CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

October 31, 2007

Flood Insurance Reform and Modernization Act of 2007

As ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs on October 17, 2007

SUMMARY

The Flood Insurance Reform and Modernization Act of 2007 would modify the National Flood Insurance Program (NFIP) to increase the amount of premiums collected and reduce the cost of expected claims. The program's outstanding debt to the Treasury of $17.5 billion also would be forgiven. CBO expects that enacting this legislation 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. CBO expects that without a change in law, the NFIP will be unable to pay all flood insurance claims promptly, and faced with a nonfunctional program, policyholders may abandon it. In such cases, the federal government may be called upon to provide additional relief in the aftermath of a disaster for properties that would have otherwise been insured. CBO cannot predict when this might occur, but today, the program faces a future with inadequate resources to pay its obligations.

The bill would direct the Federal Emergency Management Agency (FEMA) to increase premium rates by 25 percent per year on certain policies that pay less than the expected cost under current law. FEMA would be authorized to impose average annual rate increases of up to 15 percent on all other categories of policyholders. CBO estimates that premium increases at this maximum level would be necessary to establish the reserve fund that would be created under the bill to pay insurance claims whenever necessary. Finally, the bill would require policyholders to carry a larger deductible and would end the current practice of offering new policies to some property owners at less than their expected cost. These changes would increase the cost to policyholders and reduce the net cost of the program to the federal government.

CBO estimates that the proposed changes to the NFIP and the elimination of its Treasury debt would increase premium revenue over the next 10 years by nearly $19 billion and would reduce NFIP outlays by about $10.6 billion relative to current law. CBO expects this legislation would allow the program to avoid developing a growing backlog of unpaid claims, which we estimate could reach a value of $21 billion by 2017. At the same time,

because the bill would forgive the NFIP's debt to the Treasury, CBO estimates that the Treasury would forgo interest payments from the NFIP of about $9.7 billion over the 2008-2017 period. The net impact of the bill—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 the 2008-2017 period.

As the value of flood insurance coverage in force continues to grow, the expected cost of claims that the NFIP will face in the next decade also will 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 Hurricane 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, under current law, will be equal to the amounts anticipated by the program's actuaries on an expected annualized basis (which includes some probability that a catastrophic event would occur). This estimate also assumes that substantial numbers of policyholders would drop flood insurance coverage or find alternatives to the NFIP as their premiums rise steadily over the period.

The bill would authorize the appropriation of $2.4 billion over the 2008-2013 period for FEMA's flood mapping program. In addition, it would authorize the appropriation of $190 million over the 2008-2013 period to extend the pilot program to mitigate severe repetitive losses through 2013 and establish the Office of the Flood Insurance Advocate. Finally, the bill would require FEMA to participate in state-sponsored mediation programs and would direct the Government Accountability Office (GAO) to conduct multiple studies on the NFIP. Assuming appropriation of the necessary amounts, CBO estimates that implementing those provisions would cost about $1.6 billion over the 2008-2012 period and an additional $1 billion after 2012.

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 in UMRA ($66 million in 2007, adjusted annually for inflation).

The bill also would impose private-sector mandates, as defined in UMRA, on certain mortgage lenders. Based on information from industry sources and FEMA, CBO expects the direct costs to comply with those mandates would fall below the annual threshold for private-sector mandates established in UMRA ($131 million in 2007, adjusted annually for inflation).

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of the legislation is shown in the following table. The costs of this legislation fall within budget function 450 (community and regional development).

