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FLOOD INSURANCE

Information on the Mandatory
Purchase Requirement

Statement of
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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the results of our work on compliance with the mandatory purchase requirement for flood insurance. Our August 1990 report¹ will provide some useful context and insights as you move forward with your deliberations on S. 2907, the National Flood Insurance Reform Act of 1992.

The Flood Disaster Protection Act of 1973 made the purchase of flood insurance mandatory after March 1, 1974, for (1) any federal loan or grant to be used for acquisition or construction of a building or a mobile home in a designated special flood hazard area of a community participating in Federal Emergency Management Agency's (FEMA's) National Flood Insurance Program and (2) a loan secured by improved property in a special flood hazard area of a participating community if the loan is made by a lending institution that is regulated or insured by the federal government. For loans made before March 1, 1974, flood insurance is not required. Also, homes with no mortgage, or homes with mortgages held by unregulated lenders, would therefore be exempt.

Our report addressed the extent to which there was compliance with the mandatory purchase requirement for flood insurance. Specifically, we collected information on (1) FEMA and other involved parties' views on compliance, (2) the level of noncompliance in two sample states--Maine and Texas, and (3) efforts to increase compliance. A key objective of S. 2907 is to expand the extent to which properties are required to have flood insurance. As you requested, I will focus my comments on the extent to which we found flood insurance coverage, and the reasons why those households included in our work did not have flood insurance. Also, as you requested, I will touch on the financial risk to the federal government from noncompliance.

Households without flood insurance, whether in noncompliance or because they are exempt from the mandatory purchase requirement, do represent a potential cost to the government because the Flood Insurance Fund is presently financially self-sustaining, and thus claims paid on losses do not come from the U.S. Treasury. On the other hand, most flood victims who are uninsured are likely to receive either Treasury-subsidized low interest disaster loans from the Small Business Administration or outright grants from the Federal Emergency Management Agency.

Briefly, our limited review of victims of two floods in the states of Texas and Maine showed that most households in Maine that were subject to the mandatory purchase requirement did have flood insurance; however, most in Texas did not. We could not identify

¹Information on the Mandatory Purchase Requirement (GAO/RCED-90-141FS, Aug. 22, 1990).

the reason for the disparity between the two states. However, we also found that a large majority of the flood victims in the two states--78 percent--were not subject to the mandatory purchase requirement. The two primary reasons for this were that in Maine, a large number of households had unmortgaged property, and in Texas, many mortgages were held by unregulated lenders who are not subject to the mandatory purchase requirement.

BACKGROUND

The National Flood Insurance Program, administered by FEMA's Federal Insurance Administration, provides property owners with flood insurance as an alternative to disaster assistance. The program was authorized by the National Flood Insurance Act of 1968, but it did not become evident that few property owners were purchasing flood insurance until after major flooding in 1972. As I mentioned earlier, the Flood Disaster Protection Act of 1973 established the mandatory purchase requirement.

The Federal Insurance Administration has no enforcement authority of the mandatory purchase requirement. This is the responsibility of the federal agencies that regulate or insure lender institutions. Compliance is determined as part of the regulatory agencies' bank examination procedures.

COMPLIANCE AND EXTENT OF COVERAGE

During our review, the Federal Insurance Administration within FEMA estimated that nationwide about 11 million properties were located in the special flood hazard areas, or SFHAs. The Federal Insurance Administration also estimated that 1.4 million policies were in force in SFHAs and expressed concern that there may have been substantial noncompliance with the mandatory purchase requirement. In contrast, the regulatory agencies responsible for assuring compliance, such as the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve System, contended that noncompliance is not a major problem. FDIC reported, for example, that while it had found 34 percent to 38 percent of the lenders it examined to be in violation of flood insurance regulations, the violations were technical in nature, such as inadequate documentation. FDIC said that in the last 3 years, over 95 percent of the properties examined were covered by the required flood insurance. The Federal Reserve System reported that in 1988, 83 percent of the lenders examined for compliance had no violations of flood insurance regulations and that most of the violations cited involved lenders' failing to adequately document their determination of whether or not flood insurance was required.

During our work in 1989, the Federal Insurance Administration had obtained the names of the lenders for those households in SFHAs receiving disaster assistance for two then-recent disasters--

flooding that had occurred in Maine and Texas. To obtain some indication of the extent to which there was compliance with the mandatory purchase requirement, we asked the lenders involved to provide additional data explaining why properties that appeared to be subject to the mandatory purchase requirement were not insured.

