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Report to Congressional Committees

September 2007

NATIONAL FLOOD INSURANCE PROGRAM

FEMA's Management and Oversight of Payments for Insurance Company Services Should Be Improved

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Highlights

Highlights of GAO-07-1078, a report to congressional committees

September 2007

NATIONAL FLOOD INSURANCE PROGRAM

FEMA's Management and Oversight of Payments for Insurance Company Services Should Be Improved

Why GAO Did This Study

Extraordinary recent flood events raise serious questions about the solvency of the National Flood Insurance Program (NFIP), which is administered by the Federal Emergency Management Agency (FEMA). The NFIP is largely implemented by private insurance companies that sell and service policies and adjust claims under the Write Your Own (WYO) Program. This report, prepared under the authority of the Comptroller General, examines (1) how much FEMA paid the WYO companies in recent years for operating costs and how FEMA determined payment amounts; (2) how FEMA's approach to determining operating costs assures that payments are reasonable estimates of companies' expenses; and (3) how FEMA assures that financial and management controls are in place for the WYO program and operate as intended. To do these assessments, GAO interviewed FEMA and insurance officials, and analyzed statutes, regulations, payment data, methodologies, and audits of WYO companies.

What GAO Recommends

GAO recommends that FEMA take steps to ensure that it has a reasonable estimate of actual expenses WYO companies incur to help determine payments for services and that financial audits are performed. The Department of Homeland Security reviewed a draft of this report and generally agreed with our recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-07-1078.

To view the full product, including the scope and methodology, click on the link above. For more information, contact William O. Jenkins, (202) 512-8757 or jenkinswo@gao.gov.

What GAO Found

FEMA's payments to WYO insurance companies for operating costs ranged from more than a third to almost two-thirds of the total premiums paid by policyholders to the NFIP for fiscal years 2004 through 2006. In fiscal years 2005 and 2006, larger payments to WYO insurance companies were the result of settling an unprecedented number and dollar amount of claims for damages resulting from major hurricanes and flood events including Hurricane Katrina. To determine the amount of these payments, FEMA negotiated payment approaches with insurance industry representatives when it established the current WYO program in 1983 based on industry averages for operating expenses for other lines of insurance (such as homeowners, commercial, and fire), past practice, and discussion.

The approach FEMA uses to determine operating costs for WYO insurance companies, rooted in policies negotiated and established about 25 years ago, cannot ensure that payments are based on reasonable estimates of actual expenses because actual expenses incurred by the companies for their services to the NFIP are not considered. Although it has authority to do so, FEMA does not collect data on actual WYO flood insurance expenses that could provide a basis for insuring that the WYO payments are based on a reasonable estimate of actual expenses. FEMA officials said that they have not asked WYO insurance companies to provide expense information due to concerns that the approach would increase FEMA's administrative costs and cause a decline in WYO program participation. However, some data on expenses WYO insurance companies allocate to flood insurance are available. FEMA officials said that they cannot use this information due to reporting inconsistencies. Also, there is some precedent in two similar public-private insurance partnerships for collecting actual expense information. FEMA's decision to rely on long-standing practices does not meet federal internal control standards that agencies be held accountable for, among other things, stewardship of government resources.

Biennial financial statement audits—FEMA's primary mechanism to provide assurance that it receives complete and accurate financial management information from the WYO insurance companies—were not performed consistently as required by regulation. FEMA regulations require each participating company to arrange and pay for these audits by independent certified public accounting firms. However, many WYO insurance companies did not comply with the schedule in recent years. For example, for fiscal years 2005 and 2006, 5 of 94 participating companies had biennial financial statement audits performed. FEMA officials said they allowed some companies to delay having the audits done because they were in the process of contracting with new subcontractors to perform their financial reporting responsibilities. Nonetheless, without the required biennial audits, FEMA lacks an appropriate internal control mechanism for effective program oversight.

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Abbreviations

CPA	certified public accountant
DHS	Department of Homeland Security
FCIC	Federal Crop Insurance Corporation
FEMA	Federal Emergency Management Agency
NAIC	National Association of Insurance Commissioners
NFIP	National Flood Insurance Program
OIG	Office of Inspector General
WYO	Write Your Own

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United States Government Accountability Office
Washington, DC 20548

September 5, 2007

Congressional Requesters

The Federal Emergency Management Agency (FEMA), a component of the Department of Homeland Security (DHS), provides insurance protection against flood damage to homeowners, businesses, and others, and assumes the risk for insured flood losses, through the National Flood Insurance Program (NFIP). The NFIP is largely implemented by private insurance companies that participate in FEMA's Write Your Own (WYO) program. Through the WYO program, insurance companies enter into agreements with FEMA to sell and service flood insurance policies and adjust claims after flood losses. As of December 2006, 88 insurance companies were participating in the WYO program.

While the NFIP, by design, is not actuarially sound because Congress authorized subsidized insurance rates for some policyholders, the program was largely successful until recent years in paying its expenses with premium revenues—the funds paid by policyholders for their annual flood insurance coverage. As a result, since its inception in 1968, in most years the NFIP paid for flood losses and operating expenses with policy premium revenues, rather than tax dollars. However, because the program's premium rates have been set to cover losses in an average year based on program experience that did not include any catastrophic losses, the program has been unable to build sufficient reserves to meet future expected flood losses.[1] The series of extraordinary flood events in recent years—including Hurricane Katrina in August 2005, which inflicted extensive damage on the Gulf Coast—has raised serious questions about the financial solvency of the NFIP and highlighted this known program limitation. Collecting premiums that are based on an average historical loss year does not enable the NFIP to build sufficient reserves to cover losses that exceed the historic averages. As of April 2007, FEMA had paid almost $16 billion in claims for flood damage as a result of Hurricane Katrina, more than the $14.6 billion it had paid for the cumulative total of all flood events from 1968 until Hurricane Katrina occurred. After Katrina, FEMA was unable to cover all of the claims received for flood losses and

[1]See GAO, *Flood Insurance: Information on the Financial Condition of the National Flood Insurance Program*, GAO-01-992T (Washington, D.C.: July 2001).

had to increase its borrowing authority from the U.S. Treasury from $1.5 billion to more than $20 billion. In March 2006, we designated the NFIP as a high-risk program,[2] and Congress has been considering a number of legislative changes to improve the program's financial solvency.

Compounding the dramatic increase in the amount paid on flood insurance claims have been increases in the amounts of money FEMA has been required to pay for services to WYO insurance companies.[3] This report, prepared under the authority of the Comptroller General in order to contribute to the discussion about ways to improve the NFIP's financial solvency, addresses the following questions: (1) In recent years, how much in operating costs did FEMA pay to the WYO insurance companies that sell and service NFIP policies and adjust claims and how does FEMA determine the amount of these operating costs? (2) How does FEMA provide assurance that the approach it uses to determine operating costs is based on reasonable estimates of WYO insurance companies' expenses? and (3) How does FEMA provide assurance that financial and management controls in place for the WYO program operate as intended and in accordance with program requirements?

This is one of several reports and testimonies we have completed or have under way related to the administration and management of the NFIP since the unprecedented losses from Hurricane Katrina and other major flood events in 2004 and 2005 illustrated the extent of the federal government's exposure to losses in catastrophic flood years. Related work we recently completed addressed issues including the NFIP's financing, oversight and management, implementation of the program in the aftermath of Hurricanes Katrina and Rita, the inventory of insured properties that suffer repetitive flood losses, and the status of efforts to revise and improve the nation's flood maps. (See the list of related GAO products on page 52 of this report.) In addition, we have reviews under way assessing how insurance companies manage losses that may be covered by both wind and flood insurance, the impact of subsidized properties on the NFIP, and additional aspects of FEMA's financial oversight of WYO insurance companies.

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[2]See GAO, *GAO's High-Risk Program,* GAO-06-497T (Washington, D.C.: Mar. 15, 2006). GAO has periodically identified for Congress high-risk areas that are in need of broad-based transformations to address major economic, efficiency, or effectiveness challenges.

[3]WYO insurance companies may retain premium revenues collected or receive disbursements from the NFIP Fund as payment for services rendered.

To assess how much FEMA paid to WYO insurance companies in recent years for operating costs and how FEMA determines the amount of these operating costs, we interviewed FEMA officials, examined documentation such as FEMA's financial subsidy arrangement with the WYO insurance companies, and analyzed FEMA data on amounts paid to WYO insurance companies for fiscal years 2004-2006. We examined internal controls FEMA had in place to ensure the reliability of the data. We determined that the information was sufficiently reliable for our purposes by discussing with officials the internal control processes in place, observing the monthly process used by FEMA's program contractor to reconcile cost information submitted by WYO insurance companies, and reviewing audits of DHS financial statements. We conducted semi-structured interviews with representatives of a judgmental sample of five WYO insurance companies and the National Association of Insurance Commissioners (NAIC)[4] to obtain their perspectives on FEMA's payment methodologies. We chose our sample to include representatives of four of the five largest participating WYO insurance companies in terms of their market share of NFIP policies in force in 2006 and one mid-sized WYO insurance company. However, our sample is not a representative sample of all participating WYO insurance companies, so the views expressed should not be generalized to the universe of the 88 participating companies.

To determine how FEMA provides assurance that its approach to determining operating costs for WYO insurance companies results in reasonable estimates of the companies' expenses, we reviewed the statutory and regulatory framework for establishing a schedule of operating costs and federal internal control standards, and we obtained the views of FEMA and insurance industry officials on the effectiveness of the current payment approach and the potential implications of implementing other payment methodologies. We also assessed how the approach FEMA currently uses to pay WYO insurance companies for their services compares to payment methodologies used by two similar public-private insurance arrangements. These are (1) the Federal Crop Insurance Corporation's (FCIC) arrangement with private insurers for handling expenses associated with insuring agricultural crop values; and (2) the NFIP's arrangement with its Direct Servicing Agent, a FEMA contractor that sells and services policies and adjusts claims on about 4 percent of flood insurance policies that are not, for various reasons, handled through the WYO program.

[4]NAIC is the professional association of state insurance regulators.

To determine the extent to which FEMA's financial management controls for WYO companies provide assurance that payments are proper and in accordance with program requirements, we documented FEMA's regulations and procedures for monitoring and overseeing payments of expenses to WYO insurance companies for selling and servicing NFIP policies. We analyzed the schedule and results of biennial financial statement audits conducted for fiscal years 2001 to 2006. We also interviewed officials of FEMA and its program contractor. In addition, we reviewed financial audits of the NFIP done by the DHS Office of Inspector General (OIG) for fiscal years 2003 to 2006. We performed our work from June 2006 through July 2007, in accordance with generally accepted government auditing standards. Additional details on our scope and methodology are in appendix I.

Results in Brief

FEMA's total payments to WYO insurance companies for operating costs ranged from $619.2 million to $1.6 billion (in current dollars, not adjusted for inflation) or from more than a third to almost two-thirds of the total premiums paid by policyholders to the NFIP for fiscal years 2004 through 2006. In fiscal years 2005 and 2006, payments were larger than for fiscal year 2004 because the WYO insurance companies received payments in these years for settling an unprecedented number and dollar amount of claims for damages resulting from Hurricanes Charley, Ivan, Frances, and Jeanne in Florida and other East Coast and Gulf Coast states in 2004 and Hurricanes Katrina, Rita, Wilma, and other flood events in 2005. To determine the amount of these payments, FEMA negotiated payment approaches with insurance industry representatives when it established the current WYO program in 1983 based on industry averages for operating expenses for other lines of insurance (such as homeowners, commercial, and fire), past practice, and discussion with WYO insurance company participants and other insurance industry representatives. While FEMA has periodically adjusted payment amounts since 1983, the underlying methodologies it uses to calculate them have not significantly changed. FEMA pays WYO companies for selling and servicing insurance policies and adjusting and processing policyholders' claims after a flood event occurs. For selling and servicing NFIP policies, FEMA pays WYO insurance companies (1) a flat 15 percent of premiums for agent commissions; (2) a percentage for operating expenses, which historically also averages about 15 percent, based on industry averages for other lines of insurance; and (3) bonuses of up to 2 percent of their total annual premium revenues for increasing the number of NFIP policies they sell. After flood losses, FEMA pays WYO insurance companies for adjusting and processing policyholders' claims according to (1) an adjustment fee schedule used by the insurance industry for other types of insurance claims and (2) an allowance of 3.3 percent of each claim settlement amount to pay for their processing expenses. The WYO insurance companies collect their operating costs from FEMA based on these methodologies. Any portion of the premium revenues retained by the WYO insurance companies that are not used to cover expenses may be retained as profit.