	By Fiscal Year, In Millions of Dollars											
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2008-2012	2008-2017
CHANGES IN DIRECT SPENDING [a]												
Changes to the NFIP												
Estimated Budget Authority	725	600	175	0	0	0	0	0	0	0	1,500	1,500
Estimated Outlays	725	600	175	0	-225	-800	-1,275	-1,850	-2,525	-3,325	1,275	-8,500
Forgone Treasury Interest Receipts												
Estimated Budget Authority	775	925	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	4,700	9,700
Estimated Outlays	775	925	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	4,700	9,700
Total Changes												
Estimated Budget Authority	1,500	1,525	1,175	1,000	1,000	1,000	1,000	1,000	1,000	1,000	6,200	11,200
Estimated Outlays	1,500	1,525	1,175	1,000	775	200	-275	-850	-1,525	-2,325	5,975	1,200
CHANGES IN SPENDING SUBJECT TO APPROPRIATION												
Flood Mapping												
Authorization Level	400	400	400	400	400	400	0	0	0	0	2,000	2,400
Estimated Outlays	100	260	340	400	400	400	300	140	60	0	1,500	2,400
Severe Repetitive Loss Mitigation Pilot Program												
Authorization Level	0	0	40	40	40	40	0	0	0	0	120	160
Estimated Outlays	0	0	8	24	40	40	32	16	0	0	72	160
Office of Flood Insurance Advocate												
Authorization Level	5	5	5	5	5	5	0	0	0	0	25	30
Estimated Outlays	3	5	5	5	5	5	2	0	0	0	23	30
GAO Studies												
Estimated Authorization Level	1	0	0	0	0	0	0	0	0	0	1	1
Estimated Outlays	1	0	0	0	0	0	0	0	0	0	1	1
Total Changes												
Estimated Authorization Level	406	405	445	445	445	445	0	0	0	0	2,146	2,591
Estimated Outlays	104	265	353	429	445	445	334	156	60	0	1,596	2,591

a. In addition, CBO estimates that revenues from civil penalties assessed on lenders would increase by about $1 million a year over the 2008-2017 period.

BASIS OF ESTIMATE

For this estimate, CBO assumes that the bill will be enacted by the end of calendar year 2007 and that the authorized amounts will be appropriated for each fiscal year.

To estimate program expenses over the next 10 years, CBO assumes that reimbursement agreements to private insurance companies that sell and service flood insurance policies on the behalf of the federal government will remain unchanged. In addition, we assume that claims over the next 10 years, under current law, will equal amounts anticipated by the program on an actuarial basis (which includes some proportionate risk of catastrophic events) and that the premium currently assessed by FEMA on unsubsidized policies is sufficient to cover the full risk of the insurance.

Direct Spending and Revenues

Over the 2008-2017 period, CBO estimates that enacting the legislation would reduce net outlays for the flood insurance program by about $8.5 billion and would increase the Treasury's outlays for interest by about $9.7 billion—an estimated net increase in direct spending of $1.2 billion over the ten year period.

Changes to the NFIP. The Flood Insurance Reform and Modernization Act of 2007 contains several provisions that together would govern the magnitude of future rate increases for flood insurance and reduce the amount of expected claims. Those provisions would:

- Require the NFIP to establish 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 outstanding debt to the Treasury;
- Phase out subsidized premiums for some policyholders;
- Require policyholders to carry a larger deductible; and
- Prohibit FEMA from subsidizing new or previously unsubsidized policies.

CBO estimates that those changes would reduce net outlays of the NFIP because premium increases would be greater than those that would occur under current law and because no interest would have to be paid to the Treasury on the program's current debt. That decline would be partially offset by higher claims payments because, under the bill, the NFIP would have sufficient funds to pay expected claims; under current law, CBO expects 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 at least 1 percent of the value of flood insurance coverage in force during the previous year. As of August 2007, FEMA reported that flood insurance coverage in force totaled about $1.1 trillion. During the five-year period prior to the hurricane seasons of 2004 and 2005, total coverage had been increasing by about 7 percent per year. If such a rate were to continue into the future, the amount of flood insurance coverage would reach about $2.1 trillion by 2017. CBO estimates, however, that coverage in force would reach about $1.8 trillion under the bill, because some policyholders would drop coverage as a result of the premium increases estimated to occur under the bill. FEMA would gradually accumulate reserves by depositing an amount equal to 7.5 percent of the required reserve in each year until the fund is fully capitalized.

The bill also would increase the maximum amount that FEMA could increase average premium rates within each risk category from 10 percent to 15 percent. CBO expects that FEMA would need to increase most rates by the maximum allowable percentage under the bill in order to pay claims and accumulate the required reserves, even if those rates exceed the amount FEMA estimates would cover the full cost of providing flood insurance. Even so, assuming that claims over the next several years occur at the level estimated by actuarial studies, 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. Therefore, CBO estimates that it would be unlikely that FEMA would be able to collect enough premiums to meet the reserve fund target in the first few years after enactment. However, as successive rate increases are implemented, we estimate that the reserve fund would begin to accumulate reserves totaling about $8.5 billion by 2017, which is over half the amount that would be required to be deposited under the bill by that time. (If losses due to floods are less than the actuarial average over the period, the balance would be greater. If losses exceed the average—for example, because of a catastrophic event—the balance would be smaller. Based on FEMA's actuarial review of the NFIP, CBO estimates that the expected annualized loss would be about $2.4 billion for policies in force in 2008.)

