RSC Republican Study Committee

Financial Services Working Group

Congressman Scott Garrett (R-NJ), Chairman — Congressman Tom Price (R-GA), RSC Chairman

July 14, 2010

National Flood Insurance Program Reform
The Good, The Bad, and The Ugly

The National Flood Insurance Program (NFIP) is facing serious financial challenges, and cannot afford to continue on its current path. The Government Accountability Office (GAO) has included the NFIP on its annual list of high-risk government programs since 2006 because of its ongoing potential to incur billions of dollars in losses. With an **$18 billion debt** to the Treasury and the persistence of subsidized premium rates for properties in high-risk areas, the NFIP continues to be underfunded and federal taxpayers remain at risk.

Serious reforms are needed to make the NFIP more self sufficient, reduce the potential for losses, and minimize the financial risk to taxpayers.

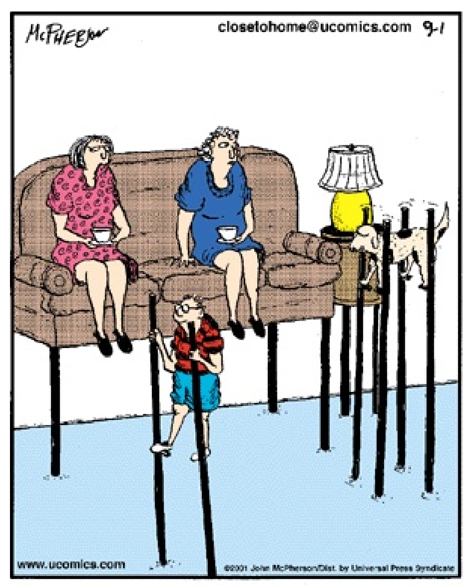
Financial Services Committee Republicans have been calling for fundamental reforms of the program for several years. Recent temporary lapses of the NFIP created uncertainty in the housing market and resulted in negative consequences for homebuyers trying to purchase required flood insurance protection.

H.R. 5114 represents a step in the right direction. The bill contains provisions that will:

- Eliminate subsidized rates over time for non-residential properties and non-primary residences, including second homes and vacation homes.
- Raise the annual cap on rate increases from 10 to 20 percent, which allow the NFIP to charge premiums more appropriate to the risk within a shorter period of time.
- Eliminate subsidies over time for homes that are sold to a new owner
- Impose minimum deductibles for all insured properties
- Require a report on the feasibility of incorporating nationally recognized building codes into the NFIP's floodplain management criteria
- Direct the NFIP to report to Congress with a plan to repay its debt to the Treasury within ten years.

While these changes are all positive reforms, there is concern over a provision to establish a new outreach grant program that represents an authorization for new spending. While there is a need to improve FEMA's communication with communities and property owners about the impact of new flood risk maps, it would be preferable if this effort be undertaken with NFIP resources. In addition, there are concerns about provisions that delay the phase out of subsidies and the phase in of risk-based rates. There is an inherent moral hazard when any premium rates are subsidized, and these reforms are urgently needed. Charging less than full-risk rates by the NFIP maintains a system of financial incentives backed by the federal government for individuals to live and build in high-risk flood zones.

While the NFIP was originally intended to reduce the need for emergency disaster assistance from federal taxpayers to local communities, it only partially achieves this goal and has a long way to go to reach its potential to be self-sufficient.



"Jerry looked into flood insurance but says it's too darned expensive."

What They're Saying Off the Hill

The SmarterSafer.org coalition (a collection of environmental groups, taxpayer advocates, and industry stakeholders) circulated a letter to Members of Congress outlining the following concerns with H.R. 5114.

> *"We urge the House to strike the provisions of H.R. 5114 that weaken insurance purchase requirements. We also urge the House to expand the scope of the bill to include the full range of reforms needed. H.R. 5114 should be amended to require FEMA's mapping program to utilize the best available science to reflect risk to communities while prioritizing natural resources protection, and to provide incentives for floodplain and natural resource protection, emphasizing natural and beneficial uses of floodplains with structural measures as a last resort. NFIP should also invest in financial protection from available program proceeds to protect taxpayers and promote better risk management and foster greater internalization of costs. In addition, FEMA is undertaking a review of the flood insurance program, and we are hopeful that such a review will result in recommendations for reform that will help strengthen and sustain the program in the long-run. For this reason, we believe that a shorter, three-year reauthorization time period is called for. This will ensure that FEMA's recommendations can be considered by Congress in a timely manner."*

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THE WALL STREET JOURNAL

The Uncertainty Principle

Dodd-Frank will require at least 243 new federal rule-makings.

So Republicans Scott Brown, Olympia Snowe and Susan Collins now say they'll provide the last crucial votes to get the Dodd-Frank financial reform through the Senate. Hmmm. Could this be Minority Leader Mitch McConnell's secret plan to take back the Senate, guaranteeing another year or two of regulatory and lending uncertainty and thus slower economic growth?