The approach FEMA uses to determine operating costs for WYO insurance companies, rooted in policies negotiated and established about 25 years ago, cannot ensure that payments are based on reasonable estimates of actual expenses because FEMA does not consider actual expenses incurred by the companies for their services to the NFIP and does not collect actual expense data from the WYO insurance companies. For example, the payment formula FEMA uses to set a payment rate of 3.3 percent of claims settlement amounts for claims processing expenses, such as setting up operations in flood-damaged areas, has been in place since the program's inception. Since it created the program in 1983, FEMA has had no basis, other than discussion with WYO insurance companies, to determine whether that payment rate is a reasonable estimate of expenses incurred. As a result of the unprecedented number and cost of flood insurance claims after Hurricane Katrina, the amount FEMA paid WYO insurance companies for claims processing expenses based on this formula increased more than tenfold from about $30 million in fiscal year 2004 to about $385 million in fiscal year 2005 not adjusted for inflation. In response, FEMA officials said they are considering a possible cap on the amount of payments in this expense category in future catastrophic loss years. Under the National Flood Insurance Act of 1968, insurance companies choosing to participate in the WYO program must keep such records as FEMA prescribes and provide access to these records for purpose of audit and examination. Although it has the authority to do so, FEMA does not collect data on actual WYO flood insurance expenses. FEMA's reluctance to impose additional cost accounting requirements on WYO insurance companies is based on concerns that the approach would (1) increase FEMA's cost of administering the program and (2) result in a decline in the number of insurance companies that choose to participate in the WYO program. Nonetheless, there is some precedent in two similar public-private insurance partnerships for considering actual expense data. The FCIC, which pays insurance companies a percentage of premium revenue for costs related to insuring agricultural crop values against financial losses by events such as droughts and other natural disasters, requires the companies to submit detailed expense reports in a consistent format. The NFIP Direct Servicing Agent, a FEMA contractor that sells and services policies and adjusts claims on about 4 percent of flood insurance policies that are not, for various reasons, handled through the WYO program, has also calculated its operating costs. Based on standards for internal control in the federal government, FEMA is responsible for implementing controls that serve as the first line of defense in safeguarding assets, preventing and detecting errors and fraud, and helping to achieve desired results through effective stewardship of public resources.[5] FEMA has not significantly changed the payment policies that are the foundation of the WYO program in more than 2 decades, and because FEMA cannot ensure that its approach to establishing a schedule of operating costs is based on a reasonable estimate of actual expenses or that the amount paid was reasonable, it may not have effectively implemented these controls.

Biennial financial statement audits—FEMA's primary management control mechanism to provide assurance that it receives complete and accurate financial management information from the WYO insurance companies—were not performed as required by regulation. FEMA's regulations and WYO Financial Control Plan require each participating WYO insurance company to arrange and pay for biennial financial statement audits by independent certified public accountants (CPA) that evaluate its financial statements for activities related to the NFIP. The audits are to be funded by the WYO insurance companies from the payments they receive from FEMA for selling and servicing policies (about 15 percent of premium revenue). However, many insurance companies participating in the WYO program received these payments in full yet did not comply with the requirement to have biennial audits done during the period from fiscal year 2001 to 2006. Specifically, for fiscal years 2001 and 2002, 40 of the 98 participating companies had financial audits performed by independent CPA firms. For fiscal years 2002 to 2003, 37 of the 103 participating companies had financial statement audits performed by CPA firms. For fiscal years 2003 and 2004, 35 of 107 participating companies had the financial audits performed; for fiscal years 2005 and 2006, 5 of 94 participating companies had biennial financial statement audits performed. FEMA officials said that FEMA granted 32 additional WYO insurance companies extensions to complete the biennial financial audits for 2005 and 2006 by September 30, 2007. The officials said that the extensions were allowed because the WYO insurance companies were in

[5]See GAO, *Standards for Internal Control in the Federal Government*, GAO-AIMD-00.21.3.1(Washington, D.C.: November 1999).

the process of contracting with new vendors or subcontractors to perform their financial reporting responsibilities and conducting financial audits would have been particularly costly and difficult. FEMA did not have a mechanism in place for tracking and reviewing the results of the biennial financial statement audits that were performed. FEMA officials were able to provide us with copies of only two biennial audit reports until the conclusion of our audit when they asked WYO insurance companies and their subcontractors to send copies of additional reports that might have been prepared. Without the required biennial audits, FEMA lacks an appropriate internal control mechanism for effective program oversight to help ensure that payments made to WYO insurance companies are proper and in accordance with program requirements. According to the standards for internal controls within the federal government, such control mechanisms are important in agencies like FEMA where large amounts of data are processed; where audit techniques may be used to identify inefficiencies, waste, or abuse; and where managers should be able to promptly review and evaluate audit findings in order to identify opportunities for improvements.

We are recommending that the Secretary of DHS direct the Under Secretary of Homeland Security, FEMA to take two actions to strengthen and improve its administration of the NFIP: (1) take steps to ensure that its approach to establishing a schedule of operating costs is based on a reasonable estimate of actual expenses by reviewing appropriate documentation of expenses incurred by WYO insurance companies; and (2) ensure that biennial financial statement audits of WYO insurance companies are conducted by independent CPA firms as required by FEMA regulation, and that FEMA reviews the audits to help ensure that payments made are proper and in accordance with program requirements.

In commenting on a draft of this report, DHS generally agreed with our recommendations to improve financial accountability over payments the NFIP makes to the WYO insurance companies. However, FEMA said our presentation in table 1 of payments to WYO insurance companies for all NFIP services for fiscal years 2004 to 2006 as a percentage of total premium revenues was “inappropriate and misleading” because it was most appropriate to compare the costs of adjusting and processing claims to total losses in a year, not premium revenue. We disagree. We believe it is appropriate to summarize aggregate expense payment data as a percentage of premiums collected because the NFIP is designed to pay for flood losses and operating expenses to the extent possible with premium revenues rather than tax dollars. FEMA’s comments are contained in appendix III.

Background

Overview of the National Flood Insurance Program

Congress established the NFIP in the National Flood Insurance Act of 1968 to provide policyholders with some insurance coverage for flood damage, as an alternative to disaster assistance, and to try to reduce the escalating costs of repairing flood damage.[6] FEMA, within DHS, administers the NFIP and is responsible for its management and oversight. Floods are the most common and destructive natural disaster in the United States. In fact, according to NFIP statistics, 90 percent of all natural disasters in the United States involve flooding. However, flooding is generally excluded from homeowner policies that typically cover damage from other losses, such as wind, fire, and theft. Because of the catastrophic nature of flooding and the inability to adequately predict flood risks, private insurance companies have largely been unwilling to underwrite and bear the risk of flood insurance. Under the NFIP, the federal government assumes the liability for the insurance coverage and sets rates and coverage limitations, among other responsibilities. In creating the NFIP, Congress found that a flood insurance program with "large-scale participation of the Federal Government and carried out to the maximum extent practicable by the private insurance industry is feasible and can be initiated."[7]

As of May 2007, more than 20,300 communities across the United States and its territories participated in the NFIP by adopting and agreeing to enforce state and community floodplain management regulations to reduce future flood damage. In exchange, the NFIP makes federally backed flood insurance available to homeowners and other property owners in these communities. Homeowners with mortgages from federally regulated lenders on property in communities identified to be in special high-risk flood hazard areas are required to purchase flood insurance on their dwellings for at least the outstanding mortgage amount. Optional, lower-cost coverage is also available under the NFIP to protect homes in areas of low to moderate risk. To insure furniture and other personal property items against flood damage, homeowners may purchase separate NFIP personal property coverage. Although premium amounts vary according to the amount of coverage purchased and the location and

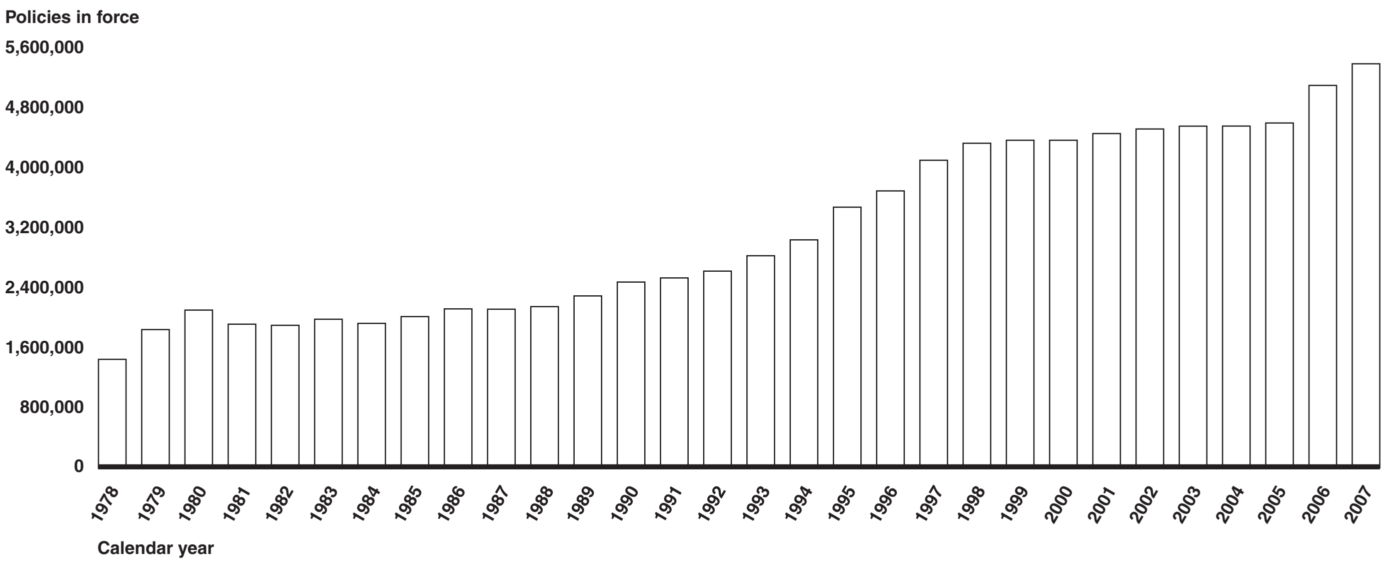
[6]The National Flood Insurance Act of 1968, as amended, is codified at 42 U.S.C. § 4001 to 4129.

[7]42 U.S.C. § 4001(b)(2).

characteristics of the property to be insured, the average yearly premium for a 1-year policy was $475, as of February 2007.

As shown in figure 1, the NFIP has grown from about 1.5 million policies in 1978 to about 5.4 million policies in April 2007.

Figure 1: NFIP Policies in Force, 1978-April 2007



Source: FEMA.

To the extent possible, the NFIP is designed to pay operating expenses and flood insurance claims with premiums collected on flood insurance policies rather than by tax dollars. FEMA has statutory authority to borrow funds from the U.S. Treasury to keep the NFIP solvent in years when losses are heavy.[8] The NFIP, by design, is not actuarially sound because Congress authorized subsidized insurance rates to be made available for policies covering certain structures to encourage communities to join the program and premiums are based on the average historical loss year; therefore the NFIP does not build sufficient reserves to cover losses that exceed the historic averages. The subsidized properties are generally referred to as Pre-FIRM (Flood Insurance Rate Map) buildings. The legislative history of the National Flood Insurance Act

[8] 42 U.S.C. § 4016.

recognized that insurance for existing buildings constructed before the NFIP was established would be extremely expensive because many of them were flood prone and did not comply with NFIP floodplain management standards that went into effect after they were built.

