



**Consumer Federation of America**

**TESTIMONY OF**

**TRAVIS PLUNKETT,  
LEGISLATIVE DIRECTOR,  
CONSUMER FEDERATION OF AMERICA**

**BEFORE THE**

**COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS  
OF THE  
UNITED STATES SENATE**

**REGARDING**

**REAUTHORIZATION OF THE NATIONAL FLOOD INSURANCE PROGRAM**

**JUNE 23, 2011**

Chairman Johnson, Ranking Member Shelby and members of the Committee, I appreciate the invitation to appear before you today to discuss how to reform and reauthorize the National Flood Insurance Program (NFIP). My name is Travis Plunkett and I am the Legislative Director of the Consumer Federation of America (CFA). CFA is a non-profit association of 300 organizations that has sought to advance the consumer interest through research, advocacy, and education since 1968. I am here today because our Insurance Director, J. Robert Hunter, is, unfortunately, not available. Hunter was the Federal Insurance Administrator under Presidents Ford and Carter, where he helped create and run the NFIP in the 1970s. He also served as Texas Insurance Commissioner.

As Hunter has testified before this Committee several times, the NFIP is in very deep trouble.<sup>1</sup> CFA recommends a three-step process to fix long-term, structural flaws in the program that are harming consumers and taxpayers. First, use legislation reported out of the Committee on a bi-partisan basis in 2007 as the basis for improving and extending the program for no more than two years beyond its expiration on September 30, 2011. Second, require the completion of a study within eighteen months that thoroughly examines more far-reaching measures to permanently address problems with the NFIP, including how to terminate the insurance aspects of the program if strong movement toward fiscal soundness cannot be made, or how to revamp it so that private insurers assume a significant amount of flood risk. Third, enact legislation that addresses these broader recommendations.

The insurance component of the NFIP has proven unworkable because political pressure has kept flood insurance rates in many areas below the real cost of providing coverage. This has led to chronic taxpayer subsidies now totaling \$18 billion. Much of this subsidy has led to risky coastal development, often by affluent builders and homeowners. The Federal Emergency Management Agency (FEMA) has been repeatedly criticized by the Government Accountability Office (GAO)<sup>2</sup> and many others for grossly mismanaging the program, especially the process of updating flood insurance maps. This has misled many people into concluding that it was safe to buy homes or start businesses in dangerous flood plains. FEMA has also failed to fix the costly “Write Your Own” (WYO) program, which allows private insurers who assume no flood risk to reap excessive fees for servicing flood policies, especially at times of severe flooding. The WYO program eats up one-third to two-thirds of the insufficient premium dollars and exposes taxpayers to unnecessary costs.

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<sup>1</sup> J. Robert Hunter's Testimony on Flood Insurance before the Senate Banking Committee, October 2, 2007. [http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/Hunter%27s\\_Senate\\_Testimony\\_Flood\\_Insurance\\_10-2-07.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/Hunter%27s_Senate_Testimony_Flood_Insurance_10-2-07.pdf); Testimony of CFA's J. Robert Hunter before the Senate Banking Committee on Oversight of the National Flood Insurance Program, October 18, 2005.

[http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/Flood\\_Insurance\\_Senate\\_oversight\\_testimony\\_101805.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/Flood_Insurance_Senate_oversight_testimony_101805.pdf)

<sup>2</sup> “FEMA: Action Needed to Improve Administration of the National Flood Insurance Program” GAO-11-297, June 9, 2011; “Flood Insurance: Public Policy Goals Provide a Framework for Reform” GAO-11-429T, Mar 11, 2011; “GAO's 2011 High Risk Series: An Update” GAO-11-394T, Feb 17, 2011; “FEMA Flood Maps: Some Standards and Processes in Place to Promote Map Accuracy and Outreach, but Opportunities Exist to Address Implementation Challenges” GAO-11-17, Dec 2, 2010; “National Flood Insurance Program: Continued Actions Needed to Address Financial and Operational Issues” GAO-10-1063T, Sep 22, 2010.

As meaningful changes to the NFIP to deal with these systemic problems have not been made, the time has come for Congress to begin the process of evaluating how to revamp the program to make it fiscally sound or to end the insurance aspect of the program and allow more effective alternatives to take its place. Such an evaluation could examine a number of factors, including: how to encourage private insurers to take some, and ultimately all, of the existing flood risk covered by the program; how the insurance part of the program could be phased out to spur such private risk taking; how low and moderate-income homeowners and renters could be protected from rate shock and provided with a targeted subsidy to help them afford private flood insurance while removing general subsidies for people who do not need them; and, requirements that should be kept in place and improved regarding flood maps and construction in local communities.

