2006, the Senate Committee on Banking, Housing, and Urban Affairs considered a Committee Print, entitled "The Flood Insurance Reform and Modernization Act of 2006," a bill to modernize and bring financial solvency to the National Flood Insurance Program, and for other purposes. The Committee voted unanimously to report the bill (S. 3589) to the Senate.

BACKGROUND

Congress established the National Flood Insurance Program (NFIP) in 1968 to provide policyholders with partial insurance for flood related damage. Communities that chose to participate in the program were required to undertake mitigation efforts to limit flood related damage as well as to implement stringent building codes for all new development. The goal of mitigation was to ensure

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that people were protected from flood related damage by requiring that they take steps to increase the durability of their homes. The program was to generate sufficient funds through premium dollars to reduce taxpayer exposure to massive liabilities for disaster-related assistance due to flooding. During its early stages, the NFIP had about 1 million policyholders and covered roughly $50 billion of risk exposure. Many of the stated goals of the NFIP have failed to be met.

At the inception of this program, Congress built in explicit subsidies for business properties and homes known as pre- flood insurance rate map (pre-FIRM) structures. Congress believed that it was inequitable to require all structures to immediately pay actuarial prices given that the owners had no notice that they were within the mandatory purchase area for flood insurance. It was expected that many, if not all of the pre-FIRM structures would be destroyed and rebuilt or mitigated within a reasonable amount of time. Therefore, Congress employed no mechanism to eliminate the subsidy given to these structures at the inception of the program. However, today, despite expectations to the contrary, more than 25 percent of all the structures covered under the flood insurance program continue to remain explicitly subsidized. The Congressional Budget Office estimates the program collects about 60 percent of the premiums needed for actuarial balance, leaving a cost to taxpayers estimated at $1.3 billion per year.

In addition to the explicit subsidy the effectiveness of the program has been reduced because of the inadequacies of the flood maps. The flood insurance rate maps (FIRMS) are used to determine flood risk, which is used for setting policy rates and determining building standards. The data used for the FIRMS in some areas is now more than 30 years old. Indeed, in areas of southern Mississippi impacted by Hurricanes Katrina and Rita, the flood elevation data was off by as much as 20 feet. Without accurate flood maps it is exceptionally difficult to gauge risk and thereby accurately price flood insurance coverage. Additionally, and more importantly, without a true understanding of the danger involved, it is impossible to ensure safety in new design and construction. Ultimately, the use of inaccurate maps has significantly impaired the effective operation of the program.

When Congress created the NFIP in 1968, no structure within the program was required to maintain flood insurance until the flood maps were completed in 1973. From 1968 until 1973, very few owners of structures within known flood risk areas took the initiative and purchased flood insurance. Since 1973, participation in the NFIP is mandated for properties within the 100-year flood plain that have a federally related mortgage on the property, and such mandatory participation is enforced through federal banking regulations. Structures in areas known as "residual risk areas" behind levees and dams and those without a federally related mortgage within the 100-year flood plain are currently not required to maintain flood insurance. Although any person owning a structure may choose to voluntarily participate, many structures within the 100-year flood plain that had a mortgage from a state-chartered institution without federal deposit insurance or who did not have a mortgage simply chose not to participate. Notwithstanding the decision of many of the owners of these structures not to participate, all of

the structures within the 100-year flood plain and areas of residual risk are exposed to heightened risk. The NFIP has failed to adequately inform and require all people with structures located within the 100-year flood plain and areas of residual risk to obtain and keep current flood insurance on their properties.

In 1986, in an effort to increase the effectiveness of this program, the NFIP reached out to form a public-private partnership with private insurance companies. The partnership was such that the private insurance companies, known as Write Your Own (WYO) companies, would handle the task of administering the program on behalf of the NFIP in order to promote participation. The WYO companies receive a fee to cover the cost of administering the flood insurance program, but profit was not to be a part of the fee. Today, 96 WYO companies participate in the administration of the NFIP, and they receive fees of 30.8% of all premiums collected. This percentage is derived from the administrative costs of five other lines of private insurance that have similarities to the administrative costs associated with the NFIP. The actual costs incurred by the WYO companies in administering this program remain unknown.

The NFIP has grown considerably over the past 38 years from 1 million policyholders and $50 billion of risk exposure to nearly 5 million policyholders and $900 billion of risk exposure. This program, however, has not been fully self-sustaining. Although, the hurricane season of 2005 finally demonstrated the inability of this program to sustain itself, there were prior instances where Congress took remedial actions in order to sustain this program before 2005. In 1986, Congress was forced to completely forgive nearly $1 billion of debt that this program had incurred. Additionally, prior to the 2005 hurricane season, the NFIP already owed the United States Treasury several hundred million dollars. Finally, because the NFIP does not attempt to maintain reserves, it cannot operate without the financial assistance of the U.S.

In addition to many of the immediate concerns outlined above, several outstanding issues remain unknown. For example, it is still unclear whether the administrative fees paid to the insurance companies accurately reflect the cost associated with administering this program. Also, it is not immediately evident whether the private insurance market is capable of underwriting a larger amount of risk associated with flood events. Most important of all, it remains to be seen if the Federal Emergency Management Agency (FEMA) is capable of administering this program, or whether this program should be re-organized into another federal agency.

