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SENATE REPUBLICAN POLICY COMMITTEE

Legislative Notice

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S. 2284 – Flood Insurance Reform and Modernization Act of 2007

Calendar No. 460

On October 17, 2007, the Senate Committee on Banking, Housing and Urban Affairs voted unanimously to report S. 2284; S. Rept. 110-214.

Noteworthy

- The National Flood Insurance Program (NFIP) was created in 1968 to provide federally backed property flood insurance coverage in the absence of available private insurance.
- The NFIP has grown significantly in the last 40 years, from an initial 1 million policyholders and $50 billion of risk to 5.4 million policyholders and $1 trillion of risk.
- Following the 2005 hurricanes, Congress increased the NFIP's borrowing authority to over $20 billion to enable the program to pay hurricane-associated claims.
- The NFIP has demonstrated an inability to repay sums borrowed to pay hurricane claims. As a result, the legislation forgives nearly $20 billion in NFIP debt owed the Treasury.
- The legislation reauthorizes the NFIP for another 5 years and contains a number of structural reforms to the NFIP program in order to enable the program to continue to pay claims in the future and to reduce the cost to taxpayers.
- The Administration strongly supports Senate passage of S. 2284. However, the Administration believes that any eventual conference agreement should avoid expanding the program to cover new non-flood related risks or increasing the coverage limits on existing policies.
- The House of Representatives passed its flood insurance reform bill (H.R. 3121) on September 27, 2007 by a vote of 263 to 146.
- The CBO estimated that S. 2284's net impact, including its effect on the NFIP and on the Treasury's interest collections, would be an increase in direct spending of about $1.2 billion over ten years.

Background/Overview

Congress created the National Flood Insurance Program through enactment of the National Flood Insurance Act of 1968 (P.L. 90-448). The NFIP was created to promote three complementary goals: to provide property flood insurance coverage since such coverage was generally not available through private insurers; to reduce taxpayer-financed, *ad hoc* disaster assistance for property owners affected by floods; and to reduce the total amount of property flood damage through floodplain management, including the implementation of flood maps and the enforcement of building standards that require structures to be moved or elevated.

Private insurers have generally refused to write flood insurance policies for several reasons. First, losses from floods are a virtual certainty in certain low-lying and coastal areas, yet consumers who live in these areas are not willing to pay premium prices sufficient to cover this risk. Secondly, consumers with lower flood risks are not willing to purchase coverage at a pooled rate, which leaves insurers unable to pool policyholders with varying degrees of exposure to flood losses. Finally, since flood losses are often catastrophic in nature, it is extremely costly to build the reserves of claims-paying capital necessary to meet obligations.[1]

With no private insurance available prior to 1968, flood victims came to depend on federal, taxpayer-financed, *ad hoc* disaster assistance.[2] Congress found such payments problematic because "they were unpredictable and necessitated bargaining after each major natural disaster."[3] A major goal of the 1968 Act was to "pre-fund" these flood assistance payments through a federal insurance mechanism.[4] Although flood insurance was voluntary at first, low participation rates led Congress to enact the Flood Disaster Protection Act of 1973 (P.L. 93-234) to compel certain property owners in high-risk areas to buy the insurance.[5] Thus, from almost the very outset of the program, the NFIP was designed as a form of social insurance – like Social Security or Medicare – with compulsory premium payments used to pre-fund a self-sustaining system with statutorily-defined payouts.

In an effort to reduce the total amount of property flood damage, Section 1315 of the Act prohibits the NFIP from providing flood insurance unless the participating community adopts and enforces floodplain management regulations that meet or exceed the floodplain management criteria established by the Act.[6] To better condition land use and building standards in