Probably not, but that still may be the practical effect. This week White House aides leaked to the press that President Obama may seek a review of regulations that are restraining business confidence and bank lending. Yet Dodd-Frank, with its 2,300 pages, will unleash the biggest wave of new federal financial rule-making in three generations. Whatever else this will do, it will not make lending cheaper or credit more readily available.

In a recent note to clients, the law firm of Davis Polk & Wardwell needed more than 150 pages merely to summarize the bureaucratic ecosystem created by Dodd-Frank. As the nearby table shows, the lawyers estimate that the law will require no fewer than 243 new formal rule-makings by 11 different federal agencies.

The SEC alone, whose regulatory failures did so much to contribute to the panic, will write 95 new rules. The new Bureau of Consumer Financial Protection will write 24, and the new Financial Stability Oversight Council will issue 56. These won't be one-page orders. The new rules will run into the hundreds if not thousands of pages in the Federal Register, laying out in detail what your neighborhood banker, hedge fund manager or derivatives trader can and cannot do.

As the Davis Polk wonks put it, "U.S. financial regulators will enter an intense period of rule-making over the next 6 to 18 months, and market participants will need to make strategic decisions in an environment of regulatory uncertainty." The lawyers needed 26 pages of flow charts merely to illustrate the timeline for implementing the new rules, the last of which will be phased in after a mere 12 years.

Because Congress abdicated its responsibility to set clear rules of the road, the lobbying will only grow more intense after the President signs Dodd-Frank. According to the attorneys, "The legislation is complicated and contains substantial ambiguities, many of which will not be resolved until regulations are adopted, and even then, many questions are likely to persist that will require consultation with the staffs of the various agencies involved."

Triumph of the Regulators

Estimate of new rule-makings under the Dodd-Frank financial reform by federal agency

Bureau of Consumer Financial Protection	24
CFTC	61
Financial Stability Oversight Council	56
FDIC	31
Federal Reserve	54
FTC	2
OCC	17
Office of Financial Research	4
SEC	95
Treasury	9
Total*	243

*The total eliminates double counting for joint rule-makings and this estimate only includes explicit rule-makings in the bill, and thus likely represents a significant underestimate.

Source: Davis Polk & Wardwell

In other words, the biggest financial players aren't being punished or reined in. The only certain result is that they are being summoned to a closer relationship with Washington in which the best lobbyists win, and smaller, younger firms almost always lose. New layers of regulation will deter lending at least in the near term, and they are sure to raise the cost of credit. Non-blue chip businesses will suffer the most as the financial industry tries to influence the writing of the rules while also figuring out how to make a buck in the new system.

The timing of Dodd-Frank could hardly be worse for the fragile recovery. A new survey by the Vistage consulting group of small and midsize company CEOs finds that "uncertainty" about the economy is by far the most significant business issue they face. Of the more than 1,600 CEOs surveyed, 87% said the federal government doesn't understand the challenges confronting American companies.

Believe it or not, Mr. Frank has already promised a follow-up bill to fix the mistakes Congress is making in this one. In a recent all-night rewrite session, he and Mr. Dodd made a particular mess of the derivatives provisions. They now say they didn't really mean to force billions of dollars in new collateral payments from industrial companies on existing contracts that present no systemic risk. But that's precisely what the regulators could demand under the current language, and the courts will ultimately decide when everyone sues after the new rules are issued.

Taxpayers might naturally ask why legislators don't simply draft a better bill now. But for Democrats the current and only priority is to pass something they can claim whacks the banks and which they can hail as another "achievement" to sell before the elections.

More remarkable is that a handful of Republicans are enabling this regulatory mess. Mr. Brown and Ms. Collins say they now favor Dodd-Frank because Congressional negotiators agreed to drop the bank tax. But lawmakers didn't drop the bank tax. They only altered the timing and manner of its collection. Instead of immediately assessing a tax on large financial companies to pay for future bailouts, the final version simply authorizes the bailouts to occur first. The money to pay for them will then be collected via a tax on the remaining firms.

Because this tax will be collected by the Federal Deposit Insurance Corporation, even opponents of the bill have viewed it as part of an insurance system. It isn't. Insurance is when you pay a premium and the insurance company agrees to replace your house if it burns down. A tax is when you pay the government and then the government decides which houses it wants to replace when there is a fire in the neighborhood.

Under Dodd-Frank, if Firm A pays to cover the cost of the last bailout, there's no guarantee that the FDIC will rescue its creditors if Firm A fails in the future. This is fundamentally different from traditional deposit insurance, which guarantees the same deal for every bank customer. Dodd-Frank allows the FDIC to discriminate among creditors at its discretion.

This transfer of wealth is a tax by any reasonable definition, borne by the customers, shareholders and employees of the companies ordered to pay it. Is this how Mr. Brown plans to reward the tea partiers who carried him to victory last winter in Massachusetts? Is this the key to a small business rebound in Maine?

A good definition of a bad law is one that its authors are rewriting even before they pass it. The only jobs Dodd-Frank will create are in Washington—and in law firms like Davis Polk.

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