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Good morning. Thank you for inviting me here today. I commend Chairman Shelby, Ranking Member Sarbanes, and the committee members for moving quickly to start a thorough re-examination of the flood insurance program.

I am the President of the Center On Federal Financial Institutions or COFFI for short. This is the first time in our young history that anyone from COFFI has appeared before your committee, so let me briefly explain who we are. We are a non-partisan and non-profit think tank focused on the federal government's massive activities as lender and insurer. Our role is educational. Federal financial institutions are complex and we want to help policymakers fully understand their options without imposing our own views. In that vein, The New York Times referred to our work as "without a hint of dogma or advocacy."

The devastation wrought by Katrina underlined three major problems at the flood insurance program, viewed as a federal financial institution:

- We cannot persuade most of the target market to buy the policies.
- The insurer's financial resources are insufficient for expected claims.
- Budget accounting for the program is structurally misleading.

The greatest damage stems from the low participation rates, since each victim of Katrina who failed to insure their home faces a major financial shock on top of their other traumas. Precise figures for participation are difficult to come by, which is a problem in itself, but it appears that fewer than 30% of vulnerable homeowners were insured nationwide.

Floods can be more frequent than fires and equally damaging, so why don't more homeowners carry flood insurance, as they do fire insurance? The full answers are complex and are discussed in great detail in an attachment to our written statement, but the simple version is this.

First, there are major economic disincentives to buying flood insurance. Uninsured flood victims receive substantial benefits unavailable to insured homeowners. The National Flood Insurance Program (NFIP) indicates that every three dollars of flood insurance claims payments reduce the value of federal disaster aid by one dollar. Flipping this around, insurance purchasers forego aid worth one-third of their entire claims payment. They may also forego state, local, and charitable aid. On top of this, flood losses are generally tax-deductible, while flood insurance premiums are not. Thus, a purely rational homeowner has many reasons not to buy the insurance.

Second, considerable research suggests that most people have a strong irrational bias against buying insurance covering infrequent catastrophe losses. It feels like throwing away money to them. This perception can be countered to some extent by how the insurance is framed, but the bias is difficult to eliminate completely.

Third, our existing mandatory provisions are leaky. The main one, which uses mortgage lending as the trigger, suffers from three disadvantages:

- One study found that 34% of coastal dwellers vulnerable to flooding had no mortgage.
- Only federally-regulated mortgage lenders and GSE's are covered.
- It appears that some homeowners cancel their flood coverage without lenders taking action.

Another mandatory provision, that aid recipients must carry flood insurance in the future, is relevant to only a portion of future claims and suffers from leakage problems as well.

So what can be done? Efforts to increase voluntary purchases are worth considering, but, unfortunately, it will almost certainly take tougher mandatory provisions to significantly boost participation, given the economic disincentives and pyschological biases. This is not just my view. COFFI recently held a policy forum on flood insurance and there was a consensus that stronger mandatory mechanisms are the only way to sharply increase participation. I would add that this is even more likely to be necessary if premium rates are boosted to deal with the financial implications of Katrina.

Enforcement of current provisions could be tightened by stricter review of whether mortgage borrowers maintain their flood insurance and possibly by expanding the mandate to non-federally regulated lenders. However, even these actions would still leave many uncovered – at a minimum the 34% or so who don't hold mortgages. A more radical solution would be to require that homeowners' policies in flood-prone areas include flood insurance, with the federal program continuing to take the actual financial risk. Issues of federal regulation could perhaps be finessed by coordination with the National Association of Insurance Commissioners.

Despite the many uninsured, the flood insurance program will lose well over 10 billion dollars on Katrina. This highlights a fundamental structural problem. The flood insurance program charges roughly one-third less in premiums than its actuaries believe would be necessary to cover long-term expected costs. This is because structures which existed before a community signed up for the program receive a subsidy of roughly $1.3 billion a year while newer structures pay approximately their actuarial cost. That represents a subsidy of just under 40% for the program as a whole.

This subsidy is not necessarily wrong. It is for **you** to decide whether taxpayers from across the nation should subsidize those living in flood-prone areas. There are reasonable arguments either way.

What IS wrong is the lack of transparency. There is nothing in the budget numbers to show the subsidy. Nor does the National Flood Insurance Program make such a number readily available. They have an excellent and well-written Actuarial Review on their website that explains the subsidy mechanism, but stops short of providing an aggregate figure. The last public number I found was in a GAO report of a few years ago which gave a figure of $500 million a year. I had to do some simple math to arrive at the updated $1.3 billion figure.

The NFIP Actuarial Review of November 2004 states that "were the catastrophic contingency contemplated in establishing all rate levels, the Pre-FIRM subsidized portion of the business would have to pay about two and a half times the current premium, and the overall target level for premiums would have to increase on the order of 50% to 75%." Those percentages correspond to $1.0 to $1.5 billion of extra premiums, based on 2004 levels. Our calculations from more detailed numbers provided in the same review put the figure at $1.3 billion.

Ideally, the taxpayer subsidy would be shown on-budget, but it is important either way that the figure be clear and readily available. There is currently a misconception among some that the flood insurance program is self-supporting, since it has been able to pay back its loans from the Treasury Department over the last 20 years. This is true, but misleading. The flood insurance program is structured in a way that should be expected to require taxpayer money over time. It is impossible to give over a quarter of policyholders, the riskiest ones at that, a 60% discount from actuarially fair rates without either overcharging the other policyholders an equal amount or eventually receiving government appropriations.

There is a danger in underpricing insurance and not admitting it, as we are seeing now with another program on which COFFI has done considerable work, the Pension Benefit Guaranty Corporation. That program has never charged premiums adequate to its risks, but still reported contributions to federal deficit reduction because of perverse budget rules. Everyone was happy with an untenable situation until PBGC started losing $10 billion a year on a GAAP accounting basis, losses that will eventually work their way through to the federal budget.

Finally, we must seriously consider the possibility that Katrina's losses were not AS improbable as the program's models would have suggested. It may be that all policies are currently subsidized, due to unrealistically optimistic assumptions about future losses from the most catastrophic hurricanes.

Thank you. The remainder of my written testimony consists of a more thorough 17-page review of many of these issues, which we published a few weeks ago. We also have other material available at www.coffi.org. This will shortly include both a transcript and a summary of the flood insurance policy forum that we recently held.