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[1] American Insurance Association, *Studies of Floods and Flood Damage 1952-1955,* New York: American Insurance Association, May 1956.
[2] Federal Emergency Management Agency, "National Flood Insurance Program: Program Description," April 1, 2002.
[3] Rawle O. King, "Federal Flood Insurance: The Repetitive Loss Problem," CRS Report for Congress RL32972, June 30, 2005.
[4] King.
[5] King. The 1973 Act revised the earlier law to make the purchase of flood insurance mandatory by requiring federally-regulated lending institutions to ensure that property owners purchase and maintain coverage when making loans to finance these properties. The 1973 Act also prohibited federal funds from being used for construction in floodplains located outside of NFIP-participating communities.
[6] FEMA. These floodplain management criteria are contained in 44 Code of Federal Regulations (CFR) Part 60, Criteria for Land Management and Use. The emphasis of the NFIP floodplain management requirements is directed toward reducing threats to lives and the potential for damages to property in flood-prone areas.

participating communities, the NFIP has attempted to identify and map the nation's floodplains. Such maps – known as Flood Insurance Rate Maps (FIRMs) – were intended to provide the flood risk information necessary for both floodplain management and to set flood insurance rates for commercial and residential structures.

Between 1968 and 1973, it became apparent that communities located in low-lying (or otherwise high-risk) areas were not willing to pre-fund their own disaster assistance if required to pay full actuarial rates. In the program's first five years, only 5,000 communities elected to participate. As such, federal *ad hoc* disaster assistance payments remained largely unchanged, and land-use management techniques were not adopted on a large scale.[7]

Congress responded by authorizing the NFIP to introduce subsidies in the form of steep premium discounts on buildings constructed before the effective date of a community's FIRM (or before the application of the new NFIP construction standards on December 31, 1974), to induce communities' participation.[8] Congress also exempted owners of these subsidized, or "pre-FIRM," structures from the NFIP's floodplain management requirements, unless these structures are at some later point substantially damaged or substantially improved. Either of those events then trigger a requirement to rebuild to current construction and building code standards.[9]

This policy – coupled with the new mandatory purchase requirements mentioned above – worked as intended: during the seven years following the 1973 Act, "nearly every community with a flood hazard joined the NFIP and the insurance policy count eclipsed 2 million by 1979."[10] Today, over 20,000 communities in all 50 states, representing about 95 percent of the highest-risk floodplains, participate in the NFIP. The NFIP is now the nation's largest single-line property insurer in the United States, with 5.4 million policies insuring in excess of $1 trillion in assets.[11]

While the subsidies and floodplain management exemptions succeeded in increasing participation, they resulted in a dramatic deterioration in the NFIP's long-term solvency. Today, about 25 percent of policyholders pay explicitly subsidized premiums and in January 2006, Federal Emergency Management Agency (FEMA) estimated a shortfall in annual premium income because of policy subsidies at $750 million.

<u>NFIP Post-Katrina</u>

Because the NFIP has not been able to build up any reserves, taxpayers were exposed to considerable risks due to the catastrophic loss event of Hurricane Katrina. When Hurricane Katrina hit the Gulf Coast in August 2005, the NFIP had outstanding borrowing of $225 million and cash on hand totaling $289 million. Yet, the insured flood damage caused by that storm alone is estimated to exceed $22 billion, a figure 10 times greater than the annual amount of

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[7] *Congressional Quarterly Weekly Report*, "Disaster Response: Does the Country Need a New National Strategy?" October 15, 1993.
[8] Thomas L. Hayes and Shama S, Sabade, "Actuarial Rate Review," National Flood Insurance Program, November 30, 2004. (P.L. 93-234)
[9] King.
[10] Hayes and Sabade.
[11] http://www.congress.gov/cgi-lis/cpquery/R?cp110:FLD010:@1(sr214)

premium income the NFIP generates, and one-and-a-half times more than the total dollar value of claims the NFIP has paid out in its history.

While the magnitude of 2005's hurricane-related flood losses may have been improbable, the eventual bankruptcy of the NFIP was not. The program was never designed to charge actuarially fair rates or to build the reserves necessary to meet its financial commitments. By failing to charge prices that reflect the value of the flood insurance in-force, the NFIP has been accumulating unfunded liabilities that eventually would have to be financed by taxpayers – an eventuality that has arrived. Since Katrina struck the Gulf Coast, Congress has increased the NFIP's borrowing authority three times to the present limit of $20.775 billion. To date, the NFIP has borrowed $17.535 billion to pay for Hurricane Katrina-related claims and the interest payments due on that borrowing. Annual interest alone will likely exceed $800 million by 2009, the year it is expected that the NFIP will exceed its borrowing limit of $20.775 billion.[12]

According to recent Government Accountability Office (GAO) testimony on October 2, 2007, the three goals of the NFIP are: (1) providing property flood insurance coverage for the many property owners who would benefit from such coverage; (2) reducing taxpayer-funded disaster assistance for property damage when flooding strikes; and (3) reducing flood damage to properties through floodplain management that is based on accurate, useful flood maps and the enforcement of relevant building standards.