We found that, for both states, of those properties required to have insurance, 68 of 190 properties, or 36 percent, did not. We also found, however, that a substantial number of the SFHA properties were not required to have the flood insurance. Of the 871 properties included in our review, 123, or 14 percent, were required to have it and did; 67 properties, or 8 percent, were required to have it but did not; and 681, or 78 percent, were not required to have flood insurance.

There were two dominant reasons why many properties were not required to have flood insurance--384 properties, or 56 percent, of those properties not required to have insurance had no mortgage, and 210, or 31 percent, had mortgages from unregulated lenders. The appendix provides additional detail on our findings.

Reasons cited by lending institutions varied as to why the properties that should have been insured were not. The most frequently cited reasons were (1) the lender erroneously classified the property as not being in an SFHA or could find no documentation in the file to determine whether an SFHA determination had been made and (2) the lender neglected to require the flood insurance at loan closing even though the lender identified the property as in an SFHA and that the property was covered by the required insurance at closing, but the policy later lapsed.

FINANCIAL RISK TO THE FEDERAL GOVERNMENT

Noncompliance with the mandatory purchase requirement does increase federal costs of aiding flood victims. A household with flood insurance should be in need of much less federal disaster assistance from other sources. The National Flood Insurance Program is currently self-sustaining; therefore, claims paid do not come from the U.S. Treasury. For the two likely forms of federal disaster assistance for which a household without flood insurance could be eligible--subsidized low interest loans from the Small Business Administration or grants from the Federal Emergency Management Agency--there is a cost to the federal government. Therefore, noncompliance with the mandatory purchase requirement results in increased cost to the federal government through the use of these two programs.

The Federal Emergency Management Agency provides grants of up to \$11,500 per household, but requires those grantees who live in SFHAs to purchase flood insurance as a condition of obtaining the grant. FEMA requires the grantees to maintain the flood insurance

policies for 3 years or until they move from the residence, whichever is less. Individual and Family Grant Assistance on subsequent floods is to be denied to disaster victims who had not maintained flood insurance as required.

The Small Business Administration makes low-interest loans to individuals and businesses to repair or replace most uninsured property that is damaged. SBA assistance is limited to \$120,000 for individuals and \$500,000 for businesses. SBA requires its applicants to purchase and maintain flood insurance for the full term of the loan for the insurable value of the property, regardless of the amount of the loan. Applicants are not eligible for subsequent disaster loans if they have not purchased or maintained required flood insurance.

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In closing, I would like to add that there has been an effort to help assure that the mandatory purchase requirement is being complied with. Federal Insurance Administration officials advised us that there has been increased interest in flood insurance requirements by the banking industry, and that there has been increased coordination and cooperation between the Federal Insurance Administration and the regulatory agencies.

Mr. Chairman, this concludes my prepared statement. I will be happy to answer any questions you or the other Members may have.

INSURANCE STATUS OF HOUSEHOLDS
INCLUDED IN GAO REVIEW

| | <u>Maine Number</u> | <u>Texas Number</u> | <u>Total Number</u> | <u>Percent</u> |
|--|-------------------------|-------------------------|-------------------------|----------------|
| <u>Required to have insurance:</u> | | | | |
| Insured | 114 | 9 | 123 | 14 |
| Uninsured | <u>33</u> | <u>34</u> | <u>67</u> | <u>8</u> |
| Subtotal | 147 | 43 | 190 | 22 |
| <u>Not required to have insurance:</u> | | | | |
| No mortgage | 363 | 21 | 384 | 44 |
| Unregulated lender | 26 | 184 | 210 | 24 |
| Mortgage pre-dates map or law | 55 | 4 | 59 | 7 |
| Not in SFHA | 9 | 10 | 19 | 2 |
| Not in participating community | 0 | 5 | 5 | 0.5 |
| Uninsurable | <u>0</u> | <u>4</u> | <u>4</u> | <u>0.5</u> |
| Subtotal | <u>453</u> | <u>228</u> | <u>681</u> | <u>78</u> |
| Total | <u>600</u> | <u>271</u> | <u>871</u> | <u>100</u> |

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