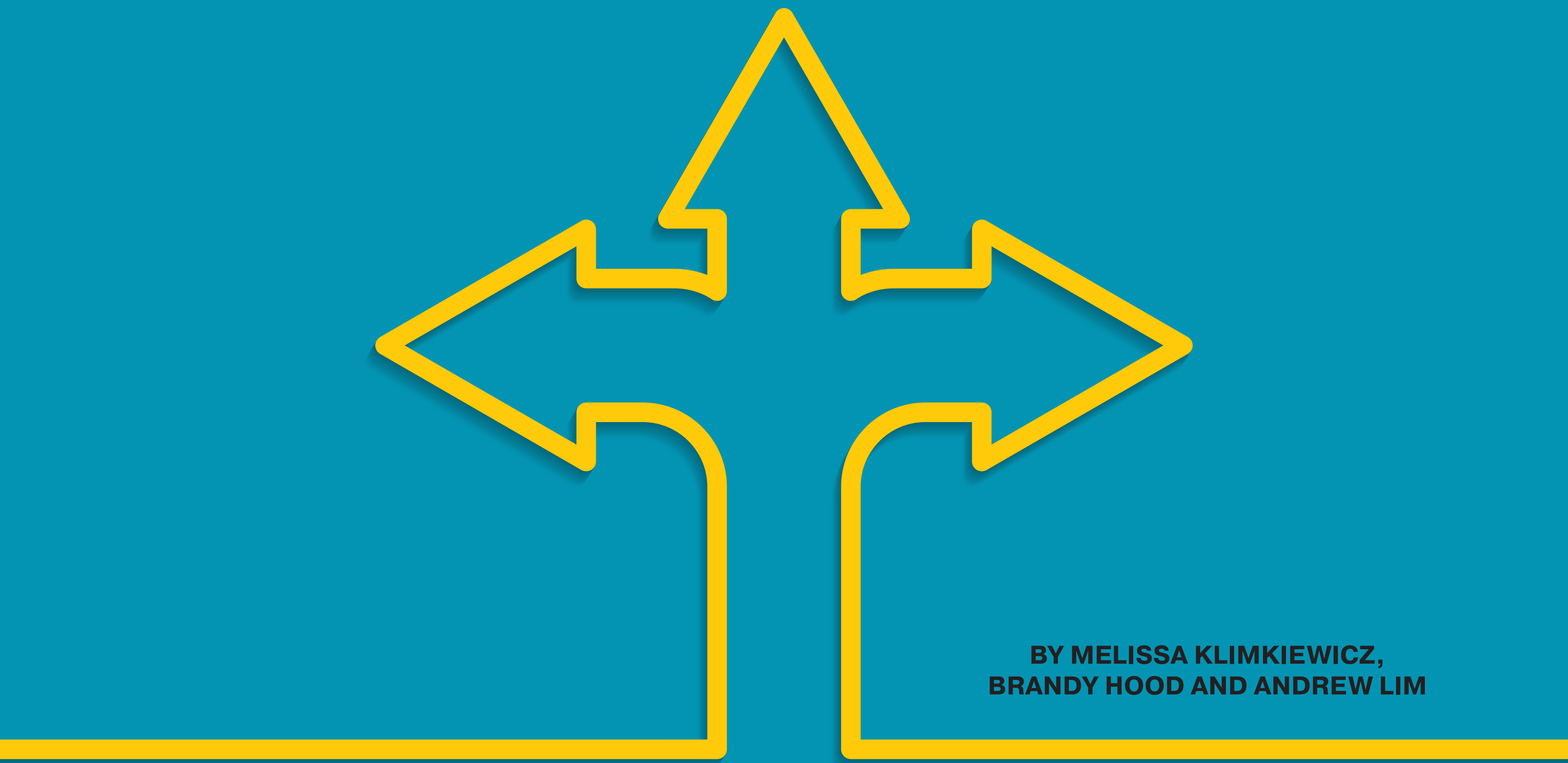
NFIP Reauthorization and Reform:

Are More Changes Coming to Lenders' Flood Insurance Requirements?



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The National Flood Insurance Program (NFIP or the Program) will expire on September 17, 2017, unless it is timely reauthorized. Because the Program is $23 billion in debt, there is significant speculation regarding whether and how Congress may restructure the Program this year. Changes to the NFIP may impact lenders' and servicers' compliance obligations, borrowers' surplus income and corresponding ability to repay their loans, and even the overall value of the real estate securing mortgage loans. This article discusses some of the options that various constituencies have suggested for the Program, along with the potential effects these changes could have on mortgage lenders and servicers.

BACKGROUND

When Congress established the NFIP in 1968, it intended for the Program to ensure affordable flood insurance coverage and encourage communities to engage in floodplain management to reduce flood risk. Congress has amended the Program over the years, including in 1973, when it created the mandatory purchase requirement that prohibits certain mortgages from being made, increased, renewed, or extended unless the buildings and any personal property securing them are covered by flood insurance. Most recently, in 2012 and 2014, Congress adopted measures to increase the financial solvency of the Program and require lenders to accept certain private flood insurance policies, among other changes.