Bill Provisions

Section 1 of the legislation contains the short title of the bill, "Flood Insurance Reform and Modernization Act of 2007."

Section 2 contains findings of Congress with respect to the National Flood Insurance Program (NFIP), including that FEMA borrowed over $20 billion from the Treasury to pay claims associated with the 2005 hurricanes and the NFIP will be unable to repay the Treasury for the amount borrowed and the annual interest which is accruing at nearly $1 billion per year.

Section 3 contains definitions, including the 100-year floodplain and 500-year floodplain.

Section 4 extends the authorization for the NFIP for an additional five years, from Fiscal Year 2008 through Fiscal Year 2013.

Section 5 expands the classification of properties to which the FEMA Director is required to extend flood insurance coverage. Current law gives priority of coverage to residential properties for occupancy from one to four families, church properties, and business properties owned or leased and operated by small business concerns. Under the legislation, coverage will be made available to "residential properties of more than four units" in a coverage amount made available to commercial properties.

[12] David Maurstad, FEMA Mitigation Division, in testimony before the Senate Banking Committee, October 2, 2007.

Section 6 phases out the subsidies for many of the "pre-FIRM" properties. Currently, 25 percent of properties in the flood insurance program pay subsidized rates because they were built prior to the existence of the flood rate maps (pre-FIRM). To strengthen the financial situation of the NFIP, this section requires the following pre-FIRM properties to pay actuarial rates (rates that reflect the true risk of flooding) phased in over four years: non-primary residences, severe repetitive loss properties, any properties where flood losses have exceeded the property value, and any business property. These provisions become effective 90 days after enactment of this Act.

In addition, FEMA will be permitted to increase premiums by 15 percent per year, up from the current 10 percent cap. This section also requires that any new flood insurance policy for a property not covered by a flood insurance policy as of the date of passage must be insured at actuarial rates.

Section 7 requires that the FEMA Director issue amended regulations defining special flood hazard areas, those where flood insurance is mandated, to include residual risk areas, those protected from flooding by man-made structures such as levees or dams. Once all essential residual risk areas are mapped, properties in these areas will be required to purchase flood insurance.

Section 8 prohibits FEMA's current practice of allowing properties that are remapped into the 100-year floodplain to indefinitely pay rates that reflect their old risk level. Under this section, any property mapped into the 100-year flood plain will be required to pay rates reflecting the new risk designation. Properties covered by flood insurance at the time of remapping will have the new rates phased in over two years at a rate of 50 percent per year.

Section 9 requires that by December 31, 2008, as a condition of state participation in the NFIP, 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 regard to maintaining flood insurance on mortgaged properties in special flood hazard areas. This will, in effect, require mandatory purchase of flood insurance for those properties in the 100-year floodplain with mortgages through state-regulated lending institutions.

Section 10 increases the cap on civil monetary penalties for lenders that fail to ensure that properties required to have flood coverage purchase such coverage from $350 to $2000 per violation. This section also eliminates the $100,000 annual cap on fines that can be levied against a lender.

Section 11 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 12 completely eliminates any obligations owed to the United States Treasury by the NFIP as a result of the 2005 hurricane season. This section also decreases the borrowing authority for the program from $20.775 billion to $1.5 billion, the borrowing authority in existence prior to the 2005 storm season. Without debt forgiveness, FEMA will have to substantially increase premiums on all policyholders.