PURPOSE OF THE LEGISLATION

This legislation makes several key reforms in order to ensure sufficient future premium income to pay new claims without relying on the American taxpayer. Several of the explicit subsidies built into the program during its 1968 inception will be phased out within a reasonable time. Pre-FIRM structures that are non-primary residences, business, severe repetitive loss properties, and cumulative loss properties will have their subsidies gradually eliminated. In addition, all state-chartered financial institutions will be required to maintain flood insurance on all mortgaged properties within the 100-year flood plain. Also, properties located in "residual risk areas" behind manmade structures such as levees and dams

will be required to purchase and maintain flood insurance, and minimum deductible levels for all structures within the program have been adjusted to accurately reflect inflation. Finally, every single structure within this program will go through a comprehensive rate review as the flood maps are updated in order to accurately assess the risk associated with each individual structure.

The NFIP incurred massive liabilities as a result of the 2005 hurricane season. This legislation eliminates the NFIP's existing debt obligations. The legislation, however, also requires the NFIP to set up a reserve fund in order to ensure that the NFIP has adequate funds. The fund seeks to make the entire program function more like an insurance program by using reserves to pay claims during high loss years while building reserves during lower loss years.

In addition to the immediate changes to this program, this legislation requires the GAO and others to undertake a considerable number of studies on every aspect of the NFIP. These studies include a full financial audit of the program, an in-depth review of the relationship between the NFIP and the WYO Companies to determine the actual cost to administer this program. The studies also seek to determine the necessity for continuing any subsidy within the program. The studies will look at whether this program should be expanded or limited based on the availability of private flood insurance. Finally, the studies will seek to determine if FEMA is capable of administering this program, or whether this program should be reorganized into another federal agency. This program is required to be re-authorized during the next Congress, and it is the intent of this Committee to use the studies to determine the manner in which this program should be further reformed.

HEARINGS

The Committee heard testimony in the 109th Congress on February 2, 2006, regarding proposals to reform the national flood insurance program. The witnesses testifying were: Mr. David Conrad, Senior Water Resources Specialist, National Wildlife Federation; Ms. Regina Lowrie, Chair, Mortgage Bankers Association; Mr. J. Robert Hunter, Director of Insurance, Consumer Federation of America; Mr. David Pressly, President, National Association of Homebuilders; Mr. Paul Gessing, Director of Government Affairs, National Taxpayers Union; Mr. David John, Research Fellow, The Heritage Foundation; and Ms. Pam Pogue, Chair, Association of State Floodplain Managers.

The Committee had previously heard testimony on January 25, 2006, regarding proposals to reform the national flood insurance program. The witnesses testifying were: The Honorable David Walker, Comptroller General, United States Government Accountability Office; Mr. David Maurstad, Acting Director, Mitigation Division, Federal Emergency Management Agency; and Mr. Donald Marron, Acting Director, Congressional Budget Office.

The Committee initially heard testimony on October 18, 2005, regarding proposals to reform the national flood insurance program. The witnesses testifying were: Mr. David Maurstad, Acting Director, Mitigation Division, Federal Emergency Management Agency; Mr. William Jenkins, Director of Homeland Security and Justice,

Government Accountability Office; Dr. Chris Landsea, National Weather Service, National Oceanic and Atmospheric Administration; Mr. Robert Hunter, Director of Insurance, Consumer Federation of America; Mr. Doug Elliott, President, Center on Federal Financial Institutions; Mr. Robert Hartwig, Senior Vice President and Chief Economist, Insurance Information Institute; Mr. Chad Berginnis, Chief Financial Manager and Immediate Past Chair, State of Ohio on behalf of the Association of State Floodplain Managers; and Professor Mark Browne, Gerald D. Stephens CPCU Chair in Risk Management and Insurance School of Business—University of Wisconsin.

SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION

Section 1. Title

This section contains the short title of the bill, "Flood Insurance Reform and Modernization Act of 2006."

Section 2. Findings

This section contains the Committee's findings that the flood insurance program is bankrupt, and is no longer a sustainable program under its current structure. Major reforms must be made to this program including but not limited to subsidy reductions/eliminations, map modernization, cost analysis for greater efficiency within the write your own insurance program, stricter compliance of mandatory coverage, and increased participation;

Section 3. Definitions

This section defines the terms 500-year flood plain and 100-year flood plain.

Section 4. Reform of premium rate structure

Subsection (a) excludes several pre-FIRM properties from continuing to receive explicit subsidies as follows: non-primary residences; any severe repetitive loss property; any business property; any property that has incurred damage in amounts exceeding its current FMV; any property which has sustained substantial damage exceeding 50 percent or substantial improvement exceeding 30 percent of its current fair market value.

Subsection (b) of this section changes the annual premium increase for the program as follows: the overall maximum annual premium increase is changed from 10 percent per year to 15 percent per year; the premium increase for phasing out the subsidized properties under subsection (a) of this section is 25 percent per year until that property is no longer subsidized under this program.