Despite repeated efforts to improve the NFIP, the Program is on shaky ground. The NFIP has been in debt since Hurricane Katrina and currently owes $23 billion to the U.S. Treasury, for which FEMA already has spent $2.9 billion on interest alone. Although it is widely acknowledged that additional reform may be necessary, Congress has not agreed on the best path forward. Short-term Program reauthorizations resulting from those disagreements have created instability and uncertainty. Between 2008 and 2012 alone, there were at least 17 short-term extensions of the Program, some as brief as five days. Furthermore, the NFIP expired four times in 2010, which created serious issues because the NFIP is not able to issue new or renewal policies or increase coverage on existing polices during an expiration period, making it impossible for lenders to comply with the mandatory purchase requirement.

POTENTIAL NFIP REFORMS

1. Increase Private Market Participation

Although the federal government currently assumes nearly all flood risk in the United States, the Republican-controlled Congress may make it a priority to shift more of the responsibility for providing flood coverage to the private market. This transferal already has begun with a requirement that lenders accept certain private flood insurance policies slated for implementation in the near term. Congress also could potentially adopt additional measures designed to grow the private flood insurance market or initiate reinsurance arrangements or alternative risk transfer mechanisms with private insurers. More drastically, Congress could completely eliminate the NFIP and instead focus on flood mitigation—although such a seismic shift does not currently seem likely.

Potential advantages of private policies over NFIP policies include: (1) higher coverage limits and more coverage options, including the ability to tailor coverage specifically to the collateral; and (2) faster responses to changing market preferences and trends. However, there are challenges to increasing the prevalence of private flood insurance policies. These include, for example, the lack of clarity surrounding lender requirements related to acceptance of private policies—which the federal banking agencies have not fully resolved through their recently proposed rules—and the administrative burden of reviewing the acceptability of each private policy. Furthermore, there are barriers to entry for private insurers, including non-compete clauses that prohibit Write Your Own insurers from also offering private policies and a lack of access to NFIP's data on flood losses and claims. Such barriers may leave property owners with few private coverage options, even if lenders are willing and able to accept private flood insurance to satisfy the mandatory purchase requirement.

Increasing private insurance participation also may decrease NFIP participation, which could worsen the NFIP's financial condition if appropriate adjustments are not made. This may be particularly true if the NFIP ends up with the highest risk policies, and such policies are provided at subsidized rates.

2. Increase NFIP Participation

As an alternative to pushing for greater private market participation, Congress could consider attempting to improve the NFIP's financial solvency by increasing the number of NFIP policies (which may, in turn, increase the aggregate amount of premiums collected). Such a strategy, which may both positively and negatively impact lenders and servicers, could be carried out in various ways, including:

- Expanding the mandatory purchase requirement to include additional flood zones. Congress could make properties located in lower risk flood zones subject to the mandatory purchase requirement by, for example, expanding the definition of a Special Flood Hazard Area (SFHA) to apply beyond flood zones A and V. Indeed, the historic flooding that hit Louisiana last year affected thousands of properties located in lower-risk zones, which could motivate Congress to more seriously consider this option.

- Expanding the mandatory purchase requirement to include additional lenders. The mandatory purchase requirement generally applies to lenders regulated by one of the federal banking agencies and to loans sold to a government sponsored enterprise or guaranteed or insured by a government agency. Congress could ➲

expand the Program to apply to more non-bank lenders.

• Promoting natural growth. Congress, in conjunction with FEMA, could promote natural growth of the NFIP by (1) making policies easier to offer, underwrite, and administer; (2) offering more product options that will appeal to property owners; (3) increasing Program coverage limits, which currently are capped at $250,000 or $500,000 for buildings in the regular Program, and allowing higher deductibles for high-value properties so that such properties can be fully insured; (4) better educating borrowers on flood risks and the Program; and/or (5) restructuring premium calculations to better price risk.

Increasing coverage limits and offering more product options could be particularly beneficial for large commercial properties, which often include multiple buildings with values that far exceed the NFIP's current coverage limitations. The NFIP's current offerings are not designed for these types of properties, although the mandatory purchase requirement still applies. (Indeed, because of the incongruity between the NFIP's current offerings and the needs of commercial property owners and their lenders, some would like Congress to consider excluding large commercial properties from the mandatory purchase requirement altogether, so that lenders and commercial property owners may satisfy their coverage needs outside the confines of the NFIP.)

These possible changes could create both benefits and risks for mortgage lenders and servicers. Increasing the number of insured properties would reduce the risk of uninsured losses—which, of course, is helpful to lenders. However, expanding the mandatory purchase requirement could increase lenders' regulatory burden—the more properties subject to flood insurance requirements, the more lender review required. In addition, expanding the mandatory purchase requirement ultimately could reduce property values, as properties may be worth less when the cost of owning the properties increases due to heightened insurance expenses. This could also impact the number of new loans made, the risk of default on existing loans, and the value of collateral securing existing loans.

3. Long-Term Reauthorization

Congress could reauthorize the NFIP for a longer period of time to offer more stability to both lenders and borrowers. Short-term authorizations and even brief Program lapses create an unstable lending situation because borrowers and lenders are unable to accurately predict future costs of homeownership and associated regulatory burdens. Program lapses are particularly disruptive because lenders may be prohibited from making, increasing, renewing, or extending any loans requiring flood insurance during lapses.

CONCLUSION

The potential reforms described above are just a few that Congress could consider in connection with reauthorizing the NFIP this year. It is not yet clear which path Congress will choose, but the likelihood that reauthorization will be coupled with major reform may be greater this year than in the recent past. Congress seems primed to tackle these issues—assuming other issues do not take priority—and with both the White House and Congress under a single party's control, a longer-term path forward may be possible.

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