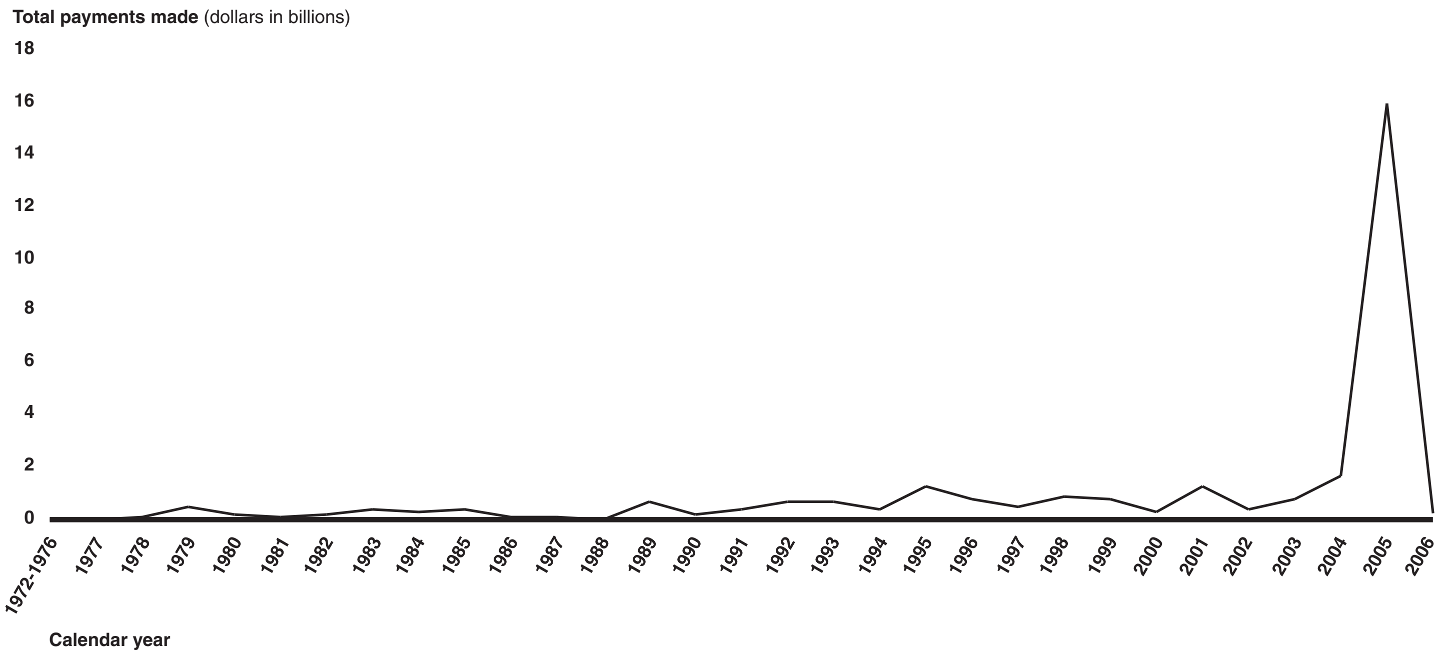
Until the last several years, FEMA had been generally successful in paying flood losses and expenses with premium revenue, exercising its borrowing authority three times in the last decade when claims payments exceeded available fund balances. In each instance, FEMA repaid the funds with interest. Prior to Hurricane Katrina in August 2005, FEMA had also made substantial progress in repaying the borrowing it had undertaken to pay losses for the 2004 hurricane season during which Hurricanes Charley, Ivan, Frances, and Jeanne caused heavy flood damage in Florida and other East Coast and Gulf Coast states. However, because the program's premium rates have been set to cover losses in an average year based on program experience that did not include any catastrophic losses, the program has been unable to build sufficient reserves to meet future expected flood losses.

Hurricanes Katrina, Rita, and Wilma, in 2005, had a far-reaching impact on the financial solvency of the NFIP. Legislation increased FEMA's borrowing authority from a total of $1.5 billion prior to Hurricane Katrina to $20.8 billion by March 2006, and, as of May 2007, FEMA's outstanding debt to the Treasury was $17.5 billion. As we have reported, it is unlikely that FEMA can repay a debt of this size and pay future claims in a program that generates premium income of about $2 billion a year.[9] Legislation has been introduced in Congress to increase FEMA's borrowing authority to pay interest on the debt and attention has focused on the extent of the federal government's exposure for claims payments in future catastrophic loss years and ways to improve the program's financial solvency.

Figure 2 shows the magnitude of the loss payments for Hurricane Katrina and other flood events in 2005 compared to claims payments over other years.

[9]See GAO, *Federal Emergency Management Agency: Challenges for the National Flood Insurance Program*, GAO-06-335T (Washington, D.C.: Jan. 25, 2006).

Figure 2: NFIP Payments to Claimants for 2005 Compared to Other Years



Source: FEMA.

In prior work, we have reported that FEMA and the WYO insurance companies settled the unprecedented number of NFIP claims after Hurricane Katrina reasonably quickly, reporting that over 95 percent of Gulf Coast claims for damage from Hurricane Katrina followed closely by Hurricane Rita were settled in May 2006, about 9 months after the storms.[10]

History and Goals of the WYO Program

Since its inception, the NFIP has relied to a large extent on the private insurance industry to sell and service policies, as Congress envisioned when it authorized the program in 1968. From 1969 through 1977, NFIP was operated under Part A of the National Flood Insurance Act (the Act), meaning that private insurers assumed a portion of the risk of financial loss.[11] In order to implement the program, the Department of Housing and Urban Development, the agency that administered the NFIP at that time,

[10]See GAO, *National Flood Insurance Program: New Processes Aided Hurricane Katrina Claims Handling, but FEMA's Oversight Should Be Improved*, GAO-07-169 (Washington, D.C.: Dec. 15, 2006).

[11]42 U.S.C. §§ 4051-4056.

entered into an agreement with a consortium of private insurers known as the National Flood Insurers Association. Under this agreement, the department reimbursed the association for operating costs, and because the association was a risk-sharing insurer, it received an additional annual operating allowance equal to 5 percent of policyholder premiums. In 1977, in part as a result of disagreements on issues of financial control between the private insurers and the department, the relationship ended.

Since 1978, NFIP has operated under Part B of the Act, meaning that the federal government bears the entire risk of loss.[12] Because insurance companies operating under Part B, such as WYO companies, are not risk-sharing insurers, they are paid only for operating costs. The FEMA director is to establish a current schedule of operating costs by negotiating with representatives of the insurance industry. Under the Act, operating costs include four components: (1) expense reimbursements covering the direct, actual, and necessary expenses incurred in connection with selling and servicing flood insurance coverage; (2) reasonable compensation payable for selling and servicing flood insurance coverage, or commissions or service fees paid to producers; (3) loss adjustment expenses; and (4) other direct, actual, and necessary expenses that FEMA finds are incurred in connection with selling or servicing flood insurance coverage.[13]

In 1983, FEMA, still operating the NFIP under Part B, established the WYO program to obtain more industry involvement in the NFIP. According to FEMA, the goals of the WYO program are to increase the NFIP policy base and the geographic distribution of policies, improve service to NFIP policyholders through the infusion of insurance industry knowledge, and provide the insurance industry with direct operating experience with flood insurance. Over the years, insurance company participation has grown and the WYO program has assumed a larger share of the total NFIP policies in force. During the first year of the WYO arrangement, 48 insurance companies agreed to participate. In 1986, WYO insurance companies administered about 50 percent of a little over 2 million policies in force. In February 2007, WYO insurance companies administered about 96 percent of the about 5.4 million policies in force at that time.

[12] 42 U.S.C. §§ 4071-4072.

[13] 42 U.S.C. § 4018(b)(1).

Roles of WYO Companies and Other Key Participants in the NFIP

A private insurer becomes a WYO company by entering into an agreement with FEMA known as the Financial Assistance/Subsidy Arrangement. Under the arrangement, private insurers agree to issue flood policies in their own name. In addition, the WYO companies adjust flood claims as well as settle, pay, and defend all claims arising from the flood policies. To enter into a WYO arrangement with the NFIP, private insurers must meet FEMA's established criteria.[14] Factors FEMA considers in determining whether companies are accepted into the WYO program include their experience in property and casualty insurance lines, standing with state insurance departments, and the ability to meet NFIP reporting requirements to adequately sell and service flood insurance policies.

Each year, FEMA is required to publish in the Federal Register the terms for participation in the WYO program, including amounts WYO insurance companies will be paid for expenses. Companies that agree to participate in the program sign a financial assistance/subsidy arrangement and are to comply with the provisions of FEMA's WYO Financial Control Plan, which outlines WYO insurance companies' responsibilities for program operations including underwriting, claims adjustments, cash management, and financial reporting, as well as FEMA's responsibilities for management and oversight.

Selling policies. Insurance agents under contract to one or more WYO insurance companies are the main point of contact for most policyholders to purchase an NFIP policy, seek information on coverage, or file a claim. Based on information the insurance agents submit, the WYO insurance companies issue policies, collect premiums from policyholders, deduct an allowance for expenses from the premium, and remit the balance to the National Flood Insurance Fund. In some cases, insurance companies hire subcontractors—flood insurance vendors—to conduct some or all of the day-to-day processing and management of flood insurance policies.

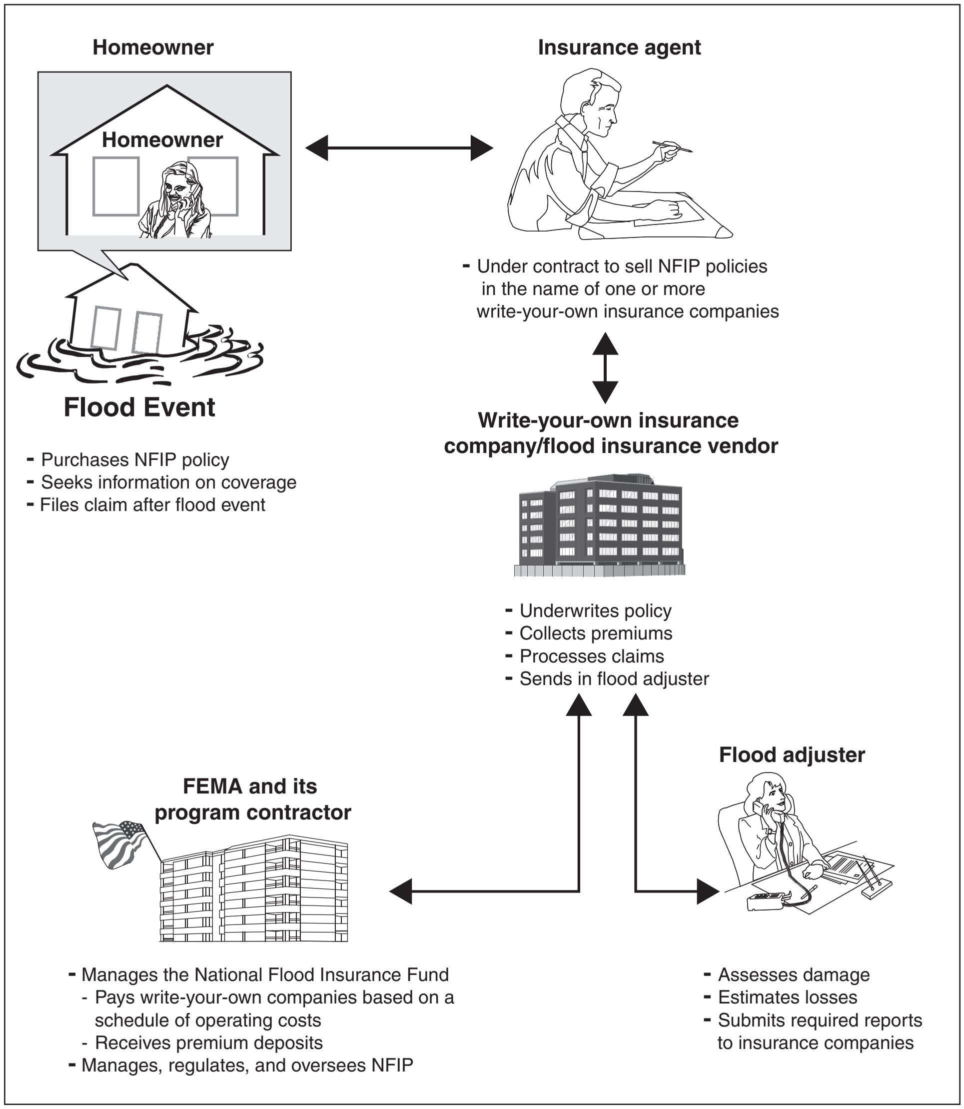
Adjusting claims. Insurance companies work with certified flood adjusters to settle NFIP claims. When flood losses occur, policyholders report them to their insurance agent, who notifies the WYO insurance company. The WYO insurance company assigns a flood adjuster to assess damages. Flood adjusters may be independent or employed by an insurance or adjusting company. These adjusters are responsible for assessing damage, estimating losses, and submitting required reports,