Section 5. Mandatory coverage areas

This section requires the Director to issue an amended final regulation defining special flood hazard areas to include areas known as residual risk areas located behind manmade structures such as levees and dams. Residual risk areas are areas that would otherwise be within the 100-year flood plain but are currently not required to obtain flood insurance because they are protected by manmade structures such as levees and dams;

Subsection (c) of this section creates a limitation that does not require mandatory participation within the flood insurance program for structures that are in residual risk areas until such time as all residual risk areas are mapped that the Director deems essential to carrying out the flood insurance program.

Section 6. Premium adjustment

This section states that all rates within the program are subject to an adjustment each time a flood insurance rate map is updated.

Section 7. State chartered financial institutions

This section requires that by December 31, 2008, as a condition of state participation in the national flood insurance program that lending institutions chartered by the states, and not insured by the Federal Deposit Insurance Corporation, shall be subject to regulations by that State that are consistent with the requirements for federal depository institutions with regards to maintaining flood insurance on mortgaged properties within the 100-year flood plain.

Section 8. Enforcement

This section increases the cap on civil money penalties from "$350," per violation to "$2,000" per violation against lenders for violations under this Act. This section also states that this is a cap, and regulators may levy fines under the stated $2,000 per violation cap where they deem necessary and appropriate. This section also eliminates the $100,000 annual cap on fines that can be levied against lenders.

Section 9. Escrow of flood insurance payments

This section requires that lending institutions place flood insurance payments into an escrow account on behalf of the borrower. This section shall apply to any mortgage outstanding or entered into on or after the expiration of the 2-year period beginning on the date of the enactment of this Act.

Section 10. Financing of funds from the Treasury

This section authorizes the Secretary of Treasury to provide funds to cover obligations of the NFIP for the 2005 hurricane season.

Section 11. Borrowing authority debt forgiveness

This section completely eliminates any obligations owed to the United States Treasury by the National Flood Insurance Program for the 2005 hurricane season. This section also decreases the borrowing for the program from $20.775 billion to $1.5 billion.

Section 12. Minimum deductible levels for claims

This section sets the minimum annual deductible for pre-FIRM structures at $2,000, and post-FIRM structures at $1,000. All deductibles are on annual basis, and once the deductible has been met, no further deductible is required for that year.

Section 13. Considerations in determining chargeable premium rates

This section requires an examination of all years within the program including catastrophic loss years to determine the appropriate historical loss average.

Section 14. Reserve fund

This section creates a reserve fund of up to 1 percent of all risk exposure in force and effect within the program. In order to achieve the appropriate reserve fund level, this section sets up a mechanism to achieve the target 1 percent ratio within 10 years. This section also gives discretion to the Director to report to Congress if hitting the reserve target ration for any given fiscal year would have serious negative implications for the overall program.

Section 15. Repayment plan for borrowing authority

This section requires that if the NFIP exercises its borrowing authority, the Director must submit a repayment plan to both the Secretary of Treasury and to Congress.

Section 16. Technical mapping advisory council

This section creates a new technical mapping advisory council similar to the one established in the 1994 amendments to the Act. The additional participants to the original council include the Office of Management and the Budget (OMB), the Army Corp of Engineers, and a representative from the Department of the Interior, respectively.

Section 17. National flood mapping program

This section requires the NFIP, with the guidance of the Technical Mapping Advisory Council, to map the 500-year flood plain and areas of residual risk as well as updating the 100-year flood plain. This section directs the NFIP to use the latest technology and the most accurate flood elevation data in creating and updating the flood maps.

Section 18. Removal of limitation on state contributions for updating flood maps

This section lifts the prohibition of states contributing more than 50 percent to map modernization in order for States to effectively and efficiently update and maintain their maps.

Section 19. Non-mandatory participation in 500-year flood plain

This section states that it is not mandatory for individuals who reside in the 500-year flood plain to obtain flood insurance, however it requires the Director to notify the communities within the 500-year flood plain to give them notice that their communities are in elevated flood risk areas.

Section 20. Notice of flood insurance availability under RESPA

This section amends 5(b) of the Real Estate Settlement Procedures Act (RESPA) by requiring the Secretary of Housing and Urban Development to include in the booklet distributed an explanation and availability of flood insurance.

Section 21. Testing new flood proofing technologies

This section requires the NFIP to allow testing of any new type of flood proofing technology and states that such structures may not be construed to be in violation of any flood risk mitigation plan developed by that State or community and approved by the Director of FEMA.

Section 22. Participation in state disaster mediation programs

This section requires the NFIP, upon request of a state insurance official, to participate in state non-binding mediation claims where there are multiple insurance claims on the same subject property.

Section 23. Reiteration of FEMA responsibilities Under 2004 reform act

This section requires the Director to submit a report to Congress every thirty days detailing the progress made on implementing the requirements of the appeals process of section 205 of the 2004 Flood Insurance Reform Act until such time as the process is fully implemented.

Section 24. Studies, audits, reports

This section requires a number of reports, audits and studies that are due to the Committee within one year from the date of the enactment of this Act. The Committee believes several critical areas of the flood insurance program must be improved upon in the coming years. Therefore, the Committee has asked the GAO and others to produce several in-depth reports to Congress detailing where improvements to this program must be made. Subsection (a) requires GAO to conduct an in-depth study on the Write Your Own program that shall include consideration of alternatives to the current structure of the WYO system. Subsection (b) requires a complete audit of the NFIP by GAO including the $23 billion dollars spent on claims during the 2005 hurricane season. Subsection (c) also requires the Director of the NFIP to submit an annual report detailing all financial aspects of the program for the preceding year. Subsection (d) requires the GAO to study the effects that expanding flood insurance beyond the current caps might have on the private insurance market. Subsection (f) requires the Secretary of Treasury to conduct a study and submit a report to Congress on the remaining subsidies within the program. Subsection (g) requires GAO to study the effects of allowing individuals from non-participating communities to purchase flood insurance through the NFIP direct program.