For this estimate, CBO assumes that FEMA could begin to implement premium increases to establish the reserve fund in May 2009. In the past, FEMA has typically proposed rate increases in November that would be effective in May of the following year. It takes a year before any rate increase is fully implemented because individual flood insurance policies are renewed throughout the year.

To estimate the amounts that could be collected and deposited into the reserve fund, CBO reduced the projected value of flood insurance in force to reflect the likelihood that some policyholders would drop NFIP coverage after successive years of 15 percent annual rate increases which could quadruple their insurance premiums if sustained for 10 years. Policyholders living in lower-risk areas would be especially likely to seek out and find alternative insurance products if their cost to participate in the NFIP far exceeds their actuarial risk. In addition, some policyholders might retain their policies, but choose to reduce the amount of coverage.

Increase Rates for Pre-FIRM Properties. The bill also would authorize the NFIP to implement larger average rate increases on certain properties that were built before flood insurance rate maps (FIRMs) were completed or before 1975, whichever is later. Those properties are collectively known as pre-FIRM properties. The bill would authorize annual average rate increases of up to 25 percent for certain pre-FIRM properties, including:

- Nonresidential structures;

- Nonprimary residences (such as vacation homes);

- Properties that have been flooded four or more times with total claims payments exceeding $20,000; or properties with two or more claims exceeding the fair market value of the property (also know an severe repetitive loss properties);

- 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.

Under current law, the NFIP charges many pre-FIRM properties a premium that is less than the actuarial cost of the insurance. On average, FEMA estimates that those policies are discounted between 60 and 65 percent. Under the bill, FEMA would increase rates on those specified types of pre-FIRM properties by 25 percent per year until the actuarial rate is achieved. At this rate, CBO expects that most of those pre-FIRM properties would start paying actuarial premiums within the next 10 years.

Based on information from FEMA, CBO estimates that about 475,000 pre-FIRM properties would be affected by the bill. 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 13 would increase the annual deductible from $1,000 to $1,500, for pre-FIRM properties with coverage of less than $100,000 and from $1,000 to $2,000 for pre-FIRM properties with coverage of more than $100,000. The bill also would increase the deductible for post-FIRM properties from $500 to $750 for coverage less than $100,000 and from $500 to $1,000 for coverage greater than $100,000. Based on information from FEMA, CBO estimates that claims payments for all properties would decrease by an average of 5 percent if this higher deductible were implemented.

Forgone Treasury Interest Payments. Section 12 would relieve the NFIP of its obligation to repay funds borrowed to pay claims from the 2005 hurricane season. As of September 2007, the program had an outstanding debt of $17.5 billion. Current law requires FEMA to repay any borrowed funds (with interest) as it collects premiums. In the absence of this legislation, FEMA would need to use a portion of its premium income to repay 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 this debt would instead be used to pay policyholders' claims and to accumulate reserves.

Interest payments from the NFIP to the Treasury are intragovernmental transactions. Eliminating those payments would increase the Treasury Department's net outlays by an estimated $1 billion per year because it would be receiving less interest income. While the forgiveness of the debt would reduce FEMA's outlays for interest payments, CBO expects that the program would use such funds to pay claims that would have otherwise gone unpaid under current law. As such, CBO estimates that forgiving FEMA's obligations to the Treasury would increase net outlays of the federal government by $9.7 billion over the 2008-2017 period.

Civil Penalties. Section 10 would increase the civil penalty from $350 to $2,000 for lenders that do not enforce the mandatory flood insurance purchasing requirement. CBO estimates that the increased revenue from the civil penalties established under this bill would amount to about $1 million a year.

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 would under current law. CBO does not have sufficient information to estimate the number of policies that could be added to the program from enacting those sections. However, because CBO assumes that the additional policies generated by those provisions would be priced initially at full-risk rates, any additional premiums collected would be at least sufficient to pay out claims on an expected-value basis.

Mandatory Coverage Areas. Section 7 would require that homes located behind levees, dams, and other man-made structures become part of special flood hazard areas. The bill would require property owners to purchase flood insurance once the NFIP updates its flood maps to include those new areas.