[14] 44 C.F.R. § 62.24.

work sheets, and photographs to the WYO insurance company, where the claim is reviewed and, if approved, processed for payment. WYO insurance companies are then reimbursed by FEMA from the National Flood Insurance Fund for the amount of the claims and expenses paid. Claims amounts may be adjusted after the initial settlement is paid if claimants submit documentation that some costs were higher than estimated.

FEMA Management and Oversight. About 68 FEMA employees, assisted by about 170 contractor employees manage and oversee the NFIP and the National Flood Insurance Fund into which premiums are deposited and claims and expenses paid. Their management responsibilities include establishing and updating NFIP regulations, analyzing data to actuarially determine flood insurance rates, and offering training to insurance agents and adjusters. In addition, FEMA and its program contractor are responsible for monitoring and overseeing the quality of the performance of the WYO insurance companies to assure that the NFIP is administered properly. Figure 3 provides an overview of the WYO companies' and others' participation in the NFIP.

Figure 3: Key Participants in the NFIP WYO Program



Source: GAO analysis of FEMA data, clipart (Art Explosion).

Payments to WYO Insurance Companies Comprised Up to Almost Two-Thirds of Total Premium Revenue in Recent Years Based on Payment Methodologies Established in 1983

FEMA's payments to WYO insurance companies for operating costs ranged from more than a third to almost two-thirds of the total premiums paid by policyholders to the NFIP for fiscal years 2004 through 2006. During the 3-year period from fiscal year 2004 through 2006, FEMA's payments to WYO insurance companies ranged from $619.2 million to $1.6 billion in current dollars that were not adjusted for inflation. FEMA establishes a schedule of operating costs for WYO insurance companies participating in the NFIP based on industry averages for operating expenses for other lines of insurance, such as homeowners, commercial and fire; past practices; and discussions with WYO insurance company participants and other insurance industry representatives. FEMA negotiated these payment methodologies with insurance industry representatives when it established the WYO program in 1983. While FEMA has periodically adjusted payment amounts since 1983, the underlying methodologies it uses for determining them have not significantly changed. FEMA pays WYO companies in two main categories (1) for selling and servicing insurance policies and (2) adjusting and processing policyholders' claims after a flood event occurs. Any portion of the premium revenues retained by the WYO insurance companies that are not used to cover expenses may be retained as profit. Because the WYO insurance companies bear no risk for NFIP losses, the payments they receive from FEMA are for work incurred in selling and servicing policies and adjusting claims.

Overall Payments to WYO Insurance Companies

As shown in table 1, in the last 3 fiscal years, payments to WYO insurance companies have consumed from over a third to almost two-thirds of the total premiums paid by policyholders to the NFIP. In fiscal years 2005 and 2006, payments were larger than for fiscal year 2004 because the WYO insurance companies received payments in these years for settling the unprecedented number and amount of claims for damages resulting from flood events including Hurricanes Charley, Ivan, Frances, and Jeanne in Florida and other East Coast and Gulf Coast states in 2004 and Hurricanes Katrina, Rita, Wilma, and other flood events in 2005.

Table 1: Payments to WYO Insurance Companies Received for Services Rendered to the NFIP (Fiscal Years 2004-2006)

Dollars in millions

Fiscal year	Premium revenue received by the NFIP Fund	Payments to WYO insurance companies for services rendered	Percent of premium revenue paid for WYO insurance company services
2004	$1,772.8	$619.2	34.9
2005	1,943.6	984.5	50.7
2006	2,439.9	1,583.5	64.9

Source: GAO analysis of FEMA data.

Note: Dollars are not adjusted for inflation.

Selling and Servicing NFIP Policies

WYO insurance companies retain premium revenues for selling and servicing NFIP policies based on three different calculations: (1) a flat 15 percentage allowance for insurance agent sales commissions; (2) an average of industry operating expenses for other lines of insurance to determine the amount for operating expenses associated with processing and servicing insurance policies, which historically also averages to about 15 percent; and (3) incentive bonuses to WYO companies of up to 2 percent of the premiums generated by selling and servicing flood insurance policies. Table 2 summarizes the methods FEMA uses to calculate payments to WYO companies for selling and servicing flood insurance policies and recent payment amounts.

Table 2: Methodology for Calculating Payments to WYO Insurance Companies for Selling and Servicing NFIP Policies and Actual Payments Made, Fiscal Years 2004-2006

Dollars in millions

Type of payment calculation[a]	Calculation methodology	Calculation result (actual or estimated)	Actual payments FY04	FY05	FY06
(1) Insurance agent sales commissions	Percentage amount established in the annual financial assistance/subsidy arrangement between FEMA and participating insurance companies	15% of premium revenue retained	$524.9	$634.6	$687.3
(2) Operating expenses[b]	Based on a 5-year rolling average of direct operating costs as reported by the industry for other types of property and casualty insurance	About 15% percent of premium revenue retained			
(3) Incentive bonus	Awarded to companies that achieve 2 to 5 percent or more growth in the number of NFIP policies they have in force	0.5% -2% of premium revenue retained	31.6	21.4	44.5

Source: GAO analysis of FEMA data.

Note: Dollars are not adjusted for inflation. In addition to these major categories of payments related to selling and servicing policies that WYO insurance companies receive for services to the NFIP, FEMA officials noted two other smaller categories of payments that are available. First, WYO insurance companies may receive special allocations if they need to hire engineers to do studies necessary to underwrite policies or adjust claims. Total payments are about $2 million a year. Second, in future years, FEMA has proposed to pay WYO insurance companies ¼ of 1 percent in additional premium revenues for expenses they incur to comply with provisions of the Flood Insurance Reform Act of 2004. The proposal is currently under review by DHS. If approved, it could be effective in fiscal year 2008. The 2004 Act mandated that NFIP policyholders receive additional informational materials explaining their coverage, which resulted in additional expenses to the WYO insurance companies for postage and mailings, among other items. Total payments on premium revenues of $2 billion would be about $5 million.

[a]FEMA did not provide payment information for insurance agent sales commissions and operating expenses as separate line items.

[b]Includes state premium tax, which FEMA officials said averages 2 percent of written premiums.

Selling and Servicing Policies: Agent Commissions

WYO insurance companies retain a flat fee of 15 percent of premium revenues for agent commissions. The WYO insurance companies, however, determine the actual amount of commission they pay to agents. The amount varies from one WYO insurance company to another and may be more or less than 15 percent. For example, one WYO insurance company flood program manager said that agents for his company receive a commission of 15 percent of the policy amount and may also receive other incentives during special flood marketing campaigns. Another flood program manager said that her company's agents received a commission that was larger than 15 percent of the policy amount. In the insurance industry, many independent agents are paid by commission only, whereas sales workers who are employees of an agency or an insurance carrier may be paid in one of three ways—salary only, salary plus commission, or salary plus bonus. In general, commissions are the most common form of compensation, especially for experienced agents.[15]

The amount of work involved in selling and servicing NFIP policies varies based on the flood risk of the insured property, according to a representative of the NAIC. For example, the representative said that NFIP policy sales for properties located in special flood hazard areas require the greatest amount of work because of the need to develop information on the elevation of the property, take photographs, and create other documentation that is required to determine the premium amount. They said that policy sales and renewals that require lesser amounts of work include (1) renewals where information has not changed; (2) sales of policies on properties that were built before NFIP floodplain management standards went into effect (because they qualify for subsidized premiums and do not require extensive documentation to determine flood risk); and (3) sales of policies for properties that are not located in special flood hazard areas (because they do not require extensive documentation to assess flood risk).

Selling and Servicing Policies: Operating Expenses

In addition to the 15 percent allowance for agent commissions, WYO insurance companies retain about 15 percent of the premium revenues for ongoing operating expenses related to administering the NFIP and providing services to policyholders. This payment amount is based on an annual agreement between FEMA and the WYO insurance companies. See appendix III for the percentage allowances FEMA authorized WYO insurance companies to retain for operating expenses incurred in selling and servicing NFIP policies for fiscal years 1984 to 2007. According to the agreement, the WYO insurance companies may withhold, as operating and administrative expenses (other than agent commissions), an amount equal to the average industry expenses ratios for A.M. Best Company's Aggregates and Averages for the following five property coverages: Fire, Allied Lines, Farmowners Multiple Peril, Homeowners Multiple Peril, and Commercial Multiple Peril (non-liability portion).[16] According to the

[15] Bureau of Labor Statistics, U.S. Department of Labor, Occupational Outlook Handbook, 2006-07 Edition, Insurance Sales Agents, on the Internet at http://www.bls.gov/oco/ocos118.htm (visited Apr. 26, 2007).

[16] A.M. Best is an insurance industry rating and information agency that compiles and publishes data submitted by insurance companies to their state regulatory authorities.

agreement, this amount is to be increased by 1 percentage point to reimburse expenses "beyond regular property/casualty expenses."[17]

The payment for administrative and operating expenses is intended to cover a variety of expenses WYO insurance companies incur in servicing NFIP policies. WYO insurance company managers said examples of expenses they incurred included fees for services of a vendor or subcontractor (if one is retained to handle all or part of the flood insurance business), payment of salaries and expenses for employees with full or part-time responsibilities for the NFIP work, payment of fees to independent public accounting firms to conduct biennial audits of financial systems for the NFIP, and payment of state taxes on the funds received from the NFIP. Other expenses reported by WYO insurance companies include costs of marketing NFIP policies, training agents to sell and service NFIP policies, and creating or modifying computer and accounting systems to report financial and statistical information required by the NFIP.

Selling and Servicing Policies: Bonuses

According to FEMA officials, the agency has used annual bonuses for WYO insurance companies since 1995[18] as an incentive to increase the number of NFIP policies in force. Under the bonus incentive program, FEMA provides WYO insurance companies with opportunities to earn additional percentages of premium revenue above the levels established annually if they increase the number of flood insurance policies they sell and service. FEMA officials said that they established bonus percentage amounts through discussions with WYO insurance company officials, noting that, as of May 2007, the NFIP had experienced 36 continuous months of policy growth.[19] One official attributed the growth to "a new American consciousness" of the importance of having flood insurance in the aftermath of Hurricane Katrina and other major flood events in 2004 and 2005. This growth in policies accounts for the recent parallel growth in bonuses. Table 3 provides information on how bonuses have been

[17]Federal Emergency Management Agency, Federal Insurance Administration, *Financial Assistance/Subsidy Agreement* (Washington, D.C.: Oct. 1, 2006).