COST OF LEGISLATION

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, June 26, 2006.

Hon. RICHARD C. SHELBY,
Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for the Flood Insurance Reform and Modernization Act of 2006.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Julie Middleton.

Sincerely,

DONALD B. MARRON,
Acting Director.

Enclosure.

Flood Insurance Reform and Modernization Act of 2006

Summary: The Flood Insurance Reform and Modernization Act of 2006 would provide the National Flood Insurance Program (NFIP) with funds to pay remaining valid claims from the 2005 Gulf Coast hurricanes and reform the program, which is currently in an unsustainable financial position. Without a change in law, the NFIP will be unable to pay all flood insurance claims promptly, and faced with a nonfunctional program, those policyholders who are not required to carry flood insurance may abandon it. CBO cannot predict when this might occur, but today the program faces a future with inadequate resources to pay its obligations.

CBO expects that enacting the Flood Insurance Reform and Modernization Act of 2006 would improve the financial status of the NFIP and significantly increase the likelihood that the program could continue to offer insurance coverage and pay claims in a timely fashion. By providing funds to pay remaining claims from the 2005 Gulf Coast hurricanes and forgiving the debt incurred to pay previous claims from 2005, the bill would essentially return the NFIP to a financial condition similar to that which existed before Hurricane Katrina.

Enacting the bill would also strengthen the NFIP's financial position in the future. It would direct the Federal Emergency Management Agency (FEMA) to impose rate increases of up to 15 percent per year on all policyholders so as to establish a reserve fund for the insurance program. That reserve fund would be available to pay insurance claims whenever it was needed. The bill also would require some policyholders that do not pay the full cost of their insurance coverage to gradually begin to do so. Finally, it would require some policyholders to carry a larger deductible amount on their insurance policies, and it would end the current practice of offering new policies to some property owners at less than their expected cost. These requirements would increase the cost to policyholders and reduce the net cost of the program to the government. Over the next several years, those changes would improve the chances that the NFIP would have sufficient funds to pay future claims.

CBO estimates that enacting the bill would reduce net outlays of the flood insurance program over the next 10 years by about $7.6 billion relative to current law. Changes in the NFIP (mostly higher premiums) and the elimination of its Treasury debt would reduce the program's net outlays by about $19 billion over that period. But the appropriation of funds to pay the remaining claims from the 2005 hurricanes and the increased availability of funds to pay future claims that could not be paid under current law would add over $12 billion to the program's outlays. At the same time, because the bill would forgive the NFIP's debt to the Treasury, that agency would forgo interest payments from FEMA of about $9.5 billion over the 2007–2016 period, CBO estimates. The net impact

of the bill—including its effect on the NFIP and on Treasury's interest receipts—would be an increase in direct spending of $1.9 billion over the 2007–2016 period.

As the value of flood insurance coverage in force continues to grow, the cost of claims that the NFIP may face in the next decade will also increase. In most years, they will probably total between $1 billion and $5 billion—similar to the losses the insurance program experienced in the years before Katrina—but there could be another catastrophic flood in the next decade with much larger losses. CBO's estimate assumes that annual flood insurance claims during this period are equal to the amounts anticipated by the program's actuaries for a typical year, but actual claims are likely to vary substantially from year to year and the total amount of claims over the next 10 years is quite uncertain. This estimate also assumes that substantial numbers of policyholders drop flood insurance coverage or find alternatives to the NFIP as their premiums rise steadily over the period.

The bill also would increase the amounts authorized to be appropriated for FEMA's flood mapping program. In addition, the bill would require FEMA to participate in state-sponsored claims mediation programs and would direct the Government Accountability Office (GAO) to conduct multiple studies. Assuming appropriation of the authorized amounts, CBO estimates that implementing these provisions would cost $1.5 billion over the 2007–2011 period and an additional $900 million after 2011.

The bill contains two intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA) because it would direct state regulatory agencies to require, and state lenders to provide, information on flood risk to more mortgage borrowers. CBO estimates that the cost for state governments to comply with those mandates would be small and well below the annual threshold established by UMRA ($64 million in 2006, adjusted annually for inflation). The legislation also would impose private-sector mandates, as defined in UMRA, on certain mortgage lenders. Based on information from industry and government sources, CBO expects that the direct costs to comply with those mandates would fall below the annual threshold for private-sector mandates established in UMRA ($128 million in 2006, adjusted annually for inflation).

Estimated cost to the Federal Government: The estimated budgetary impact of the bill is shown in the following table. The budgetary impact of this legislation falls within budget function 450 (community and regional development).

