CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

May 31, 2006

Honorable Judd Gregg
Chairman
Committee on the Budget
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

I am pleased to respond to your questions about the financial condition of the National Flood Insurance Program (NFIP) and its ability to meet its obligations to the Treasury and to its policyholders. The NFIP's current financial situation is unsustainable. The Federal Emergency Management Agency (FEMA) lacks the financial resources to cover the program's costs and the authority to make changes that might ensure that future obligations could be met. Specifically:

- FEMA estimates that the NFIP needs about $3 billion more to pay claims resulting from the 2005 Gulf Coast hurricanes. Without legislation providing additional budgetary resources, those claims cannot be paid in a timely fashion.

- Interest costs on the NFIP's debt from the 2005 Gulf Coast hurricanes will total about $1 billion a year. Even if FEMA increases the premiums charged for flood insurance by the maximum percentage allowed by law, premium income in the next several years is unlikely to cover claims, debt service, and other costs of the program.

- The NFIP has operated on an actuarially unsound basis, with many property owners paying premiums that do not account for the full risk of insuring their properties. Thus, over the long term, premium income will be insufficient to cover the program's costs. If this policy of subsidizing certain types of properties continues, it can be expected to lead to a shortfall of about $1.3 billion a year over the long term for currently insured properties.

At the current premium rates charged for flood insurance, can the program continue to meet its obligations without its debt to the Treasury being forgiven or without perpetual increases in its borrowing authority?

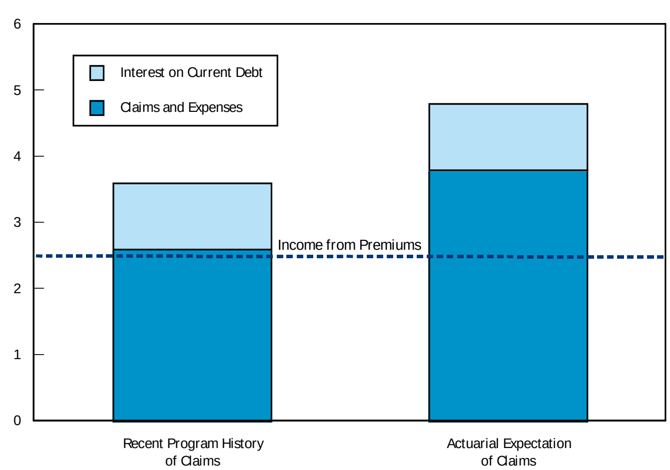
It is very unlikely that the NFIP will be able to make timely payments on policyholders' claims in 2007 and in future years without a change in law. The program's current and future obligations for policyholder claims, operating expenses, and debt service are likely to far exceed its income from premiums.

The NFIP incurred liabilities estimated to total at least $23 billion as the result of the 2005 Gulf Coast hurricanes. Subsequently, the Congress authorized FEMA, which operates the program, to borrow $20.8 billion from the Treasury to pay some of those claims. That borrowing authority is not expected to be sufficient to cover all the outstanding claims. FEMA estimates that an additional $3 billion in additional resources will be needed in late 2006 or early 2007 to cover the remaining claims from the 2005 hurricanes.

Even if $3 billion in additional borrowing authority was provided to FEMA to cover the claims currently outstanding, the NFIP would probably not have sufficient funds in future years to cover its claims, operating expenses, and interest on its borrowing. At current premium rates and allowing for continued growth in the number of policies, the Congressional Budget Office (CBO) projects that premium income would average about $2.5 billion per year over the next five years. But interest payments on FEMA's debt to the Treasury will amount to $600 million in 2006 and will grow to over $1 billion annually by 2007. Even if new claims and operating expenses were incurred at no more than the rates typical of recent experience (excluding 2005), they would total between $2 billion and $3 billion per year, bringing the NFIP's average annual obligations to between $3 billion and $4 billion over the next five years. Thus, at current rates, premium income would probably be insufficient to cover the program's costs, even if those costs were at the relatively low levels experienced for most of the past decade (see Figure 1).

Figure 1.

Estimate of the National Flood Insurance Program's Cash Flows



Source: Congressional Budget Office

Moreover, average annual losses over the long term are likely to be higher than those incurred in most recent years. The program has about 4.9 million policies in force, with a total exposure of nearly $900 billion. Under current law, about 1.2 million of those policyholders pay premiums that do not cover the full risk of insuring their properties.[1] CBO estimates that this policy results in an actuarial imbalance in the NFIP of about $1.3 billion a year. In other words, the program would need to collect an additional $1.3 billion a year in premiums to have sufficient funds to pay expected claims over many years, excluding any obligations for service on its current debt. Flood events and claims in any year can vary from minor to catastrophic; an actuarial assessment of the cost of insurance considers the probabilities of all possible events. With debt-service costs included, the program's average annual costs would be close to $5 billion, and the shortfall between premium income at current rates and actuarial expectations of the program's long-run obligations would exceed $2 billion a year.

If legislation increased FEMA's borrowing authority by $3 billion, and the agency acted administratively to raise NFIP premiums to the maximum authorized level, could the program meet its future obligations including debt service?

In the absence of legislative changes, FEMA would have to raise its premiums substantially in order to generate the funds necessary to pay claims and debt-service costs. Under current law, the program can increase rates on each risk category of insured properties by an average of 10 percent a year.[2] Depending on the response of policyholders to such sizable yearly rate increases, CBO estimates that annual rate increases of 10 percent could generate $10 billion to $15 billion over the next 10 years to meet the program's obligations.