## **I. The Consumer Interest in Fixing the NFIP**

In assessing the potential impact of changes to the NFIP on consumers, it is important to note that most policyholders receive few if any subsidies under the program. Some consumers receive intended subsidies, such as those who own structures built before the flood maps began being issued in 1974. However, many others benefit from unintended taxpayer subsidies that support unwise construction in the nation's flood plains, which is exactly the opposite intent of the NFIP. The policyholders who benefit from these unintended and expensive subsidies include: the owners of structures in areas with flood maps that have not been updated; builders selling homes that appear to be safe from flood under outdated flood maps, but are not; and, those who own "grandfathered" buildings in higher risk areas who FEMA still allows to pay older, lower rates, contradicting the program's intent.

CFA is often asked how a consumer group can favor bringing the NFIP into actuarial soundness, which will likely raise rates for some consumers. CFA strongly believes that the program should set fair, actuarially sound rates that accurately reflect the potential loss risk. However, the worst thing government can do is run an "insurance" program that is not true insurance, but an unwise and untargeted subsidy program that misleads consumers into putting their homes, businesses and lives at risk in areas that are dangerously flood-prone and that often unfairly subsidizes affluent individuals and contractors who do this building.

Homeowners who buy new homes in areas that they think are safe from floods are harmed when old maps underestimate risk. Some are misled into believing their homes are safe from floods when they build or buy new homes built to the old map's 100-year flood estimates that are, in fact, far below the real 100-year elevation. These people and their families are at risk of being killed or injured if a storm hits, or of having their homes or treasured possessions destroyed. Paying a little more and being truly aware of the risk is a blessing, not a curse, for consumers.

Other homeowners will look at these inaccurate flood maps and think, "I don't need insurance, I am way outside the risk area." But they are really well inside the area of high risk when the maps are old and development, erosion, climate change and other impacts have caused the 100-year flood to rise significantly, as those living on the Gulf found out the hard way during

Hurricane Katrina. CFA's study of Hancock County Mississippi flood maps after Hurricane Katrina hit found that the average map (of 76 in the county) was 20 years old and 10 feet too low in measuring the 100-year flood elevation.<sup>3</sup> Many home and business owners were misled into building unwisely, or not buying needed insurance, in the county where Hurricane Katrina hit, exposing the deeply flawed program's weaknesses in a most tragic way.

The current patchwork of general subsidies that drain the program of resources should be phased out. Targeted subsidies should be used to help low- and moderate-income people in flood-prone areas who cannot afford flood insurance. It is improper for the government to require the purchase of insurance, as the NFIP does, and not help those who cannot afford it. It is also improper to give broad, hidden subsidies to consumers and call it "insurance." Targeted subsidies for those who are most in need would cost far less than the current mix of general subsidies, some of which appear not to have been authorized by Congress.

## II. Signs that the NFIP is in Serious Trouble

The NFIP was intended to end unwise construction in high-risk flood plains throughout the country, while providing affordable coverage for people who really needed it. In return for taxpayer funding for the development of flood risk maps and the provision of subsidized insurance for older buildings, new construction was to be done wisely, and full "actuarial" rates were to be paid for flood coverage. Over time, the subsidies would be phased out and the program would reach complete actuarial soundness.

The NFIP was brilliantly designed, but it has failed to live up to its promise. Politics and inept administration have made it a sort of Frankenstein monster, encouraging and even subsidizing unwise construction. Millions of consumers have also been misled into thinking their homes or businesses were not in harm's way, because FEMA has completely mismanaged the process of updating flood insurance maps.

**A. *The NFIP is bankrupt, requiring billions of dollars in taxpayer support.***<sup>4</sup> Such a deficit would be acceptable for a short time if the program was doing what Congress intended, ending unwise construction in the nation's flood plains and requiring inhabitants of flood plains to bear their own risk through actuarially sound insurance premiums. However, the NFIP is doing the opposite of what Congress intended. These unwise subsidies will likely persist and worsen until the program is dramatically restructured or ended.

**B. *This taxpayer subsidy is not just due to catastrophe losses, but is routine.*** FEMA Administrator Craig Fugate testified before this Committee earlier this month that it is collecting \$3 billion a year in premiums, but said that this amount would be \$4.5 billion if

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<sup>3</sup> "An Examination of the National Flood Insurance Program," testimony of J. Robert Hunter, Director of Insurance, CFA before the Committee on Banking, Housing and Urban Affairs of the U. S. Senate, October 2, 2007. [http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/Hunter%27s\\_Senate\\_Testimony\\_Flood\\_Insurance\\_10-2-07.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/Hunter%27s_Senate_Testimony_Flood_Insurance_10-2-07.pdf)