Expansion of Mandatory Coverage Requirement to State Chartered Lenders. Section 9 would require that the NFIP refrain from selling flood insurance policies in states that do not require state-chartered lenders to require that certain loans be covered by flood insurance at certain levels. Under current law, such a requirement already exists for lenders insured by the Federal Deposit Insurance Corporation.

Nonmandatory Participation for the 500-year Floodplain. Section 23 would require the NFIP and regulated lending institutions to notify communities if they are entirely or partially located within the 500-year floodplain (that is, an area with at least a 0.2 percent chance of being inundated with water in any year). Owners of properties within the 500-year floodplain (but outside of the 100-year floodplain) would not be subject to mandatory purchase requirements but might voluntarily purchase flood insurance upon receiving notification of potential risk.

Spending Subject to Appropriation

The bill also would authorize additional discretionary spending. Assuming appropriation of the specified amounts, CBO estimates that such spending would total about $1.6 billion over the 2008-2012 period.

Flood Mapping Program. Section 19 would authorize the appropriation of $400 million for each of fiscal years 2008 through 2013 to update and maintain flood maps. In 2007, the Congress provided $199 million for this activity (see Public Law 109-295). Under the bill, maps also would be updated to include the 500-year floodplain 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 provision would cost $1.5 billion over the 2008-2012 period and an additional $900 million thereafter, subject to appropriation of the specified amounts.

Severe Repetitive Loss Mitigation Pilot Program. Section 31 would authorize the appropriation of $160 million to extend through 2013 a pilot program to reduce potential future damages to properties that have experienced repetitive losses through floods. In 2004, the Congress authorized $40 million a year for the pilot program to operate through 2009 and, in 2007, provided $50 million through the National Flood Insurance Fund (NFIF) for this activity (see Public Law 109-295). The bill would continue that authorization level for fiscal years 2010 through 2013. CBO estimates that implementing this section would cost $72 million over the 2008-2012 period and an additional $88 million after 2012, subject to appropriation of the authorized amounts.

Over the next 10 years, some or all of such costs might be offset by lower claims payments, depending on the effectiveness of the mitigation efforts. CBO expects that such lower claims would have no effect on premium levels, but would result in additional amounts set aside in the reserve fund. Furthermore, savings from lower future claims cannot be attributed directly to this legislation because the size and duration of any mitigation program would depend on amounts provided in future appropriation acts.

Office of Flood Insurance Advocate. Section 32 would authorize the appropriation of $5 million a year over the 2008-2013 period to establish the Office of the Flood Insurance Advocate**.** The office would assist in resolving conflicts between policyholders and the NFIP and would propose changes in the administrative process to prevent future conflicts from occurring. CBO estimates that implementing this provision would cost $23 million over the next five years, subject to appropriation of the specified amounts to the National Flood Insurance Fund.

Studies. The bill would direct the Government Accountability Office to conduct several studies on the NFIP, including an annual report on the financial activities of the program. CBO estimates that conducting those studies would cost about $1 million over the 2008-2012 period, subject to appropriation of the necessary funds.

Participation in Claims Mediation. Section 26 would require FEMA to participate in state-claims mediation programs to help expedite the settlement of disputed flood insurance claims. The additional administrative costs of this provision are uncertain because it is unclear how the program would be implemented. If large staff increases were necessary, however, it is likely that the NFIP would increase the policy fee assessed on policyholders to cover this additional cost—resulting in no net cost to the federal government.

INTERGOVERNMENTAL AND PRIVATE-SECTOR IMPACT

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 floodplain. 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 insurance 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 ($66 million in 2007, adjusted annually for inflation).

The legislation would impose private-sector mandates, as defined in UMRA, on certain mortgage lenders. Based on information from industry sources and FEMA, CBO expects the direct costs to comply with those mandates would fall below the annual threshold for private-sector mandates established in UMRA ($131 million in 2007, adjusted annually for inflation).

The bill would require federally regulated mortgage lenders when making, increasing, extending, or renewing any loan secured by property located in an area within the 500-year floodplain to notify the purchaser or lessee and the servicer of the loan that such property is located in that floodplain. 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 may continue flood insurance coverage 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.

PREVIOUS CBO ESTIMATES

On September 20, 2007, CBO transmitted a cost estimate for H.R. 3121, the Flood Insurance Reform and Modernization Act of 2007, as ordered reported by the House Committee on Financial Services. Both bills would modify the NFIP, but contain substantial differences that are reflected in the cost estimates.

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