[18]FEMA also provided annual incentive bonuses in 1989-1991.

[19]In addition to the marketing incentive bonuses, FEMA helps WYO insurance companies pay for their NFIP marketing efforts through the NFIP cooperative advertising program, which provides WYO companies and insurance agents the opportunity to split their advertising costs for any approved flood insurance print or Yellow Pages display ads with the NFIP as well as the development of public relations and of collateral materials such as brochures.

awarded and distributed. As the table shows, most participating WYO insurance companies received bonus payments in each of the fiscal years, and in fiscal year 2006, 67 percent of the companies received the highest bonus amount of 2 percent of premium revenues.

Table 3: Incentive Bonus Award Structure and Distribution to WYO Companies, Fiscal Years 2004-2006

Policy growth level (%)	Bonus level (% of all premiums)	Actual bonus payments (dollars in millions)			Number and percentage of WYO companies receiving bonus					
		FY04	FY05	FY06	FY04		FY05		FY06	
<2.0	0	0	0	0	22	22%	37	40%	21	24%
2.0	0.5	0	$1.63	$0.023	3	3%	4	4%	1	1%
3.0	1.0	$0.48	3.04	0.104	4	4%	7	8%	2	2%
4.0	1.5	2.07	6.02	2.4	26	26%	6	7%	5	6%
5.0	2.0	29.04	10.72	42.1	44	44%	39	40%	59	67%
Total		**$31.58**	**$21.42**	**$44.5**	**99**	99%	**93**	100%	**88**	100%

Source: GAO analysis of FEMA data.

Note: The number of insurance companies participating in the WYO program fluctuates; numbers for ends of fiscal years are reported. Dollars are not adjusted for inflation. Percentages within each fiscal year do not total 100% due to rounding. WYO companies that achieved policy growth of less than 2 percent for any fiscal year were not eligible to receive bonuses. For 2004, FEMA officials advised that bonuses were based on overall growth and retention; therefore, although three companies achieved overall growth of 2.0 to 3.0 percent, they were not awarded bonuses.

While FEMA Officials Consider WYO Payments for Selling and Servicing Policies to Be Fair, Insurance Industry Stakeholder Views Were Mixed

FEMA officials said that the methodologies they use for paying WYO companies for selling and servicing flood insurance are fair for both the government and the insurance industry. The officials noted that because the methodologies approximate the expenses incurred for insurance policy sales and servicing on an industrywide basis, they result in fair compensation for the WYO insurance companies. According to FEMA officials, many of the traditional operating costs associated with other lines of insurance are also incurred in selling and servicing flood insurance for the NFIP (i.e., commissions to agents, staff salaries, taxes, and building and equipment costs). Moreover, FEMA officials considered the payment of the same percentage of premium revenue to WYO insurance companies for more and less time-consuming sales and renewals to be a reasonable approach because it results in a reasonable overall compensation rate for the services the companies perform. They said that because the method for paying companies to sell and service policies has worked well over the years, FEMA has not deemed it necessary to significantly change its approach since it was put into place at the inception of the WYO program in 1983.[20]

Of the five WYO companies we interviewed (including four of the five largest participating in the NFIP), views on the sufficiency of FEMA's payment structure were mixed. Three WYO company officials stated that the expense percentage was generally sufficient, while two stated that it was too low. In addition, one NAIC representative we interviewed said that the methodology was generally fair to the insurance companies and taxpayers, and another noted that expense allowance percentages are probably too high for some renewals and too low for new business but overall work out to a reasonable amount of compensation.

After Flood Losses, FEMA Pays WYO Insurance Companies for Adjusting Claims and Providing Claims Processing Services

In addition to paying WYO companies for selling and servicing NFIP flood insurance policies, FEMA also provides payments after a flood loss occurs. WYO companies are paid both for adjusting claims and for processing claims and providing certain claims-related services, such as setting up temporary flood insurance claims processing centers. Table 4 provides information on the methodologies FEMA uses to calculate these payments and recent payment amounts.

[20]FEMA has never relied on actual flood insurance expense data to determine operating costs. However, in 1998 to 1999, FEMA reviewed its methodology for paying WYO insurance companies and, as a result, slightly modified the way in which it calculated payments for selling and servicing flood insurance policies based on average expenses of other lines of property and casualty insurance. Specifically, FEMA began using direct, as opposed to net, expense information for the property and casualty insurance lines, meaning that FEMA no longer reimbursed WYO insurance companies for reinsurance expenses, which are not relevant for flood insurance because the federal government through the Treasury is ultimately responsible for program losses that exceed program funds. As a result, FEMA reduced the operating expense allowance by one percent. See 64 Fed. Reg. 27,705 (May 21, 1999). However, 2 years later, FEMA determined that the operating expense allowance should be increased by about 1 percent for expenses beyond regular property/casualty expenses, effectively negating the reduction made in 1999. See 66 Fed. Reg. 40,916 (Aug. 6, 2001).

Table 4: Methodology for Calculating Payments to WYO Insurance Companies for Adjusting and Processing Claims after a Flood-Loss Event, and Actual Payments Made, Fiscal Years 2004-2006

Dollars in millions

Type of payment calculation	Calculation methodology	Calculation result (actual or estimated)	Actual payments		
			FY04	FY05	FY06
(1) Claims adjustments	Dollar or percentage of incurred loss based on adjuster fee schedule	Ranges from $60 to $1,250 in flat fees for claims up to $50,000 Fees for claims above $50,000, fees range from 2.1% to 3% of the claims settlement amount.	$32.4	$97.2	$466.5
(2) Claims processing	Based on actual incurred loss	3.3% per incurred loss	30.3	231.3	385.1
Total			**$62.7**	**$328.5**	**$851.6**

Source: FEMA.

Note: Dollars are not adjusted for inflation. WYO insurance companies also process claims that fall into other categories, such as "erroneous assignment" or "closed without payment" and receive fees of $60 and $225, respectively. For claims of $50,000-$100,000, the fee equals 3%; for claims up to $250,000, the fee is 2.3% with a $3,000 minimum; and for claims above $250,000, the fee is 2.1% with a minimum of $5,750.

Claims Adjustment Fees

FEMA pays WYO insurance companies for adjuster fees based on a fee schedule that FEMA periodically negotiates with WYO insurance company representatives. Using the fee schedule, FEMA, through the WYO insurance companies, pays adjuster fees based on the amount of each claim settled, with higher fees for larger claims settlement amounts. While some WYO insurance companies use adjusters who are company employees, other WYO insurance companies hire and pay claims adjusting firms that employ their own workforces. These adjusting firms may keep a percentage of the fee for expenses and profit and pay a portion to independent adjusters they engage. For example, while one adjusting firm we visited paid independent adjusters 40 percent of the amount on the adjuster fee schedule, FEMA officials said that independent adjusters typically received 70 percent of the amount on the adjuster fee schedule.

According to FEMA's director for NFIP claims, the adjuster fee schedule system is based on fee schedules used by independent adjusting firms for claims on other lines of insurance (i.e., homeowners).[21] According to the

[21]Like other WYO payment agreements, this payment method was implemented in 1983, about the same time other lines of insurance moved to implement fee schedules based on claims settlement amounts rather than paying for claims adjustments based on the adjusters' time and expense.

director, rates paid on the fee schedule have been adjusted periodically since 1983 and were last revised in 2004 based on discussions with the WYO insurance companies and independent adjusting firms.[22] Table 5 shows excerpts from the adjuster fee schedule effective as of May 2007 for claims with loss dates of September 2004 and later.

Table 5: Excepts from the Adjuster Fee Schedule

Claim range	Fee
Closed without payment	$225
$225.01 to 1,000	425
$2,500.01 to 5,000	500
$5,000.01 to 7,500	575
$7,500.01 to 10,000	650
$10,000.01 to 15,000	750
$15,000.01 to 25,000	850
$25,000.01 to 35,000	1,000
$35,000.01 to $50,000	1,250
$50,000.01 to $100,000	3 percent of the loss settlement amount
$100,000.01 to 250,000	2.3 percent of the loss settlement amount but not less than $3,000
$250,000.01 and up	2.1 percent of the loss settlement amount but not less than $5,750

Source: FEMA.

Note: Based on gross loss.

Expense Payment for Claims Processing Activities

After a flood loss, in addition to claims adjustment payments, FEMA pays WYO insurance companies for processing claims at a rate of 3.3 percent of the flood insurance property settlement. According to FEMA officials, this allowance is provided to WYO insurance companies to set up operations to process claims in flood-damaged areas. For example, WYO insurance companies may set up disaster recovery centers to organize their claims processing efforts on behalf of the NFIP and special telephone hotlines to provide service, and pay travel expenses for employees and salaries of temporary workers to staff recovery centers. According to FEMA officials, the rate of payment for these expenses was initially determined by FEMA

[22] In addition, FEMA authorized payments of $750 per expedited claims adjustment, a process that did not require site visits by certified flood claims adjusters, to settle about 17,200 claims for damage from Hurricanes Katrina and Rita in 2005.

based on data on expenses incurred to adjust losses for other lines of insurance provided by A.M. Best, the insurance industry rating and information agency. However, during the 1980s, the insurance industry changed its requirements for reporting expenses incurred for loss adjustments; therefore, comparison information for other lines of insurance was no longer available, according to a FEMA official. Since that time, the official said that FEMA has not changed the claims expense allowance percentage because of discussions with representatives of the insurance industry who consider the percentage to be reasonable.

Views Mixed on the Sufficiency of Payments for Post-Flood Activities

The views of the five WYO insurance company managers we interviewed were mixed on whether the 3.3 percent claims adjustment expense allowance FEMA pays is sufficient in relation to the costs they incur. One WYO insurance company manager thought the expense percentage was sufficient. Three WYO company managers said that the expense percentage was generally reasonable in catastrophic loss years but not in average loss years, and another WYO insurance company manager said the expense percentage was reasonable in noncatastrophic loss years but not in catastrophic loss years when prices charged by adjusters for their services increase and resources are not as readily available to manage claims adjustment operations. NAIC representatives said that they were not able to comment on whether the amount paid was generally reasonable for the insurance companies and taxpayers because they did not have data necessary to form an opinion.

A senior FEMA official said that while FEMA has discussed the reasonableness of the payments for claims processing expenses with representatives of the WYO insurance companies, FEMA has not, since 1983, assessed the amount of the payments based on either expenses incurred by the WYO companies for processing of NFIP claims or actual costs incurred by insurance companies for processing claims on other lines of insurance. The official said that some consideration was being given to capping the amount of the claims expense allowance paid in catastrophic loss years. The official said that a draft proposed rule is being discussed with WYO insurance company officials and action could be taken as early as fiscal year 2008.

FEMA's Long-standing Approach for Establishing a Schedule of Operating Costs Cannot Ensure That WYO Insurance Company Payments Are Based on Reasonable Estimates of Actual Expenses

FEMA's methodologies for determining WYO's operating costs, rooted in policies established about 25 years ago, cannot provide assurance that payments are based on reasonable estimates of actual expenses because actual expenses incurred by the companies for their services to the NFIP are not considered. It is important that FEMA be able to rely on a methodologically sound approach for making decisions about NFIP operating costs, given both the program's growth and rise in payouts in recent years. Although FEMA has the authority to collect expenses information and FEMA officials said that they have considered alternative methodologies for paying WYO insurance companies, the officials raised concerns about collecting expense information from WYO insurance companies. Nevertheless, there is a precedent for doing so since two other public-private insurance partnerships with similarities to the WYO program use information on the actual costs incurred by participating insurance companies as one basis for determining how much to pay for services.