<sup>4</sup> The current deficit is estimated at \$18 billion by the GAO. GAO, "National Flood Insurance Program: Continued Actions Needed to Address Financial and Operational Issues," GAO-10-1063T, Sep 22, 2010. <http://www.gao.gov/new.items/d101063t.pdf>

coverage rates were actuarially sound. This represents an astonishing 50 percent shortfall in the amount collected.<sup>5</sup> If correct, this estimate means that, over the next decade, the current \$18 billion NFIP deficit will almost double. From the beginning of the program until late 2009, the Congressional Budget Office (CBO) determined that the average annual taxpayer subsidy has been \$1.3 billion for the known/intended portion of the subsidy involving structures that existed before flood maps were developed. What is more shocking is that the NFIP's actuarially rated coverage, which is supposedly self-supporting, has been priced 5 percent too low if paid catastrophic claims are not considered and an astonishing 100 percent too low if they are included.<sup>6</sup> Moreover, the GAO reported this month that the number of policies receiving subsidized rates has steadily increased recently and will likely continue to grow if changes to the program are not made.<sup>7</sup>

- B. *NFIP subsidies are hidden.*** FEMA administratively “grandfathers” rates from old maps when new maps are developed, which means that there is a hidden subsidy for structures covered by the NFIP from the old map. (FEMA allows new rates if the price drops but freezes the rate if the risk increases, as is usually the case.) This subsidy, which is not stipulated in law, means that the number of structures receiving subsidies will grow continuously. Absent a huge infusion of funds from Congress, the NFIP has no chance of paying back the borrowed funds or of building adequate reserves for future catastrophic flooding. Another hidden subsidy stems from old maps, which almost always show flood elevations that are too low because construction raises elevations over time. (See discussion below.)
- C. *GAO found that the NFIP is a “high-risk” program for the American people.*** GAO placed the program on the high-risk list in 2006 “because of the potential for the program to incur billions of dollars in losses and because the program faces a number of financial and management problems.”<sup>8</sup> The GAO findings included: the NFIP could not generate enough revenue to repay the billions it had borrowed from taxpayers; the program would not be able to cover catastrophic claims that it paid in the future; oversight of the WYO program was weak, with potential for overpayment and inefficiency; FEMA does not study the program’s expenses to see if WYO insurers are overpaid; the NFIP is actuarially unsound; maps are out of date; FEMA does not understand the long-term impact of planned and ongoing development on projected damage estimates; NFIP debt is likely to grow; and, FEMA has not implemented its own financial control plan.<sup>9</sup>
- D. *FEMA has created a Write-Your-Own program that overcharges taxpayers and policyholders and is riddled with conflicts-of-interest.*** Considerable evidence has

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<sup>5</sup> Testimony of William Craig Fugate, FEMA Administrator, before the Committee on Banking, Housing and Urban Affairs of the U.S. Senate, Hearing on Reauthorization of the National Flood Insurance Program, June 9, 2011. [http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing\\_ID=a2c7e4b9-5b4d-4635-befe-8ce662da1774&Witness\\_ID=bdf843f6-112e-4009-80bb-2cc0f50d92c8](http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=a2c7e4b9-5b4d-4635-befe-8ce662da1774&Witness_ID=bdf843f6-112e-4009-80bb-2cc0f50d92c8)

<sup>6</sup> Ibid.

<sup>7</sup> GAO, “FEMA: Action Needed to Improve Administration of the National Flood Insurance Program” GAO-11-297, June 9, 2011, p. 52. <http://www.gao.gov/products/GAO-11-297>

<sup>8</sup> See GAO’s listing of the NFIP problems at:

[http://www.gao.gov/highrisk/risks/insurance/national\\_flood\\_insurance.php](http://www.gao.gov/highrisk/risks/insurance/national_flood_insurance.php)

<sup>9</sup> Ibid.

demonstrated that private insurers in this program overcharge for administrative and claims settlement duties<sup>10</sup> and that FEMA has repeatedly mismanaged this aspect of the program.<sup>11</sup> Additionally, FEMA refuses to broadly inform policyholders that they have an option to directly purchase flood insurance and potentially save taxpayers a considerable amount of money.<sup>12</sup> These WYO insurers also have a serious conflict-of-interest when they settle hurricane claims for the program, since they make more money if they determine that losses were caused by flood damage rather than wind damage. This is because taxpayers pay for 100 percent of flood claims under the NFIP, while WYO insurers must pay 100 percent of legitimate wind claims. Many Gulf Coast consumers are still in court dealing with claims that they believe should have been paid under their wind coverage.