	By fiscal year, in millions of dollars—									
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
CHANGES IN DIRECT SPENDING [a]										
Payment of Remaining 2005 Claims:										
Estimated Budget Authority	2,400	0	0	0	0	0	0	0	0	0
Estimated Outlays	1,825	375	200	0	0	0	0	0	0	0
Reforms to the NFIP:										
Estimated Budget Authority	900	600	250	0	0	0	0	0	0	0
Estimated Outlays	900	600	250	−150	−650	−1,150	−1,775	−2,250	−2,700	−3,125
Forgone Treasury Interest Receipts:										
Estimated Budget Authority	875	875	925	975	975	975	975	975	975	975
Estimated Outlays	875	875	925	975	975	975	975	975	975	975
Total Changes:										
Estimated Budget Authority	4,175	1,475	1,175	975	975	975	975	975	975	975
Estimated Outlays	3,600	1,850	1,375	825	325	−175	−800	−1,275	−1,725	−2150
CHANGES IN SPENDING SUBJECT TO APPROPRIATION										
Flood Mapping and Studies Estimated Authorization:										
Level	401	400	400	400	400	400	0	0	0	0
Estimated Outlays	101	260	340	400	400	400	300	140	60	0

[a] In addition, CBO estimates that revenues would increase by about $1 million a year over the 2007–2016 period.

Basis of estimate: For this estimate, CBO assumes that the bill will be enacted near the beginning of fiscal year 2007 and that the authorized amounts will be appropriated for each fiscal year.

Direct spending and revenues

Over the 2007–2016 period, CBO estimates that enacting the legislation would reduce net outlays for the flood insurance program by about $7.6 billion and would increase the Treasury's net outlays for interest by about $9.5 billion.

Funding for Claims from the 2005 Gulf Coast Hurricanes. Section 10 would appropriate such sums as are necessary to pay the remaining claims from the 2005 Gulf Coast hurricanes that exceed the program's resources. According to FEMA, the total claims for those hurricanes will be about $23.1 billion. The NFIP has already been authorized to borrow $20.8 billion for that purpose. Based on information from FEMA, CBO estimates that enacting this bill would provide another $2.4 billion for paying claims from the 2005 hurricanes and that the resulting outlays would occur over the 2007–2009 period.

Reforms to the NFIP. The bill contains several provisions that together would govern the magnitude of future rate increases for flood insurance and reduce the amount of expected future claims. Those provisions would:

Require the NFIP to create a reserve fund;

Increase the ceiling on average annual rate increases that can be imposed on policyholders from 10 percent a year to 15 percent a year;

Forgive the program's current outstanding debt to the Treasury;

Phase out subsidized premiums for some policyholders;

Raise the deductibles for certain types of policyholders; and

Prohibit FEMA from issuing new subsidized insurance policies.

CBO estimates that these changes would reduce net outlays of the NFIP by about $10 billion over the 2007–2016 period. The program's net outlays would decline, relative to current law, because premium increases would be greater and no interest would have to be paid to the Treasury on the NFIP's current debt (which would be forgiven). That decline would be partially offset by higher claims payments because, under the bill, the NFIP would have sufficient funds to pay average expected claims; under current law, it would not.

Establish a Reserve Fund and Increase the Limit on Annual Rate Increases. FEMA would be required to establish a reserve fund equal to 1 percent of the value of flood insurance coverage in force in the previous year. By the end of 2006, FEMA expects that the value of flood insurance coverage in force will be about $1 trillion; by 2015, the amount of coverage is likely to reach $1.5 trillion. The bill would direct FEMA to gradually accumulate the necessary reserves over 10 years.

In addition, section 4 would authorize the NFIP to increase rates on policies within each risk category by an average of up to 15 percent per year. Under current law, the limit on rate increases is 10 percent. CBO expects that FEMA would have to impose annual 10 percent rate increases on flood insurance policies under current law

in order to pay claims and service its outstanding debt to the Treasury. Under the bill, however, CBO expects FEMA would need to increase most rates by 15 percent annually in order to pay claims and accumulate the required reserves. CBO interprets this legislation as directing FEMA to implement rate increases to meet the funding targets for the reserve fund even if those rates exceed the estimated actuarial cost of providing flood insurance.

For this estimate, we assume that FEMA could begin to implement premium increases to establish a reserve fund starting in May 2007, and that it would take one year before any increase was fully implemented because individual flood insurance policies are renewed throughout the year. Starting in May 2007, the bill would direct FEMA to collect 10 percent of the reserve fund requirement (or about $1 billion) in 2007. That directive would imply a very large rate increase; however, under the bill, the increase would be capped at 15 percent. If claims over the next several years occur at the actuarial average, a significant portion of the increased premium collections would be needed to pay flood claims and would not be available to accumulate in a reserve fund for at least a few years.