Annual NFIP premium increases of 10 percent would increase the government's collections and make more funds available to pay claims, operating expenses, and debt-service costs. Even if few policy holders dropped their coverage, such an action would leave the program short of sufficient funds to meet all of its obligations for at least several years. Eventually, substantial annual rate increases over a long period of time might raise annual collections by an amount sufficient to pay all obligations and to compensate for the actuarial imbalance in the program's financing. However, raising rates for all policyholders in this manner would result in some property owners having to pay insurance premiums well above actuarially

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1. See the statement of Donald B. Marron, Acting Director, Congressional Budget Office, *The Budgetary Treatment of Subsidies in the National Flood Insurance Program*, before the Senate Committee on Banking, Housing, and Urban Affairs, January 25, 2006.

2. Since 2001, the program has had average annual rate increases of between 2 percent and 3 percent. For 2006, the program raised rates a little over 4 percent. FEMA has not indicated what it plans to do in subsequent years.

sound rates, while others continued to pay premiums below the full cost of insuring their properties. That practice could undermine the program and result in a substantial erosion of insurance coverage, as property owners might drop or reduce coverage.

What would be the budgetary consequences of legislation to authorize the borrowing of more funds to pay remaining claims from the 2005 Gulf Coast storms and then forgiving all NFIP debt to the Treasury?

Increasing the program's borrowing authority to pay remaining claims from the 2005 Gulf Coast hurricanes would result in outlays of about $3 billion, primarily in 2007.

The repayment of the principle of the NFIP's debt to the Treasury would be a nonbudgetary transaction between the two agencies, but forgiving the accumulated debt—at that point, close to $24 billion—would have budgetary consequences. Such action would acknowledge that the program's premium income is inadequate to pay its costs without a subsidy from general funds. With the debt forgiven, the NFIP could continue to operate just as it did prior to the 2005 Gulf Coast storms. That is, the program might remain actuarially unsound but capable of covering its claims and operating costs in typical years (although not in years when flooding is unusually severe). By reducing the need for rate increases, forgiving the NFIP's debt could lead FEMA to charge lower premiums than it otherwise would, thus reducing collections from policyholders. That could cost the Treasury $10 billion to $15 billion over the next 10 years.

What are the budgetary consequences of legislative options to reform or terminate the NFIP?

You asked CBO to consider the budgetary consequences of either reforming the program (thereby eliminating some or all of the current subsidy provided to certain properties) or terminating the program and letting policyholders seek coverage from private insurance firms.

Reforming the program to eliminate or reduce subsidies. Roughly 1.2 million flood insurance policyholders, about one-quarter of the total, pay rates that are explicitly subsidized—that is, below the level that the NFIP estimates would be required for the program to be considered actuarially sound so that its receipts and spending would be expected to break even over many years. CBO estimates this subsidy amounts to about $1.3 billion a year.

CBO analyzed a proposal in H.R. 4973, the Flood Insurance Reform and Modernization Act of 2006, to gradually increase rates on properties that are either nonresidential structures or not primary residences (such as vacation homes) that were built before the community's flood insurance rate map (FIRM) was completed (or before 1975, whichever is later).[3] The bill would authorize FEMA to increase rates on those specified types of properties by 15 percent a year until the actuarial rate is achieved. According to FEMA, approximately 450,000 properties meet those criteria, and the average premium for those properties is about $800 a year. According to CBO's estimates, reducing the subsidy on those properties would increase receipts from flood insurance premiums by about $1.5 billion over the next 10 years.

Proposals to further reduce subsidies in the NFIP by also targeting pre-FIRM primary residences, or to eliminate the subsidies more quickly by speeding the phase-in of higher rates would increase receipts by more than the amounts expected under H.R. 4973. If all subsidies were eliminated, receipts would be sufficient over the long term for the NFIP to meet its future obligations, but would be insufficient to cover past losses (which are reflected in the program's current debt).

Higher premiums would cause owners of some properties to either drop their flood insurance policies or to reduce the amount of their coverage. As a result, the Congress might be under increased pressure to appropriate funds for disaster relief in the event of a major flood.

Eliminating the NFIP. One of the primary reasons that the Congress created the NFIP (through enactment of the National Flood Insurance Act of 1968) was to finance losses from floods through the collection of premiums from policyholders instead of paying for those losses from federal disaster relief funds. For many years, the availability of flood insurance through the private market has been quite limited. How the private insurance market for flood insurance might change in the absence of a federal program is unknown. If private flood insurance did not become widely available, it is likely that the government would end up paying for some of the losses from floods in the form of appropriations for disaster relief.

Over the long term, eliminating the flood insurance program should save the government about $1.3 billion per year, the estimated subsidy cost of the program, less whatever additional amounts the Congress chose to spend for disaster relief. Eliminating the NFIP would not change the government's obligation to pay existing valid claims.

3. See CBO's cost estimate for H.R. 4973, the Flood Insurance Reform and Modernization Act of 2006, as ordered reported by the House Committee on Financial Services on March 16, 2006. That estimate was issued on April 4, 2006.

I hope this information is helpful to you. If you wish further details on this analysis, we would be happy to provide them. The CBO staff contact is Julie Middleton.

Sincerely,

Donald B. Marron

Donald B. Marron
Acting Director

cc: Honorable Kent Conrad
Ranking Member

Identical letter sent to the Honorable Richard Shelby