**E. FEMA is far behind in keeping flood maps up-to-date.** “FEMA is not reviewing its flood maps every five years as required by law...older maps do not reflect significant changes in local conditions that tend to increase the risk of flooding.”<sup>13</sup> Coastal erosion, climate change, urbanization, loss of wetlands and other changes tend to make flooding worse. Old maps encourage construction in high-risk areas and subsidize such construction by charging actuarial rates with a hidden subsidy, which is the difference between what the old map would require to be charged and what the charges would be if the map were current. According to the GAO, 50 percent of the maps are over 15 years old and another eight percent are between 10 and 15 years old.<sup>14</sup>

**F. FEMA does not take into account development that is already planned and in the process of being completed when a map is published.** By the time a map is printed, it is out of date. FEMA’s own research shows the problem. In a test of what planned development would do to projected damages in the pricing model they use, FEMA funded a study that showed that it would raise projected damages by 20 percent in Fort Collins, CO, by 100 percent in Du Page County, IL and Macklenberg, NC and by a whopping 1,200 percent in Harris County, TX.<sup>15</sup> Ignoring what is planned means that a greater subsidy is built into the rate development process FEMA uses.

**G. FEMA is running into opposition as it updates its maps because communities are balking at adopting the much higher 100-year storm elevations now required.** Big increases in elevations are often needed, since FEMA allowed the Flood Insurance Rate Maps (FIRMs) to become so antiquated. FEMA has been too willing to compromise under political pressure from affected communities regarding the restrictions on development that are required. As a result, FIRMs are not being developed that will result in actuarially sound rates and properly

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<sup>10</sup> GAO, “Flood Insurance: Opportunities Exist to Improve Oversight of the WYO Program,” GAO-09-455, August 2009. <http://www.gao.gov/products/GAO-09-455>

<sup>11</sup> GAO, “FEMA: Action Needed to Improve Administration of the National Flood Insurance Program,” GAO-11-297, June 9, 2011, p. 26. <http://www.gao.gov/products/GAO-11-297>

<sup>12</sup> “Resources: Frequently Asked Questions,” FEMA, May 26, 2011.

[http://www.floodsmart.gov/floodsmart/pages/faqs/faqs\\_considering.jsp](http://www.floodsmart.gov/floodsmart/pages/faqs/faqs_considering.jsp)

<sup>13</sup> “The National Flood Insurance Program: Factors Affecting Actuarial Soundness,” Congressional Budget Office, November 2009. <http://www.cbo.gov/doc.cfm?index=10620>

<sup>14</sup> GAO, “Flood Insurance: FEMA’s Rate Setting Process Warrants Attention,” GAO-09-12, October 31, 2008. <http://www.gao.gov/products/GAO-09-12>

<sup>15</sup> “Managing Future Development Conditions in the National Flood Insurance Program,” Blais, et al, October 2006.

elevated homes and businesses, and include all at-risk homes within the designated flood plains.

**H. FEMA is not ensuring that communities live up to their land-use commitments**, the “quid-pro-quo” that Congress mandated for the creation of the entire program. FEMA’s own studies show the problem. It has a goal of visiting communities once every five years to promote, monitor and enforce compliance. The real rate is only once every ten years, however, “and only half of those contacts include a community visit. This is not a sufficient level of FEMA or state presence to maintain a level of monitoring necessary to avert compliance problems.”<sup>16</sup>

Worse, even if problems of compliance are found, FEMA is timid. FEMA uses probation and suspension, the two sanctions they have to assure compliance, “only sparingly.” As of June 23, 2010, less than one percent of the communities participating in the NFIP (212 out of 21,153) have been suspended from participating in the NFIP for non-compliance with the maps. Virtually all of the suspended communities appear to be small, rural towns. One study of the NFIP found that the threat of penalty is

used so infrequently that there has developed a widespread perception that it is unlikely to be imposed in any given situation. This perception deprives the threat of its credibility and thus keeps recalcitrant communities unresponsive. Further, FEMA regional office and state staff themselves have grown to believe that they will never be able to succeed in having probation imposed on a noncompliant community, and their frustration is detrimental to an effective community compliance initiative. ***FEMA should make an effort to act with deliberation on existing or future recommendations for probation action, with an eye toward re-establishing the credibility of this sanction.***<sup>17</sup> (Emphasis in original).

This study also recommended that FEMA should undertake an investigation of state compliance with NFIP criteria, since FEMA regional staff and state officials do not “know whether the development activities of state agencies (are) in compliance with NFIP regulations.” Finally, these 2006 FEMA studies found noncompliance with recordkeeping and construction requirements in the Community Rating System (CRS) communities that were getting a rate break for complying well with such requirements. This “affects the viability of the flood insurance fund even more than noncompliance in other communities.”<sup>18</sup>

Anyone who walks barrier islands on the nation’s eastern and gulf coasts and looks at recent construction along the beaches will know that the NFIP has failed to stop unwise construction at high-risk locations. It does not take an engineer to find relatively new structures that are at high risk and are not safe from storm surge. For years, CFA has been urging FEMA to create an enforcement program administered by an independent party, like

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<sup>16</sup> “An Evaluation of Compliance with the NFIP Part A: Achieving Community Compliance,” Monday, et al., a study for FEMA, 2006.

<sup>17</sup> Ibid.