For this cost estimate, CBO assumes that FEMA would impose 15 percent rate increases on its policyholders each year over the 2007–2016 period in an attempt to reach the reserve amounts specified in the bill, but that it probably would fall short of that target in this period. CBO estimates that flood insurance coverage in force would grow from about $1 trillion today to around $1.5 trillion by 2015. It is unlikely that FEMA would be able to collect enough premiums above amounts it pays for claims over the next 10 years to fully capitalize a reserve fund equivalent to 1 percent of insurance coverage in force. CBO estimates that, with all of the program changes authorized by the bill, the NFIP would have a reserve fund with a balance of about $10 billion in 2016, less than the estimated target of about $15 billion for that year. (If losses due to floods are less than average over that period, the balance would be greater. If losses exceed the average, the balance would be smaller. Based on FEMA's actuarial review of the NFIP, CBO estimates the expected loss is about $3.5 billion for policies in force in 2006.) To estimate the amounts that could be collected in response to the bill's reserve fund requirement, CBO reduced the projected amount of flood insurance coverage to reflect the likelihood that some policyholders would drop NFIP coverage or find alternatives to that coverage after successive years of 15 percent annual rate increases ultimately quadrupled their insurance premiums. Policyholders that live in lower-risk areas that are paying actuarially fair insurance premiums today might seek and find alternative insurance products in the future if their cost to participate in the NFIP far exceeded their actuarial risk. Alternatively, some policyholders in this situation might choose to reduce their flood coverage or drop it altogether. Such resources would reduce the total coverage in force and hence the required size of the reserve fund.

Increase Rates for Pre-FIRM Properties. Section 4 would authorize the NFIP to gradually increase premiums on certain properties that were built before flood insurance rate maps (FIRMs) were completed or before 1975, whichever is later—known collectively as pre-FIRM properties. The affected pre-FIRM properties include:

Properties that have been flooded four or more times with the total claims payments exceeding $20,000; or properties with two or more claims exceeding the fair market value of the property;

Nonresidential structures;

Nonprimary residences (such as vacation homes);

Properties that sustain damage exceeding 50 percent of the fair market value of the property after enactment of the bill; and

Properties that undergo improvements or renovations exceeding 30 percent of the fair market value of the property after enactment of the bill.

Under current law and policies, many pre-FIRM structures are charged a flood insurance premium that is less than the full actuarial cost of the insurance. Thus, such policies are considered to be subsidized by the program. The bill would authorize FEMA to increase rates on those specified types of pre-FIRM properties (but not other types of pre-FIRM properties) by 25 percent a year until the actuarial rate is achieved. At that rate, CBO expects that many, but not all, of these pre-FIRM properties would start paying actuarial rates within the next 10 years.

According to FEMA, approximately 455,000 pre-FIRM properties would be affected by the bill, and the average premium for those properties is about $800 a year. CBO expects that owners of some of those properties would either drop flood insurance coverage or reduce their level of coverage in response to an increase in premium charges.

Raise Deductible for Pre-FIRM Properties. Section 12 would increase the deductible for pre-FIRM properties from $1,000 to $2,000 for both the structure and its contents. For pre-FIRM properties, which do not pay actuarial rates for their insurance, the increase in the deductible would not affect the price of the insurance, but it would decrease the amount of claims payments made for such properties. Based on information from FEMA, CBO estimates that claims payments would decrease by about 7.5 percent if this higher deductible were implemented.

Bar New Subsidized Policies for Pre-FIRM Properties. Section 4 would prohibit FEMA from offering new subsidized insurance policies. CBO estimates that this provision would reduce spending by a negligible amount over the next 10 years because we expect few new properties eligible for pre-FIRM rates to be added to the flood insurance program.

Forgone Treasury Interest Payments. Section 11 would relieve the NFIP of its obligation to repay funds borrowed to pay claims from the 2005 Gulf Coast hurricanes. Current law requires FEMA to repay any borrowed funds (with interest) as it collects premiums. In the absence of legislation to relieve FEMA of it obligation to repay debt, FEMA would need to use a portion of its premium income to pay debt-service costs to the Treasury. Under this bill, such payments would not be necessary, and income that the NFIP would otherwise use to service its debt would instead be used to pay policyholders' claims and accumulate reserves.

Interest payments from the NFIP to the Treasury are intragovernmental transactions; they are recorded in the budget as outlays for FEMA and as offsetting receipts (that is, negative out-

lays) for the Treasury. Eliminating those payments would reduce FEMA's outlays (making more funds available to pay claims and accumulate reserves)—but it also would increase the Treasury Department's net outlays by $0.9 billion to $1.0 billion per year because it would be receiving less interest income.

Additional Claims Payments Under the Bill. CBO expects that enacting this legislation would enable the flood insurance program to continue to grow in size and to pay claims that it would be unable to pay in a timely fashion under current law. That would be possible because the legislation would appropriate $2.4 billion needed to pay remaining NFIP claims from 2005, increase premiums and deductibles, and eliminate the program's debt to the Treasury. Over the 2007–2016 period, CBO estimates that NFIP would pay over $12 billion for current and future claims that probably could not be compensated under current law. That estimate assumes that flood insurance claims would be equivalent to the expected annual cost of the program as estimated by FEMA's actuaries—over $3.5 billion today. In future years, those expected losses will increase with inflation and change as the number of policies in force varies.

Other NFIP Modifications. The bill would make certain changes to the NFIP that might increase the number of policies in the program and result in the program collecting more premium income than it currently does. CBO has no information to estimate the number of policies that could be added to the program from enacting these sections.

Mandatory Coverage Areas. Section 5 would require that homes located behind levees, dams, and other man-made structures become part of special flood hazard areas, which are areas at high risk for flooding. The bill would require property owners to purchase flood insurance once the NFIP updates its flood maps to include those new high-risk areas. CBO assumes that the additional policies generated by this new mandatory purchase requirement would be priced initially at actuarial rates. CBO has no basis for estimating the number of policies that might be sold under this provision.