FEMA's Methodologies Cannot Ensure That the Schedule of Operating Costs Is Based on Reasonable Estimates of Actual Expenses

While the WYO program has operated without interruption since 1983 in both catastrophic and noncatastrophic flood years, FEMA has not determined whether payments it makes reasonably reflect the actual expenses WYO insurance companies have incurred in selling and servicing NFIP policies and settling claims for flood losses. The methodologies FEMA currently uses to determine payment amounts for the WYO insurance companies for services rendered do not meet the federal internal control standard that agencies be held accountable for, among other things, stewardship of government resources. For example, as noted earlier, FEMA allows the WYO insurance companies to retain a percentage of premium revenue it collects based on average expenses for five property/casualty lines of insurance; this amount is increased by 1 percentage point to reimburse expenses for the NFIP beyond regular property/casualty expenses. However, without obtaining and considering audited data on the actual costs incurred by the WYO companies, FEMA has no assurance that the additional 1 percentage point—about $20 million annually programwide—is an accurate reflection of the expenses WYO companies actually incur beyond regular property/casualty expenses. Nor can FEMA determine, based on current payment methodologies, how WYO insurance company costs might have changed over time because its payment approach is rooted in policies established in 1983, when the WYO program began. For example, the payment formula FEMA used to set the 3.3 percent payment rate for claims processing expenses incurred by WYO insurance companies has been in place since the program's inception, and FEMA has no basis, other than discussion with WYO insurance company officials, for determining that the 3.3 percent claims processing payment is a reasonable estimate of expenses incurred.

It is important that FEMA be able to rely on a methodologically sound approach for making decisions about NFIP operating costs, given both the program's growth and rise in payouts. As shown earlier in figure 1, participation in the NFIP has steadily increased over time from approximately 2 million to over 5 million policies in force. Annual premium revenue, which is the basis for calculating payments to WYO insurance companies for selling and servicing policies, has increased as well, from $385 million in 1983 to more than $2 billion in 2007. And costs of claims settlements have trended upward, as the costs of labor and materials to repair flood-damaged properties have increased, resulting in larger payment amounts to WYO insurance companies for adjusting claims. As a result of the unprecedented number and cost of flood insurance claims after Hurricane Katrina, the amount FEMA paid the WYO insurance companies based on its formula for claims processing (i.e., setting up temporary flood insurance claims processing centers) was $385.1 million in fiscal year 2005—a more than tenfold increase from the $30.3 million, not adjusted for inflation, paid for such expenses in fiscal year 2004.

FEMA officials said that they are in the process of discussing with WYO insurance company officials a proposed cap on the amount WYO insurance companies will be paid for claims processing expenses in future catastrophic loss years that could become effective in fiscal year 2008, as noted above. FEMA officials also said that they believed the insurance companies participating in the WYO program generally had lower expenses than other companies that choose not to participate in the WYO program. They cited their analysis of 2004 operating expenses, which compared the expenses for homeowner policies for insurance companies that participated in the WYO program to companies that did not participate and found that companies that did not participate in the WYO program generally reported higher expenses. Nevertheless, because FEMA does not collect actual data from WYO insurance companies specific to their flood insurance expenses, it cannot ensure payments are based on reasonable estimates of actual flood insurance expenses.

FEMA officials said that they have considered methodologies other than the current approach for paying WYO insurance companies, including having the companies submit information on their actual expenses for reimbursement for services rendered to the NFIP. However, they said that such an approach could create a number of additional challenges that might have a negative impact on the program. For example, because the costs of doing business vary from one WYO insurance company to another, according to the business models they have developed for carrying out their services to the NFIP and the amount of their flood insurance business, the NFIP would, in the agency's view, have to pay different companies at different levels, which could result in higher FEMA administrative costs and could also fail to reward WYO insurance companies with the most efficient operations. The officials also said that compensation based on actual expenses could also result in inefficient companies entering the WYO program because there is no incentive for them to control expenses. In addition, FEMA officials stated that they would likely have to hire additional staff and provide resources to review and validate WYO expense data, further increasing program costs. However, FEMA could choose, for example, to use data on actual expenses to establish payment rates based on an average of expenses WYO insurance companies incur, similar to its current approach. Thus, WYO insurance companies would continue to have an incentive to perform efficiently.

FEMA Has Legal Authority to Collect Data on Actual WYO Expenses to Determine If Payments Are Based on Reasonable Estimates of Expenses, but Officials Cited Concerns about Potential Implications

Under the National Flood Insurance Act of 1968, insurance companies choosing to participate in the WYO program must keep such records as FEMA prescribes and provide access to these records for purpose of audit and examination. Although it has authority to do so, FEMA does not collect data on actual WYO flood insurance expenses that could provide a basis for ensuring that the WYO schedule of operating costs is based on a reasonable estimate of expenses. FEMA's reluctance to impose additional cost accounting requirements on WYO insurance companies is based on concerns that the number of companies choosing to participate in the WYO program would decline if FEMA did so.

The National Flood Insurance Act of 1968 mandated that FEMA negotiate with representatives of the insurance industry to establish a current schedule of operating costs.[23] Operating costs include:

- expense reimbursements covering the direct, actual, and necessary expenses incurred in connection with selling and servicing flood insurance coverage;

[23] 42 USC § 4018(a).

- reasonable compensation payable for selling and servicing flood insurance coverage;
- loss adjustment expenses; and
- other direct, actual, and necessary expenses incurred in connection with selling or servicing flood insurance coverage.

In addition, the act provides FEMA with broad audit and access authority to the records of insurance companies choosing to participate in the WYO program. In particular, WYO insurance companies must "keep such records as the [FEMA] Director shall prescribe, including records which fully disclose the total costs of the program undertaken or the services being rendered, and such other records as will facilitate an effective audit."[24] Any WYO records pertinent to program costs and services rendered are subject to audit and examination by FEMA (and GAO).[25] While these provisions provide a legal basis for FEMA to collect cost data from WYO insurance companies to ensure that the schedule of operating costs reasonably reflects actual WYO insurance company expenses, FEMA officials expressed concerns that new cost accounting requirements would drive insurance companies out of the WYO program.

Under its agreement with participating WYO insurance companies, FEMA can request that the companies provide "a true and correct copy of the Company's Fire and Casualty Annual Statement, and Insurance Expense Exhibit," which the companies are required to file with their respective state insurance authorities. The Insurance Expense Exhibit provides a statutory allocation of income to lines of business, thereby measuring the underlying profitability of the insurance operations. According to NAIC officials, all revenues and expenditures, whether or not they are associated with particular policies, are allocated to lines of business, including flood insurance, and various sets of operating returns are calculated in the Exhibit, so that profitability by line of business may be measured. They said that WYO companies allocate costs related to their flood insurance business based on a reporting requirement established by the NAIC in 1997 and that companies determine their own allocation methods, which according to NAIC procedures, must be "reasonable."

[24] 42 U.S.C. at § 4084(a).

[25] 42 U.S.C. at § 4084(b). The statutory audit and access rights provided under this section are codified in regulation as part of the Financial Assistance/Subsidy Agreement between FEMA and all participating WYO insurance companies. 44 C.F.R. pt. 62, app. A, art. XIV.

FEMA officials said the requirement for insurance companies to provide information on costs allocated to their flood insurance business was established at FEMA's request, and FEMA has reviewed the data annually since 2004. However, the officials said they could not use the information to help determine the reasonableness of payments to WYO insurance companies for the services they perform for the NFIP because the methods WYO companies use to report their flood insurance-related expenses in the Insurance Expense Exhibit vary by company. They said that FEMA has not required that WYO insurance companies report their flood- related expenses separately because of their reluctance to increase federal reporting requirements on their WYO partners in the NFIP.

FEMA officials expressed concern that the number of companies that choose to participate in the WYO program would decline dramatically if additional cost accounting requirements were established for them. The officials said that potential impacts of less private-sector participation include a reduced ability to respond quickly to catastrophic flood events and more difficulty for policyholders in locating agents to sell and service NFIP policies. That concern notwithstanding, however, more specific and relevant information on actual expenses allocated by the WYO insurance companies to their flood insurance business could help FEMA determine the reasonableness of its expense estimates if the flood insurance data already maintained by participating WYO insurance companies were consistently reported.

Based on the standards for internal control in the federal government, FEMA is responsible for implementing controls that serve as the first line of defense in safeguarding assets, preventing and detecting errors and fraud, and helping to achieve desired results through effective stewardship of public resources. Moreover, internal controls are integral to ensuring the reliability of financial reporting and the effectiveness and efficiency of operations, including the use of resources. FEMA has not significantly changed the payment policies that are the foundation of the WYO program in more than 2 decades, and because FEMA cannot ensure that its approach to establishing a schedule of operating costs is based on a reasonable estimate of actual expenses, it has not effectively implemented these internal controls. A review of the WYO insurance companies' operating costs would be prudent and timely.

Other Federal Programs Collect Actual Cost Data to Help Determine Payments for Insurance Industry Services

While FEMA has not elected to collect actual cost data from WYO companies, it has the legal authority to do so, as noted above, and there is precedent within the federal government for doing so. Two public-private insurance partnerships similar to the NFIP's arrangement with WYO insurance companies collect information on the actual costs incurred by participating insurance companies as a basis to help determine how much to pay for services.

The first is the FCIC, which bears the risk for insuring agricultural crop values under the auspices of the U.S. Department of Agriculture's Risk Management Agency.[26] The FCIC protects farmers who participate in the program against financial losses caused by events such as droughts and other natural disasters.

Like FEMA does for the NFIP, the Risk Management Agency pays insurance companies a percentage of premium revenue for expense allowances for services to the FCIC. Unlike the NFIP, however, beginning in 1994, the FCIC began to require companies to submit detailed expense reports in a consistent format following standard industry guidelines, including the NAIC guidelines for allocating expenses among lines of business. While the FCIC does not use these reports as a direct basis for reimbursing individual insurance companies, the actual expense information contained in the reports informs the agency's methodology for establishing future reimbursement rates for expenses related to insurance services. FCIC requires that companies submit documentation of their expenses and uses this information to determine the appropriate percentage as a basis for compensation. This documentation is intended to provide a basis for program oversight to ensure that payments made to private insurance companies for their expenses in providing insurance services are reasonable—documentation that is currently lacking in the NFIP.

One potential advantage that results from FCIC's direct access to expense data is that this information may be used to enhance program oversight. For example, in reviewing actual expense data submitted by the insurance companies participating in the FCIC in 1997, we found that some expenses

[26]In 2007, 16 private-sector insurance companies sold and serviced policies for the FCIC. The program insured crops valued at about $44.3 billion in fiscal year 2005, with about 1.3 million policies in force.

reimbursed by FCIC were excessive.[27] Among the expenses reported were those associated with profit-sharing bonuses and lobbying. In addition, even within the expense categories reasonably associated with the sale and service of crop insurance, we found expenses that appeared excessive for reimbursement under a taxpayer-supported program, suggesting an opportunity to further reduce future reimbursement rates. These expenses included agents' commissions that exceeded the industry average, unnecessary travel-related expenses, and questionable entertainment activities. Currently, comparable oversight activities cannot be performed on NFIP's WYO program participants because the data needed for such analysis have not been obtained.

The second public-private partnership comparable to the NFIP is an entity that participates in the flood insurance program, but not as a WYO insurance company. This entity is the NFIP Direct Servicing Agent—a FEMA contractor that sells, services, and adjusts claims on about 4 percent of flood insurance policies that are not, for various reasons, handled through the WYO program.[28] FEMA pays the NFIP Direct Servicing Agent for selling and servicing flood insurance and for adjusting and processing claims after a flood event through a competitively awarded contract at a fixed cost. The contractor has calculated its cost to sell and service policies as well as adjust claims following a non-catastrophic event based on prior experience as a vendor for several WYO insurance companies. Based on these calculations, the contractor charges a flat price per policy that is not based on the premium amount. For example, a flood insurance policy with a $400 premium would cost the NFIP Direct Servicing Agent the same to service as a policy with $800 in premiums, based on a flat fee paid per policy per month. For catastrophic flood events, such as Hurricane Katrina, the NFIP Direct Servicing Agent

[27] See GAO, *Crop Insurance: Opportunities Exist to Reduce Government Costs for Private-Sector Delivery*, RCED-97-70 (Washington, D.C.: April 1997).