<sup>18</sup> Ibid.

the GAO, that would conduct spot checks to see if local building enforcement is occurring, even regarding the current inadequate maps, but FEMA has not done so and Congress has not required it.

- I. *Instead of challenging communities that refuse to make land-use improvements as required by updated rate maps, FEMA offered “preferred risk” policies that under-price insurance.*** As detailed by the GAO in their most recent critical report of FEMA’s management of the NFIP, FEMA recently created a new coverage option called the “Preferred Risk Policy (PRP) Eligibility Extension that lowers rates for up to two years for policies that would have converted to higher premium costs upon renewal.<sup>19</sup> This is an unauthorized give away of taxpayer money to subsidize high-risk structures for no reason other than the fact that new maps had raised required building elevations. Giving high risk people below-cost rates for two years is an unjustifiable increase in taxpayer subsidies. If a subsidy is needed, it should be targeted to policyholders who have low or moderate incomes. General subsidies should be ended
- J. *FEMA has mismanaged the NFIP’s policy and claims management system at considerable cost to taxpayers. The GAO found that FEMA spent seven years and \$40 million dollars to create a new policy and claims management system called “NextGen” that it canceled in November of 2009 because it was ineffectual. “As a result, the agency continues to rely on an ineffective and inefficient 30-year old system.”***<sup>20</sup>
- K. *State Farm Mutual Insurance Company stopped servicing flood insurance policies for the federal government last fall, causing 829,273 NFIP policyholders to scramble for coverage.*** State Farm blames Congress and FEMA for poor administration of the program. The move is also at least equally likely to be related to State Farm’s long-term strategy to significantly reduce its home insurance risk along the nation’s coasts. FEMA’s spokesperson Rachel Racusen says that these policyholders will be just fine because they will be able to continue to use State Farm’s agents “or one of the other 90 insurers that sell flood insurance through the NFIP.”<sup>21</sup> However, this approach will likely cost taxpayers millions of dollars and result in poor customer service. It would be a mistake to allow “captive” State Farm agents to work for another WYO carrier because these agents are only responsible to State Farm. They are not prepared, trained, equipped or otherwise ready to deal with another company. Only so-called “independent” agents have such experience. Additionally, WYO companies cost about twice as much administratively as FEMA’s contractor, which handles the direct program of flood insurance for FEMA. Removing the agent and using the direct contractor would reduce overhead and profit-costs for the State Farm policies by about two-thirds, saving millions of taxpayer dollars.
- L. *If FEMA were to try to make the program more actuarially sound, existing law limits that possibility.*** Currently, rates cannot rise more than 10 percent a year. Limits on one-year rate

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<sup>19</sup> GAO, “FEMA: Action Needed to Improve Administration of the National Flood Insurance Program,” GAO-11-297, June 9, 2011, p. 53. <http://www.gao.gov/products/GAO-11-297>

<sup>20</sup> GAO, “FEMA: Action Needed to Improve Administration of the National Flood Insurance Program,” GAO-11-297, June 9, 2011, p. 57. <http://www.gao.gov/products/GAO-11-297>

<sup>21</sup> “State Farm Won’t Handle Claims for Flood Insurance Program,” *National Underwriter*, June 7, 2010.

increases are necessary because consumers need time to adjust to insurance price increases but 10 percent is too low. The House proposal to raise the allowable rate increase to 20 percent makes more sense.<sup>22</sup> However, it is important to note that this limit is not related to income or any measure of the ability of homeowners to pay increased rates. This means that a substantial portion of the NFIP subsidy will likely continue to be provided to affluent homeowners living on barrier islands, or near lakes and other waterways.

***M. Congress has allowed the NFIP to lapse several times recently, creating uncertainty and instability in the program.*** As an insurance executive recently put it, “this is now the fourth time Congress will have let this program lapse, and it’s beginning to feel like ‘Groundhog’s Day,’” said Blain Rethmeier, a spokesman for the American Insurance Association.<sup>23</sup>

***N. Until now, Congress has been unwilling to stop the trend toward making NFIP more of a giveaway program to some consumers and businesses than an insurance program with sound risk management.*** Overall, Congress has not moved fast enough to lift woefully inadequate limits on flood insurance rates to allow the program to move to actuarial soundness, which is undermining hope for a self-sustaining NFIP anytime in the near future.<sup>24</sup>

### **FEMA’s Response to System Problems at the NFIP**

In his testimony before the Committee on June 9<sup>th</sup>, FEMA Administrator Craig Fugate acknowledged many of the systemic problems with the NFIP that I have cited, but offered little information and no details regarding what the agency will do to address long-standing and well-documented concerns about its management of the NFIP. It is of particular concern to CFA that he provide no information about how FEMA intends to cut the excessive costs of the WYO program or overcome the wind/water conflicts-of-interest that exist for insurers who participate in the program. I understand that the agency is in the middle of a lengthy effort to review proposals for NFIP reform. However, after years of concern about the direction of the NFIP from Congress, the GAO and outside organizations, the Senate deserves a more specific, urgent reform plan from FEMA.