Section 13 increases minimum deductibles as follows: minimum pre-FIRM property deductibles will be increased from $1,000 to (a) $1,500 if the property is insured for $100,000 or less, or (b) $2,000 if the property has over $100,000 in coverage. Minimum post-FIRM property deductibles will increase from $500 to (a) $750 for those with $100,000 of coverage or less, or (b) $1,000 if the flood insurance policy covers greater than $100,000.

Section 14 changes how the NFIP prices premiums. Currently price premiums are calculated to cover an average loss year. This section requires the NFIP to use actuarial principles in determining rates, and to consider catastrophic loss years in the calculation of average losses.

Section 15 creates a reserve fund to help cover losses in higher-than-average loss years. The reserve fund establishes a limit of 1 percent of all risk exposure in force within the program. Under this section, FEMA will be required to put 7.5 percent of the target reserve fund away each year until the reserve fund meets its target. 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. In order to meet reserve targets, FEMA may not increase premiums more than otherwise allowable.

Section 16 requires, whenever the NFIP exercises its borrowing authority, that a detailed reporting and repayment plan be submitted to the Treasury and Congress.

Section 17 clarifies that condominium owners with flood insurance policies should receive claims payments regardless of the adequacy of flood insurance coverage of the condominium association and other condominium owners.

Section 18 re-establishes the Technical Mapping Advisory Council, similar to the one established in 1994, to ensure that the NFIP adopts meaningful standards for updating and maintaining maps. The Advisory Council will be comprised of government officials and others with expertise in mapping, and will make recommendations to FEMA on how to improve the accuracy of maps and on standards that should be adopted for flood rate maps, data, map maintenance efforts and funding needs and strategy. FEMA will be required to report annually to Congress on recommendations made by the Technical Mapping Advisory Council and actions taken by FEMA to address such recommendations.

Section 19 requires that FEMA establish an ongoing mapping program to review, update, and maintain flood insurance rate maps, including all areas within the 100-year and 500-year floodplains and areas of residual risk, including those protected by levees and dams. Additionally, this section requires that the most accurate data be used in mapping and maintenance, and requires that each map include certain elements to ensure consistency and accuracy. This section authorizes $400 million annually for mapping.

Section 20 eliminates the current prohibition barring states from contributing greater than 50 percent of the cost of map modernization, thus allowing states to invest additional funds in mapping.

Section 21 requires various federal departments to work together to coordinate mapping and risk determination budgeting, and requires the Office of Management and Budget (OMB), FEMA, and others to submit a joint report to Congress within 30 days of the budget submission on the crosscutting budget issues with respect to mapping.

Section 22 requires FEMA to contract with the National Academy of Public Administration to conduct a study on improving interagency coordination on flood mapping and funding and on how to establish joint funding mechanisms with federal, state, and local agencies to share the collection and use of data for mapping.

Section 23 states that while it is not mandatory to purchase flood insurance in the 500-year floodplain, due to the risk of flooding, it requires that communities be given notice when they are mapped into a 500-year floodplain, and requires lenders to give notice to purchasers of property in the 500-year floodplain.

Section 24 amends section 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 of, and information on, the availability of flood insurance.

Section 25 allows structures to be built to test flood-proofing methods so long as the structures are taken down after testing. The Committee report stated "there is some concern about the safety of flood-proofing, and this Committee believes that FEMA should consider the safety of any planned testing."

Section 26 requires that FEMA, at the request of a state commissioner of insurance, take part in state-sponsored, non-binding mediation to resolve insurance claims disputes where there are multiple insurance claims on the same property. This section also maintains federal jurisdiction over the NFIP.

Section 27 reiterates the responsibilities of FEMA under the 2004 reauthorization Act to establish minimum training requirements, and requires that FEMA report to Congress within three months on the status of all reforms.

Section 28 contains provisions to ensure that FEMA can determine the accuracy of flood claims payments. This section requires FEMA to collect from insurance companies that sell flood insurance policies (Write Your Own companies or "WYO") information on total claims made on a property in addition to flood, including wind and other damages, if the insurance company also underwrites the insurance for the other damages.