[28] The NFIP Direct Servicing Agent services all policies not covered by WYO insurance companies. Among the reasons an NFIP policy would be serviced by the direct servicing agent are (1) the WYO insurance company that sold the policy withdrew from the WYO program or went out of business or (2) the policies are on a special class of properties that have suffered repetitive losses that FEMA has chosen to administer through its servicing agent. The NFIP Servicing Agent does not pay state premium taxes that WYO insurance companies must pay on flood insurance premiums.

submits receipts to the NFIP and is reimbursed for expenses related to setting up a catastrophe center and hiring additional staff.[29]

While the approach used to compensate the NFIP Direct Servicing Agent for its services illustrates that information on actual costs incurred can be developed by private sector entities participating in the NFIP, FEMA officials have cautioned that differences in compensation approaches are based on a different role for the contractor in the NFIP than that of the WYO insurance companies. While the WYO insurance companies are paid on a percentage basis to provide incentives for them to increase the number of NFIP policies they have in force, the NFIP Direct Servicing Agent does not market the NFIP; rather, it services the specialized group of policies it is assigned in its contract with FEMA. Nevertheless, the financial arrangement with the Direct Servicing Agent shows that cost information can be collected and is useful in determining reasonable payments.

Although public-private partnerships for federal insurance programs such as these include considerations of actual expense information and FEMA has the legal authority to obtain such information from WYO insurance companies, FEMA's current methodologies for determining payment amounts are not based on an assessment of actual expenses the WYO insurance companies incur and do not require that WYO insurance companies maintain or report their expenses. As a result, FEMA does not know whether the payments it makes to the WYO insurance companies reasonably reflect the expenses they incur in selling and servicing NFIP policies and establishing operations in flood-damaged areas.

[29]These activities are paid for through a Letter of Credit with the U.S. Treasury and the Direct Servicing Agent is reimbursed for its actual expenses.

Financial Management Controls Did Not Provide Assurance That Payments to WYO Insurance Companies Were Proper and in Accordance with Program Requirements

Biennial financial statement audits—FEMA's primary management control mechanism to provide assurances that it receives complete and accurate financial management information from the WYO insurance companies—were not performed on a consistent basis as required by regulation. FEMA's regulations and the WYO Financial Control Plan require each participating WYO insurance company to arrange for biennial financial audits that assess its financial statements for activities related to the NFIP; audit costs are covered by the expense allowance received from FEMA for selling and servicing policies. However, many insurance companies participating in the WYO program did not comply with the schedule. In addition, FEMA did not have a mechanism in place for tracking and reviewing the results of the biennial financial statement audits that were performed. Because the biennial financial statement audits were not consistently completed and reviewed, FEMA lacks assurance that it is making proper payments for the services of the WYO insurance companies and that financial information is being properly presented.

FEMA Regulations and Guidance Require Biennial Financial Audits of WYO Insurance Companies to Assess the Quality of Financial Controls over NFIP-Related Activities

FEMA regulations as implemented through its WYO Financial Control Plan require each participating WYO insurance company to arrange for biennial financial audits by independent CPA firms that assess its financial statements for activities and controls related to the NFIP.[30] The biennial financial statement audits are intended to provide FEMA with an independent assessment of the quality of financial controls over activities related to WYO companies' participation in the NFIP and the integrity of the financial data they report. Biennial financial statement audits provide assurance that WYO insurance companies report complete and accurate information on their NFIP activities, which are necessary to ensure that payments made from the NFIP fund for services rendered are proper and in accordance with program requirements. The third-party financial audits are intended to reduce or eliminate the need for FEMA to conduct on-site

[30]The financial control requirements applicable to WYO insurance companies appear at 44 C.F.R.§62.23(j) and 44 C.F.R. pt. 62, app. B, which incorporates by reference a separate document, "The Write Your Own Program Financial Control Plan Requirements and Procedures."

visits to WYO insurance companies to oversee their financial activities.[31] The audits provide opinions and report on the fairness of the WYO insurance companies' financial statements, the adequacy of internal controls, and the extent of the WYO insurance companies' compliance with applicable laws and regulations. Some WYO insurance companies conduct in-house financial management operations while others subcontract with a flood insurance vendor, or subcontractor, to handle financial reporting requirements and operations. When a vendor is involved, WYO insurance companies that have contracted with the same vendor generally hire an independent CPA firm to audit the vendor's financial operations and provide an opinion on the quality of the financial systems for all of the WYO insurance companies that subcontract with the vendor.

Under FEMA regulation, WYO insurance companies are responsible for selecting CPA firms to conduct their audits in accordance with generally accepted auditing standards and generally accepted government auditing standards issued by the Comptroller General. The audits are to be funded by the WYO companies from the expense allowance (about 15 percent of premium revenue) they receive for selling and servicing policies.

FEMA has several other methods for managing and overseeing the quality of work performed by WYO insurance companies including monthly reconciliations and manual validation and recalculation of the amounts retained by the WYO insurance companies, reviews of the operations of the WYO insurance companies at least once every 3 years, and quality assurance reinspection of a sample of claims adjusted after each flood event. Our review of these other methods of management and oversight determined that they did not provide direct information about the

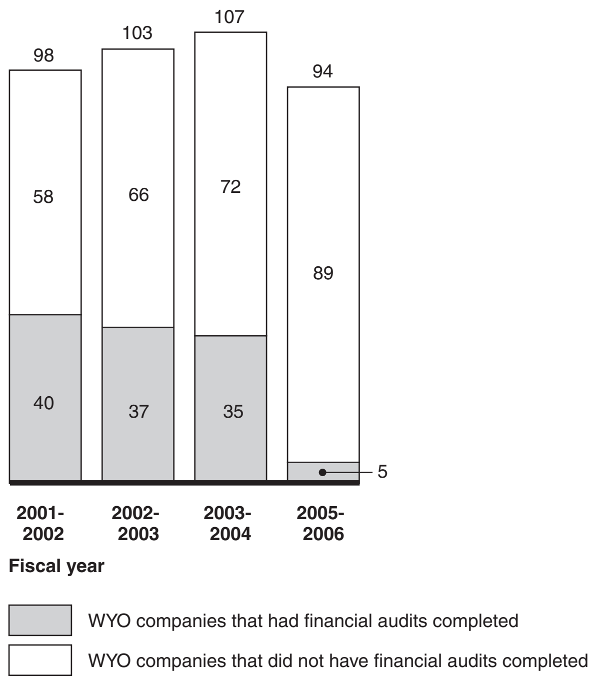
[31]An exception to the requirement is allowed for WYO insurance companies that were audited by a CPA firm under contract with the FEMA or DHS Office of Inspector General (OIG) during the 2-year period. For those WYO insurance companies, biennial financial audits are required to cover only 1 year of the 2-year period. In March 2003, when FEMA became part of DHS, the DHS OIG assumed responsibility for financial audits of the NFIP. However, FEMA's WYO Financial Control Plan was last revised in December 1999 and did not reflect the change in responsibility. FEMA provided two DHS OIG audit reports for the NFIP--a 2002 audit that included tests of controls related to the financial activities of six WYO insurance companies and a 2004 audit that included tests of controls related to five WYO insurance companies. According to an official of the DHS OIG, in 2005, no official audit report was issued because the independent CPA firm that conducted the audit submitted the results late. Instead of issuing an audit report, the independent CPA firm provided a copy of the audit results to the NFIP. As of May 2007, the 2006 DHS OIG audit of the NFIP was still in process, according to the official.

propriety and accuracy of payments made to the WYO insurance companies for their NFIP-related activities. In addition, when FEMA has concerns regarding the propriety of a WYO insurance company's financial reporting, the agency may conduct audits "for cause." However, according to NFIP officials, FEMA has not conducted any audits for cause during the 7-year period we reviewed.

Most WYO Insurance Companies Did Not Meet the Biennial Financial Statement Audit Schedule Required by FEMA

As shown in figure 4, for biennial audits done during the period from fiscal year 2001 to 2006, the majority of participating WYO insurance companies did not comply with FEMA's requirement for biennial audits of their financial operations to be conducted. The officials also said that 34 additional WYO insurance companies were granted extensions by FEMA to complete their fiscal year 2005-2006 biennial financial statement audits by September 30, 2007.

Figure 4: Biennial Financial Statement Audits of WYO Insurance Companies Completed from Fiscal Years 2001 to 2006



Source: GAO analysis of FEMA data.

Note: Numbers for participating WYO insurance companies are those at the end of fiscal years 2002, 2003, 2004, and 2006.

Thirty-nine of the 40 biennial financial statement audits that were completed for fiscal years 2001 to 2002 were the results of a review by one independent CPA firm at a vendor for the 39 WYO insurance companies. Similarly, 23 of the 37 biennial financial statement audits completed for fiscal years 2002 to 2003 and all 35 of the biennial financial statement audits that were completed for fiscal years 2003 to 2004 were the results of reviews of two vendors and resulting reports by two independent CPA firms. In these cases, the CPA firm visited a single flood insurance vendor or subcontractor with which the audited WYO insurance companies subcontracted to handle aspects of their NFIP business.

According to the Deputy Assistant Administrator for Insurance of FEMA's Mitigation Division with responsibility for management and oversight of the NFIP, FEMA did not require all WYO insurance companies to meet the schedule for completing biennial financial statement audits during the period we reviewed because some companies were in the process of contracting with new vendors, or subcontractors, to do their financial reporting so doing financial audits would have been particularly costly and difficult. In addition, the Deputy Assistant Administrator said that FEMA had no indication that the WYO insurance companies that did not have biennial financial statement audits performed had any financial management weaknesses. Nonetheless, without having the biennial audits conducted as required by regulation, FEMA lacks assurance that WYO insurance companies have financial systems in place to ensure that proper payments are made and controls are in place for the services of the WYO insurance companies. This assurance is necessary for FEMA to meet the internal control standard for federal government agencies that they have reasonable assurance program objectives are being achieved and operations are effective and efficient. In addition, according to standards for internal controls within the federal government, such a control mechanism is important in agencies like FEMA where large amounts of data are processed; where audit techniques may be used to identify inefficiencies, waste, or abuse; and where managers should be able to promptly review and evaluate audit findings in order to identify opportunities for improvements.

The Deputy Assistant Administrator also said that FEMA did not seek to recoup the portion of the allowance paid from the NFIP fund for biennial financial statement audits from the companies that did not have them performed. He said that reimbursement was not requested because the public-private partnership depends upon a level of cooperation without a constant exchange of dollars.

Biennial Financial Statement Audits Identified One Company with Material Weaknesses and Some Noncompliance and Internal Control Weaknesses

For the biennial financial statement audits that were completed from fiscal year 2001 through fiscal year 2006, the independent CPA firms identified material weaknesses in one instance and they identified some other internal control weaknesses and instances of noncompliance with financial reporting requirements.[32] In all but one of the audit reports completed, the independent CPA firm issued an unqualified opinion that for the WYO insurance companies it audited, the financial statements fairly presented, in all material respects, the WYO program assets,

[32]The American Institute of Certified Public Accountants standard defines a material weakness as a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

liabilities, and accumulated deficit. The various audit opinions also stated that the results of operations and cash flows of the companies' participation in the WYO program for the 2-year periods audited conformed with generally accepted accounting principles in the United States.

The audit in which material weaknesses were identified involved one WYO insurance company during fiscal years 2002 to 2003. The independent CPA firm that conducted the audit found significant deficiencies in design or operation of internal controls over financial reporting that could affect the company's ability to record, process, summarize, and report financial data. Actions by the WYO insurance company to resolve the weaknesses identified were documented and included engaging a new vendor for its financial management functions. According to the Deputy Assistant Administrator, as of July 2007, the company did not participate in the WYO program.