### **III. The Future of the NFIP**

As mentioned above, CFA recommends that Congress evaluate far-reaching, longer term measures that would either permanently fix fatal flaws in the NFIP, such as ideas for getting private insurers to assume substantial flood risk, or that would phase out the program in a responsible manner and create effective, affordable alternatives. While this research is being done, we recommend the adoption of legislation that would take steps to bring the program back towards solvency and that would extend it for no more than two years.

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<sup>22</sup> H.R. 1309, Flood Insurance Reform Act of 2011, Section 5(a).

<sup>23</sup> “NFIP Lapses Again Due to Senate Inaction,” *National Underwriter*, May 28, 2010.

<sup>24</sup> NFIP is an insurance program and is not designed to be a charity program. The current subsidies are disbursed indiscriminately, with no test of the ability of the subsidy recipient to pay the real cost of risk of the structure he or she owns.

- A. ***Congress should study ending the NFIP to correct fatal flaws.*** If Congress were to decide to end the systemic problems with the NFIP described above, the only responsible way to do so would be to make sure that the program becomes fully actuarially sound. However, to date, strong political pressure on Congress and from Congress, as well as from state and local leaders, has prevented the program from becoming actuarially sound. It is likely that developers will continue to find loopholes to let them build unsafe structures, politicians will resist community suspension, and higher (but proper) rates will not be allowed.

The only counter-weight to this one-way pressure to soften the program's impact on communities, developers and consumers at taxpayer expense would be to encourage private insurers to get more involved in at least some of the risk-taking aspects of the program. If the private sector has some "skin in the game," then there would be pressure brought to bear by insurers to make sure maps are accurate and enforced, updated actuarial rates were used and that everyone was doing all things necessary to make the program effective and to protect the taxpayer (and the insurer's) bottom line. Insurers would resist pressure from politicians and developers to lower rates below cost. Politicians would resist pressure from insurers to have rates that were excessive. These checks and balances would help keep flood insurance prices reasonable but adequate.

However, many private insurers will not jump at the opportunity to underwrite more flood risk. Many are in the midst of significantly cutting back on the coverage they offer on the coasts because of wind risk. As private sector participation in the risk-taking aspect of NFIP is questionable, it is necessary to study the possibility of protecting taxpayers by ending the insurance component of the program in a responsible way that protects vulnerable consumers.

The point of the study would be to evaluate potential outcomes if the program is ended and to develop a transition plan that allows all affected parties to prepare for the consequences of such an event. The transition plan will be complex and must be done with great concern for the current inhabitants of floodplains, particularly NFIP policyholders. CFA recommends that Congress task the GAO and FEMA with evaluating the following specific topics when making recommendations about how to end the NFIP, as part of the legislation to extend the NFIP beyond September 30, 2011.

1. **Ending only the insurance part of the program.** (As stated below, accurate and up-to-date FIRM information on risk is vital if any private sector insurance underwriting is to become viable.) Ultimately, after a long transition where the federal government participates in risk taking either directly or through reinsurance, a private market could develop if there is accurate and current risk information and safe construction in the flood plains.
2. **Providing a long transition period to allow all parties time to adjust to the lack of a federal insurance program.** Thirty years, for example, would provide time for the government to gradually phase out its subsidies, for insurers to determine how to underwrite flood risk and for consumers to find alternatives to the NFIP.

3. **Phasing out the provision of insurance over this period.** A likely first step in the phase-out process would be for the federal government to stop writing new business. Even this measure would have to be done in a way that allowed *safely* constructed new homes to receive mortgages through the provision of clear, accurate information on flood risk to lenders.
4. **Protecting LMI homeowners and renters.** Congress could likely end the NFIP over a five or ten-year period if not for the need to protect LMI consumers from rate shock. The study should consider providing an ongoing subsidy to LMI homeowners during the transition and even after some degree of private insurance enters the market.
5. **Requirements that should be placed on communities in flood plains and on FEMA regarding flood maps.** Keeping the mapping and community participation requirements in current law would provide private insurers with sufficient information to begin to take risk. This knowledge base is vital to encouraging a private response. Insurers will need information to help them write coverage for structures at actuarial rates and to have an ability to determine which communities are requiring safe building in flood plains to help them focus their insurance capacity. When HUD did its 1966 Feasibility Study into why flood insurance was not privately available at the time, it found that the factors were:
  - Lack of any way to accurately determine pricing (i.e., no mapping of the flood risk);
  - Consumers knew more about the risk of flood than the insurers, which meant that there would be adverse selection by people against any price insurers set;
  - If prices were raised, only people at higher and higher risk would buy the insurance;
  - No one was controlling new construction, so changes up or down stream could make prices for insurance too low;
  - Lenders did not require flood insurance.