Nonmandatory Participation for the 500-year Flood plain. Section 19 would require the NFIP and regulated lending institutions to notify communities if they are entirely or partially located within the 500-year flood plain. Properties within the 500-year flood plain would not be subject to mandatory purchase requirements but could voluntarily purchase flood insurance, which CBO assumes would initially be priced at actuarial rates. As the cost of those policies increased far above actuarial rates to capitalize the proposed reserve fund, CBO expects few of these property owners would elect to buy flood insurance.

Civil Penalties. Section 8 would increase the civil penalty from $350 to $2,000 for lenders that do not enforce the mandatory purchase requirement. CBO estimates that the increased revenue from the civil penalties established under this bill would amount to about $1 million a year.

Spending subject to appropriation

The bill also would authorize additional discretionary spending. Assuming appropriation of the authorized amounts, CBO estimates

that such spending would total about $1.5 billion over the 2007–2011 period and an additional $900 million after that period.

Flood Mapping Program. Section 17 would authorize the appropriation of $400 million a year over the 2007–2012 period for updating flood maps to include the 500-year flood plain and areas that would be flooded if a dam or levee failed. In addition, the bill would reestablish the Technical Mapping Advisory Council to assist with managing flood mapping activities. Based on historical spending rates for this program, CBO estimates that implementing this section would cost $1.5 billion over the 2007–2011 period and an additional $900 million in subsequent years.

Participation in Claims Mediation. Section 22 would require FEMA to participate in state-sponsored claims mediation programs to help expedite the settlement of disputed flood insurance claims. The additional administrative costs of this provision are uncertain because FEMA does not know how it would implement this provision. If staffing increases were significant, however, it is likely that the NFIP would raise the administrative fees assessed on policyholders and that added income from those fees would offset any increase in costs.

Studies. Section 24 would direct GAO to conduct four studies on various aspects of the NFIP as well as an audit of the program's spending related to the 2005 Gulf Coast hurricanes. CBO estimates that conducting those studies would cost about $1 million over the 2007–2011 period.

Impact on State, Local, and tribal Governments: The bill contains two intergovernmental mandates as defined in UMRA. It would require state agencies that regulate mortgage lenders to require that those lenders provide borrowers with information about flood insurance if the property covered by the mortgage is located in the 500-year flood plain. It also would require state agencies that offer direct mortgages to provide such information. Based on information from mortgage lenders, state regulatory agencies, and state housing authorities, CBO estimates that the cost for state regulatory agencies would be minimal and the number of loans for which state agencies would be required to provide flood information would be small. The total cost for state agencies to comply with those requirements would be well below the annual threshold established in UMRA ($64 million in 2006, adjusted annually for inflation).

Impact on the Private Sector: The legislation would impose private-sector mandates, as defined in UMRA, on certain mortgage lenders. Based on information from industry and government sources, CBO expects that the direct costs to comply with those mandates would fall below the annual threshold for private-sector mandates established in UMRA ($128 million in 2006, adjusted annually for inflation).

The bill would require mortgage lenders—when making, increasing, extending, or renewing any loan secured by property located in an area within the 500-year flood plain—to notify the purchaser or lessee and the servicer of the loan that such property is located in the 500-year flood plain. The bill also would require certain mortgage lenders to notify policyholders that insurance coverage may cease with the final mortgage payment and to provide direction as to how the homeowner could continue flood insurance cov-

erage after the life of the loan. In addition, certain mortgage lenders would be required to deposit premiums and fees for flood insurance in an escrow account on behalf of the borrower. According to industry representatives, the cost for mortgage lenders to provide the additional notices and direction and to escrow flood insurance payments would be small. Therefore, CBO estimates that the aggregate direct cost of complying with the mandates would fall below the annual threshold.

Previous CBO Estimate: On April 4, 2006, CBO transmitted an estimate for H.R. 4973, the Flood Insurance Reform and Modernization Act of 2006, as ordered reported by the House Committee on Financial Services on March 16, 2006.

H.R. 4973 contains a number of provisions similar to those in this bill, such as increasing rates on certain pre-FIRM properties, increasing the annual limit on rate increases, and providing funds to pay the remaining claims from the 2005 Gulf Coast hurricanes. H.R. 4973 would not, however, forgive the NFIP's debt to the Treasury, and CBO estimated that all of the additional premium income under the bill would have to be used to pay claims. The cost estimates reflect those differences between the bills.

Estimate prepared by: Federal Costs: Julie Middleton and Perry Beider; Impact on State, Local, and Tribal Governments: Melissa Merrell; Impact on the Private Sector: Paige Paper/Bach.

Estimate approved by: Robert A. Sunshine, Assistant Director for Budget Analysis.

REGULATORY IMPACT STATEMENT

In accordance with paragraph 11(b), rule XXVI, of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact of the bill.