Section 29 requires that FEMA collect accurate and adequate information on WYO company expenses. Under this section, FEMA is required to promulgate rules within 180 days formulating a data collection methodology to gather expense information from insurance companies in a consistent manner. Within 60 days of a final rule on expense data collection, all WYO companies will be required to submit five years of data based on that methodology. Using that data, FEMA will be required to conduct rulemaking on reimbursement rates, to ensure that WYO companies are being reimbursed based on actual expenses, including standard business costs and operating expenses. After the rulemakings, GAO is required to report to Congress on the efficacy of the rules.

Section 30 requires FEMA to submit an annual report to Congress on NFIP's activities and financial health, including the amount paid in premiums, losses, expenses, number of policies, insurance in force, estimate of average loss year, and a description and amount of claims paid. This section also requires GAO to conduct a study of pre-FIRM structures to determine what types of properties are pre-FIRM, who owns the properties, locations, property values, and other information.

Section 31 extends the pilot program established in 2004 to mitigate severe repetitive loss properties through 2013. FEMA will be required to issue a rule implementing the pilot program within 90 days, and report to Congress on the status and implementation of the pilot program within six months.

Section 32 establishes an Office of the Flood Insurance Advocate to assist policyholders with any problems they have with the NFIP and claims.

Administration Position

The Statement of Administration Policy is as follows:

> The Administration strongly supports Senate passage of S. 2284. This bill would meaningfully reform the National Flood Insurance Program (NFIP), strengthen its current financial position, and increase its ability to fund future claims.
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> The Administration is pleased that the bill would provide the Federal Emergency Management Agency (FEMA) with greater flexibility to set premium rates and would require certain policyholders that currently enjoy subsidized rates to pay full actuarial rates over a four-year transition period. The bill would also provide meaningful protection for American taxpayers by increasing minimum deductibles, requiring FEMA to use actuarial principles in determining rates, and creating a new reserve fund to substantially reduce the likelihood that the NFIP will need to borrow funds during higher-than-expected loss years.
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> The Administration also supports provisions that would expand mandatory purchase requirements related to areas having special flood hazards by requiring the inclusion of areas of residual risk. The Administration recognizes the importance of improving the quality of flood risk information and looks forward to working with Congress to ensure that implementation concerns are addressed in the final version of the bill.
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> The Administration looks forward to continuing to work with Congress to reform and strengthen the NFIP for the benefit of policyholders and taxpayers. The Administration believes that any eventual conference agreement should avoid expanding the program to cover new non-flood related risks or increasing the coverage limits on existing policies.

The Administration is strongly opposed to the inclusion of the wind coverage provision passed by the House in the final version of the bill. Shifting liabilities for windstorm damage from the private sector to the NFIP would be fiscally irresponsible. If the final bill presented to the President includes provisions to expand the NFIP to include coverage for windstorm damage, his senior advisors will recommend that he veto the bill.

The Administration has constitutional concerns regarding a provision in the bill purporting to require FEMA claims adjustors to participate in State-sponsored mediation at the request of State insurance commissioners. The Constitution carefully allocates power between the branches of the Federal government, and between the States and the Federal government. This balance could be upset were Congress to confer on State officials the authority to compel agents of the Federal executive into the State's service.

The Administration has additional constitutional concerns regarding a provision in the bill that would require the National Flood Insurance Advocate, a Federal officer or employee, to file reports directly to Congress, including recommendations made by that official to his superior, without any prior review by superior executive branch officials. This provision would unconstitutionally interfere with the President's authority to supervise the unitary executive branch and to recommend to the consideration of Congress only such measures as the President deems necessary and expedient, conflict with the constitutional separation of powers, and raise concerns with respect to constitutionally based privileges. Moreover, to the extent that the powers and authorities given to the National Flood Insurance Advocate under the bill would entail the exercise of delegated sovereign authority, the provisions for his appointment would conflict with the requirements of the Appointments Clause of the Constitution.

Cost

The CBO estimated that S. 2284's net impact, including its effect on the NFIP and on the Treasury's interest collections, would be an increase in direct spending of about $1.2 billion over ten years. For a copy of CBO's revenue estimate, please see http://www.cbo.gov/ftpdocs/87xx/doc8777/SenateNFIP.pdf.