Unlike 1966, we now have the ability to solve many of these old insurance concerns. Maps, if they are kept up-to-date, can calculate rates that are actuarially sound for every structure. Adverse selection is minimized since lenders in the high-risk flood plains now require all building owners to get flood insurance. Flood plain management is in place as a condition of flood insurance availability in a community.

6. **Encouraging private insurers to take some, and ultimately all, of the existing flood risk.** This could be done either on a property-by-property basis or with some overall sharing of risk. The sharing might start with the government taking 95 percent of the risk and setting actuarial rates that would have to be paid. Insurers would initially assume 5 percent of the risk and set rates for those structures they would underwrite. FEMA could advertise which insurers were selling flood insurance in its “Flood Smart” ad program. Over time, the government’s percentage of the risk would decline. In order to incentivize insurers to participate, the government could develop a stop-loss reinsurance program, which caps the private insurer annual exposure to loss.

7. **Mandating the purchase of flood coverage.** If flood insurance is unavailable, there should obviously be no requirement to purchase it. On the other hand, if the private market does develop, a purchase requirement might allow insurers to effectively spread their risk. This would further increase their ability to soundly underwrite flood coverage. Whether and how to mandate purchase during the transition is a key question the study must consider.

B. ***The Senate Flood Insurance Reform and Modernization Act of 2007 (S. 2284) is the best starting point for making much-needed incremental changes to the NFIP.*** S. 2284 takes several very important steps to protect taxpayers, increase the market penetration of flood insurance, and eliminate unjustified subsidies in the flood program. In particular, the bill would phase out subsidies for vacation and second homes, properties built before the availability of Flood Insurance Rate Maps (FIRMs), and structures that have experienced severe repetitive losses. It would also require the NFIP to build reserves over time, add a 500-year floodplain to the flood maps, and require the evaluation of flood risk behind dams and levees. It would also take the important step of creating a flood insurance advocate's office to assist those with flood coverage in resolving problems with the NFIP and add deductibles to NFIP policies.

CFA recommends that the Committee add provisions to this bill that would move the NFIP even more quickly towards solvency, so that it will become financially viable over time and be there for homeowners who need it. The bill should require a study of NFIP to determine the steps needed to make it fully self-sufficient, including the review detailed above on how to increase private insurer underwriting of flood risk or to responsibly end the program should self-sufficiency be unattainable. Just studying these possibilities will demonstrate that Congress is serious about making the program viable for the long term. The bill should also increase the cap on allowable rate increases per year from 15 to at least 20 percent. Finally, in order to give Congress a meaningful opportunity to make needed, more far-reaching changes to the program that result from required studies, the bill should only renew the NFIP for two years, instead of five.

C. ***House legislation to renew the NFIP (H.R. 1309) has significantly improved over previous House bills, but still contains some damaging provisions.*** (This bill has been marked-up this year by the House Financial Services Committee and is currently on the House Floor.) On the positive side, the bill allows rates to rise by 20 percent annually, rather than the 10 percent cap in the current program. It adds mandatory deductibles to NFIP policies. It phases in full actuarial rates a bit more slowly than we would like to see (at 20 percent of the required increase per year over five years) for commercial properties, second and recently purchased homes, existing policyholders, severely damaged homes, and repetitive loss homes. No subsidy is allowed on lapsed policies. It also protects those who are required to purchase high-priced "forced-placed" coverage by requiring repayment to the borrower for any coverage that is paid for under a forced-placed policy in force at the same time an NFIP policy is in place.

The bill also requires some important studies within 18 months of the effective date,

including both a FEMA and GAO report on how to privatize the program. FEMA is also required to report annually on its ability to pay claims with and without authorized borrowing authority. It must study community-based flood insurance and adding building code requirements to flood plain management standards. Finally, the National Academy of Sciences must evaluate how to do a “graduated risk” assessment of flood risk behind levees.

The bill also contains several negative provisions. FEMA is permitted to suspend flood insurance purchase requirements for one to two years for several questionable reasons: (1) if an area has no history of flooding, even though the science underlying the new maps that show increased flood risk is sound; (2) if a community says it is upgrading a levee or dam that has been decertified because it can’t provide 100-year flood protection, even when improvement efforts are not complete; or (3) when someone appeals a requirement to purchase insurance.

The bill also contains several provisions that will increase the cost of the program and taxpayer exposure. It allows maximum policy coverage to be indexed according to the cost-of-living. Coverage for loss-of-use is also added. Maximum coverage benefits will be indexed. It also requires policy rates in newly mapped areas to be significantly less than what is actuarially required for the first year of coverage.