This legislation seeks to address several gaps in coverage areas within the National Flood Insurance Program. Section 7 of this legislation requires states, as a requirement of participation in the program, to require state-chartered financial institutions to maintain flood insurance on all current and future mortgages starting December 31, 2008. This section will enhance safety and soundness of state chartered financial institutions by ensuring that assets used to secure loan payments are sufficiently covered in the event that assets are damaged or destroyed by a flooding event. Section 8 updates the maximum allowable civil money penalties per violation that regulators may impose against financial institutions for failing to comply with the provisions of this Act. Section 8 also eliminates the $100,000 annual cap that regulators may impose on financial institutions to ensure compliance with this Act. Section 9 of this Act requires that all flood insurance payments are escrowed, which insures that flood insurance payments remain current and that assets used to secure loan payments are protected.

This legislation also requires the NFIP to keep and maintain a reserve fund of one percent of total risk exposure. This provision ensures that policyholders' claims will be paid without the assistance of the U.S Treasury and is also consistent with the goal of working to eliminate some of the $1.3 billion annual subsidy for the program.

It is expected that the reported bill will have no impact on the personal privacy of the current or prospective flood insurance pol-

icyholders. This bill is expected to strengthen the financial status of the NFIP by making rates more actuarially sound. This bill also provides for more equitable treatment between policyholders as well as protecting the U.S. taxpayer from further loss.

CHANGES IN EXISTING LAW (CORDON RULE)

On May 25, 2006, the Committee unanimously approved a motion by Senator Shelby to waive the Cordon rule. Thus, in the opinion of the Committee, it is necessary to dispense with section 12 of rule XXVI of the Standing Rules of the Senate in order to expedite the business of the Senate.

ADDITIONAL VIEWS OF SENATOR JIM BUNNING

I am pleased that the Committee has included many necessary reforms to shore up the financial shortcomings of the National Flood Insurance Program (NFIP) in this legislation. However, I still have serious concerns about both the financial soundness and the administration of the NFIP.

The NFIP was created in 1968 to make certain a minimum level of insurance against losses from flooding was available to property owners. But the program was not created actuarially sound. Because Congress made purchase of policies mandatory for some property owners, premium rates were subsidized by the taxpayers for properties in existence before the purchase requirement. Because the government bears the risk of loss and does not have to make a profit, the program is implicitly subsidized by the taxpayers. And because premiums are based on broad zone classifications and badly outdated maps, policyholders are not even charged actuarial rates on newly constructed structures.

After nearly 40 years, the subsidies and fiscal unsoundness remain. Financially, that makes no sense. The explicitly subsidized properties present a greater risk of loss because they often do not meet modern building standards. The flawed premium calculation methodology also prevents charging policyholders for the risks they pose to the taxpayers.

The original design of the NFIP has also produced several perverse—and dangerous—incentives. First, because there is no incentive to fortify old structures, the program encourages policyholders not to make their structures safer. Second, because premiums are not based on risk and are implicitly subsidized, the program encourages building in high-risk areas. Third, because vacation homes and other properties can be insured and subsidized, the program provides extra benefits to the least needy. Fourth, the mere existence of not-for-profit insurance backed by the taxpayers prevents private insurers from even trying to offer competing products.

This legislation builds upon the reforms enacted in 2004. It eliminates the subsidies for the properties least deserving of taxpayer handouts. It allows larger annual premium adjustments to increase premium income to the program. More at-risk structures are required to purchase insurance policies, and the current mandatory purchase requirements will be better enforced. Future catastrophic losses will be offset by the creation of a reserve fund and an improved formula for calculating annual premium rates. Finally, numerous administrative changes, including more detailed mapping, will help the program better cope with future losses.

Unfortunately, these reforms come at a high price—well over $20 billion. But even more reforms are needed to make the program financially sound. There has been opposition to significant reforms

in the NFIP since day one, but the taxpayers deserve better and this Committee must continue to implement needed changes. The current authorization expires at the end of 2007, and I hope that the lessons and losses of the past will encourage more significant reforms in the reauthorization.

While I believe this legislation addresses some significant problems in the design of the NFIP, there are also problems not of Congress's creation. The administration of the program by the Federal Emergency Management Agency (FEMA) has, at times, been in defiance of the clear intent of Congress. Had the Bunning-Bereuter-Blumenauer Flood Insurance Reform Act of 2004 not been enacted, victims of the 2004 and 2005 hurricane seasons would have had no insurance coverage for flood damage. Yet FEMA has still not fully implemented that law. Provisions of that Act establishing education and training requirements for insurance agents and a pilot program for mitigation of severe repetitive-loss properties must continue to be improved.

Most inexcusably, the appeals process established in that Act has yet to be implemented. FEMA did not even propose a rule until 23 months after the Act was signed into law and 17 months after the statutory deadline passed. And the rule proposed by FEMA was wholly inadequate and provided no protections for policyholders. I have received a written promise from the Secretary of Homeland Security that changes to provide due process for appellants will be made when the rule becomes final. Those changes will include setting a 90-day deadline for FEMA to resolve appeals, establishing a point of contact within FEMA for a claimant to get assistance with filing an appeal, and requiring FEMA to provide an explanation of why the claim was denied and what information is necessary to file the appeal.

Looking to the upcoming reauthorization, this Committee must again make significant reforms to financially fortify the NFIP. If FEMA continues to defy Congress's intent in the 2004 Act, or in this legislation, there must be serious consequences. We owe it to the policyholders to ensure the program works, and we owe it to the taxpayers to ensure they do not have to foot the bill for another catastrophic loss.

JIM BUNNING.

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