The bill authorizes FEMA to purchase private reinsurance, which is silly and unnecessary, given the financial ability of the federal government to cover losses. It is analogous to requiring a very large insurance company, such as State Farm or Lloyd’s of London, to seek reinsurance from a very small, single-state reinsurer. Moreover, when a big insured event occurs, reinsurers often suspend coverage or overreact by making rates too high,<sup>25</sup> which will further increase federal costs.

The bill also increases the chances that taxpayers will be overcharged by the WYO program by requiring that those who are insured through the more-efficient and less-costly direct program be notified that they should consider finding a WYO company. Since WYO program costs are significantly higher than those of the direct program, this requirement encourages policyholders to make a choice that will cost taxpayers more money. Even worse, the bill requires FEMA to study how to keep participation in the direct program under 10 percent of the NFIP portfolio, even if WYO costs continue to be too high.

Finally, the bill renews the NFIP for five years, instead of two. As mentioned above, this is too long to renew a program that needs far-reaching changes, which will be recommended in the bill’s mandated studies.

***D. The COASTAL Act of 2011 is well-intended, but unnecessarily complex and probably unworkable under FEMA’s management.*** The Consumer Option for an Alternative System To Allocate Losses Act of 2011 (S. 1091) was proposed this year by Senator Wicker. This bill does more to ease the NFIP shortfall than the current program, with an allowable 20 percent annual cap on rate increases and mandated full actuarial rates on new and lapsed

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<sup>25</sup> As a leading reinsurance executive told Hunter, reinsurers often get “too greedy” when a big event opens the door for price gouging.

policies. It also does not raise program costs by increasing coverage limits or adding new loss-of-use coverage. It requires state-chartered banks to mandate the purchase of flood insurance when underwriting mortgage loans, but insurers that do mortgage lending do not have to meet this requirement. However, the bill does not require study of how to get private sector involvement or how to cut the systemic program deficits, both of which are very important to bringing the program back into solvency.

As with the 2007 Senate bill and the House bill, this legislation extends the NFIP for five years without making broad reforms. This is too long for Congress to wait to take the further steps recommended by the studies required in final legislation.

The centerpiece of the bill is a system to handle wind and water claims that is unnecessarily complex and probably unworkable. It requires FEMA to come up with models to calculate wind speed and storm surge whenever a named storm hits. These models must be accurate to 90 percent, but it is quite unclear exactly what such a 90 percent standard requires. (As written, the requirement is statistically meaningless.) The bill requires a massive effort to develop these models involving data collection from academics, private persons, state and federal agencies and so on. It would even require storm “sensors” to be put along the coasts.

When adjusters find a loss to be “indeterminate,” because they are unable to tell which losses are due to wind damage and which are from water damage, the as-yet-unavailable data from the massive collection effort will be plugged into a yet-to-be-determined formula the Administrator of FEMA will create. The formula would include the property’s FEMA Flood Elevation Certificate and other information the Administrator would like to use. Taken together, these very complex requirements seem quite inappropriate for an agency that has had serious, well-documented trouble managing relatively simple NFIP requirements, such as the WYO program and the mapping of flood plains, where the science is mature.

Wind and flood insurers are required to use this method to distribute losses. Other insurers “may” use this process if the policyholder agrees to it at the time of policy sale. There is no judicial review of this formula, or the data that is used to create it. However, there is an appeal to a five-member Arbitration Panel. Prior to the allocation, insurers can do a “good faith” allocation and true it up when the formula results are known. All this relates only to “indeterminate” claims. Other claims will rely on good faith between wind insurers and FEMA. Disputes here are also to be sent to the Arbitration Panel.

The method proposed in this legislation for accurately assessing wind versus water claims is unnecessarily complex and costly. A look at what private insurers do when faced with apportioning costs from losses is instructive. Large property/casualty insurers do not bother to balance out subrogations they have between themselves after auto accidents since there are so many claims and they have learned that doing a lot of research on each claim is not required, since the costs between insurers even out over time. Therefore, it makes no sense with flood insurance to try to be so complex. The law of averages will lead to a fair division between wind and water claims over time. All that is needed are three things: a federal claims adjusting contractor to do all of the adjusting of flood claims; an occasional GAO audit of the WYO carriers to make sure their apportionments are not biased on the wind

claims; and for FEMA to disallow insurer use of anti-concurrent causation clauses, which allow them to refuse to pay wind damage if flood damage occurred to the insured property at the same time. If apportionment bias is occurring, FEMA must then initiate enforcement actions against WYO companies by removing them from the program.

After this monumental effort, the Wicker bill allows the policyholder and insurer to agree to opt-out of this approach. It also allows an insurer to opt-in so that every one of its claims from a named storm will be done using this method. (It seems unlikely that many insurers would want to opt-in, however.) In sum, the goal of the legislation is laudable, but the methods it requires will create a lot of bureaucratic difficulty and would likely fail.

Thank you for the opportunity to offer CFA's thoughts on reform and reauthorization of the NFIP.