Among the instances in which internal control weaknesses and instances of noncompliance were identified, a CPA firm noted in its fiscal year 2001 to 2002 audit report that it considered a vendor's lack of internal control procedures over its financial reporting to be a significant deficiency that could adversely affect its ability to record, process, summarize, and report financial data for the 39 WYO insurance companies with which it had contracted to perform financial management activities. The audit report also found that accounting department and executive staff did not have the appropriate accounting expertise to adequately review and identify errors in the financial reporting process. The vendor disagreed with the audit report recommendation that it develop formalized procedures or controls over financial reporting but indicated that it would evaluate and document future procedures as necessary. A FEMA official said that FEMA did not follow up on the audit recommendations because the vendor went out of business shortly after the audit was completed. An audit report for fiscal year 2003 to 2004 covering another vendor's financial management activities for 35 WYO insurance companies cited instances of noncompliance such as documentation missing from policy files and reports from claims adjusters not being filed within specified time frames. WYO insurance companies agreed to take action to address the audit recommendations.

FEMA Did Not Track or Review Financial Statement Audits

FEMA did not have a mechanism in place for tracking and reviewing the results of the biennial financial statement audits that were performed. FEMA officials were able to provide us with copies of only two biennial audit reports until the conclusion of our audit when they asked WYO insurance companies and their subcontractors to send copies of additional reports that might have been prepared. Thus, it was apparent that the results of the financial audits were not considered and used by FEMA to identify opportunities for program improvements.

Conclusions

The NFIP was structured more than 25 years ago as a public-private partnership between the government and private insurance companies that agree to sell and service flood insurance policies on the government's behalf. Over the years, the program has made flood insurance widely available to consumers, while FEMA and the taxpayers have assumed all of the financial risks for the program, should premiums be insufficient to cover claims. In the aftermath of the catastrophic flood events of 2005, which tested all aspects of the federal government's response to large-scale natural disasters, FEMA and the WYO insurance companies worked together to settle an unprecedented number of flood insurance claims reasonably quickly. Moreover, the partnership has, over time, relieved FEMA of the need to develop, hire, and train an in-house corps of sales agents, adjusters, and others to administer flood insurance. However, while the WYO program has been beneficial, FEMA runs the risk of not being able to ensure that it is able, as time goes on, to manage and control the program's costs. In fiscal year 2006—the catastrophic year that included payments for claims resulting from Hurricane Katrina—FEMA paid almost 65 cents of every dollar collected in premiums to the WYO insurance companies.

Two factors account for the operating cost-related risks FEMA incurs through the WYO program. First, because FEMA cannot ensure that the schedule of operating costs it pays to WYO insurance companies is based on reasonable estimates of their expenses, FEMA does not know whether the operating costs it pays appropriately reflect the expenses the WYO insurance companies incur in selling and servicing NFIP policies and adjusting claims. This is primarily because FEMA has not significantly changed its methodologies for determining the schedule of operating costs for WYO insurance companies since 1983, when the current structure was created. As a result, the underlying methodologies may not take into account factors that have changed over the life of the program. For example, costs of claims settlements have trended upward as the costs of labor and materials to repair flood-damaged properties have increased, resulting in larger payment amounts to WYO insurance companies for adjusting claims. Information on costs WYO insurance companies allocate to their federal flood business has been collected and reported by the NAIC since 1997 and reviewed by FEMA since 2004. Such information could be helpful to FEMA officials in determining appropriate payments to WYO insurance companies for the services they perform for the NFIP; however, FEMA officials said that they do not use the information to help determine a schedule of operating expenses because the WYO insurance companies are inconsistent in the ways they allocate costs to flood insurance and report the data.

Second, a lack of sufficient oversight of WYO insurance companies' financial management processes limits FEMA's ability to ensure that payments made to the WYO insurance companies participating in the NFIP were proper and in accordance with program requirements—and ensure that its operations are effective and efficient. Biennial financial statement audits were not completed as required by FEMA regulation.

Recommendations for Executive Action

To improve financial accountability over payments the NFIP makes to the WYO insurance companies, to strengthen controls over expenditures of policyholders' and taxpayers' dollars, and to provide assurance that payments made to the WYO insurance companies are proper and in accordance with program requirements, we are recommending that the Secretary of Homeland Security direct the Under Secretary of Homeland Security, FEMA, to take the following two actions:

1. Ensure that its approach to establishing a schedule of operating costs is based on a reasonable estimate of actual expenses by taking such actions as FEMA deems necessary such as working with NAIC to ensure consistency in the way all WYO insurance companies compile and report data on expenses allocated to their federal flood business.

2. Ensure that biennial financial statement audits of WYO insurance companies are conducted by independent CPA firms as required by FEMA regulation, and that FEMA reviews the audits to ensure that payments made are proper and in accordance with program requirements.

Agency Comments and Our Evaluation

On August 29, 2007, DHS provided written comments on a draft of this report dated August 14, 2007. DHS generally agreed with our recommendations to improve financial accountability over payments the

NFIP makes to the WYO insurance companies. However, DHS said our presentation in table 1 of payments to WYO insurance companies for all NFIP services for fiscal years 2004 to 2006 as a percentage of total premium revenues was “inappropriate and misleading” because it was most appropriate to compare the costs of adjusting and processing claims to total losses in a year, not premium revenue. We disagree. We believe it is appropriate to summarize aggregate expense payment data as a percentage of premiums collected because, as noted in the report, the NFIP is designed to pay for flood losses and operating expenses to the extent possible with premium revenues rather than tax dollars. Our report also provides detailed information on the types of WYO payments made each year separately for claims and other costs, including agent commissions and expenses for selling and servicing policies.

DHS concurred with our recommendation to work with NAIC to improve the consistency in the way WYO insurance companies compile and report this data so that it is useful as an estimate of the WYO companies’ actual expenses for selling and servicing flood insurance policies. As progress is made, it will be incumbent upon FEMA to determine whether the data already collected on flood insurance program expenses are reliable and sufficiently comprehensive for FEMA to make a reasonable estimate of WYO insurance companies’ actual expenses. DHS also concurred with our recommendation that financial statement audits be conducted and the results reviewed.

We are sending copies of this report to the Secretary of the Department of Homeland Security, the Administrator of the Federal Emergency Management Agency, selected congressional committees, and other interested parties. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov. Please contact William Jenkins at (202) 512-8757 or jenkinswo@gao.gov if you or your staff have any questions concerning this report. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix IV.

William O. Jenkins, Jr.
Director, Homeland Security and Justice Issues

List of Congressional Committees:

The Honorable Christopher J. Dodd
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Joseph I. Lieberman
Chairman
The Honorable Susan M. Collins
Ranking Member
Committee on Homeland Security and Governmental Affairs
United States Senate

The Honorable Barney Frank
Chairman
The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
House of Representatives

The Honorable Bennie G. Thompson
Chairman
The Honorable Peter T. King
Ranking Member
Committee on Homeland Security
House of Representatives

The Honorable Henry A. Waxman
Chairman
The Honorable Tom Davis
Ranking Member
Committee on Oversight and Government Reform
House of Representatives

Appendix I: Scope and Methodology

To assess how much the Federal Emergency Management Agency (FEMA) paid in recent years to the Write Your Own (WYO) insurance companies that sell and service NFIP policies and adjust claims and how FEMA determines the amount of these operating costs, we analyzed data on amounts paid to WYO insurance companies for fiscal years 2004-2006. We also interviewed FEMA officials on how FEMA set the payment levels and how the agency reviews the methodologies in place to determine that they remain appropriate over time, and we examined available documentation on FEMA's payment methodologies. The data we examined included the amounts FEMA paid to WYO companies for selling and servicing policies, for growth incentive bonuses, and for expenses related to adjusting flood claims and paying flood claims adjusters. We discussed with FEMA officials the internal control processes in place and observed the monthly process used by FEMA's program contractor to reconcile cost information submitted by WYO insurance companies. We also reviewed audits of Department of Homeland Security (DHS) financial statements prepared for the DHS Office of Inspector General. We determined that the information was sufficiently reliable for our purposes. We conducted semi-structured interviews with representatives of a judgmental sample of five WYO insurance companies and National Association of Insurance Commission (NAIC) officials to obtain their perspective on FEMA's payment methodologies. Our sample included representatives of four of the five largest participating WYO insurance companies in terms of their market share of NFIP policies in force in 2006 and one mid-sized WYO insurance company. Our sample is not a representative sample of all participating WYO insurance companies, so the views expressed should not be generalized to the universe of the 88 participating companies.

To determine how the approach FEMA uses to establish a schedule of operating costs provides assurance that it is based on reasonable estimates of WYO insurance companies' expenses for the services rendered, we reviewed the statutory and regulatory framework for establishing a schedule of operating costs and obtained the views of FEMA and insurance industry officials on the effectiveness of the current payment approach and the potential implications of implementing other payment methodologies. We also assessed how the approach FEMA currently uses to pay WYO insurance companies for their services compares to payment methodologies used by two similar public-private insurance arrangements. To compare other public-private insurance partnerships, we first identified the universe of similar arrangements with which to compare the NFIP. We reviewed literature including prior GAO reports on federal government insurance programs. We determined and confirmed with NFIP officials that the only other federal insurance program with similar public-private partnership arrangements was the Federal Crop Insurance Corporation (FCIC), an insurance program that protects participating farmers against the financial losses caused by events such as droughts, floods, hurricanes, and other natural disasters. In addition, we determined that FEMA’s contract with the NFIP Direct Servicing Agent, the contractor that administers four percent of NFIP policies on behalf of FEMA, used methods for calculating and paying for activities to sell and service policies and adjust claims that should be included in our scope. We then interviewed officials and reviewed contract and budget information on these two arrangements. Our analysis was designed to compare and contrast the arrangements to the NFIP’s WYO program. We did not make determinations on which programs had the best practices because information was not available on the expenses incurred by WYO insurance companies for their services to the NFIP. Our review was limited to the structure of the financial arrangements between the federal government and the FCIC and NFIP Direct Servicing Agent to compensate the private entities for selling and servicing government insurance policies and adjusting claims. We did not assess the overall performance of the FCIC and the NFIP Direct Servicing Agent.

To determine the extent to which FEMA’s financial management controls for WYO companies provide assurance that payments are proper and in accordance with program requirements, we reviewed FEMA’s regulations and procedures for monitoring and overseeing payments of expenses to WYO insurance companies for selling and servicing NFIP policies. We analyzed the schedule and results of biennial financial audits conducted for fiscal years 2001 to 2006. In addition, we reviewed financial audits of the NFIP done by the DHS Office of Inspector General for fiscal years 2003 to 2006. In addition to biennial financial audits, we also reviewed other FEMA oversight mechanisms. We analyzed the results of 15 operational reviews and follow-up visits FEMA performed at WYO insurance companies from 2001 through February 2005, and we reviewed a statistically valid sample of quality assurance reinspections of claims adjustments for Hurricanes Katrina and Rita, and we determined that these oversight mechanisms did not provide direct information about the propriety and accuracy of payments made to the WYO insurance companies for their NFIP-related activities. We performed our work from June 2006 through July 2007, in accordance with generally accepted government auditing standards.

Appendix II: Percentage Allowances FEMA Authorized WYO Insurance Companies to Retain for Operating Expenses Incurred in Selling and Servicing NFIP Policies (Fiscal Years 1984–2007)

Fiscal year	Expense allowance percentage
2007	30.2
2006	30.8
2005	31.2
2004	31.8
2003	31.8
2002	32.3
2001	31.0
2000	31.7
1999	31.7
1998	31.6
1997	32.6
1996	32.6
1995	32.6
1994	32.6
1993	32.0
1992	31.8
1991	30.3
1990	30.5
1989	30.1
1988	30.4
1987	32.2
1986	32.7
1985	32.0
1984	29.5

Source: FEMA.

Appendix III: Comments from the Department of Homeland Security

U.S. Department of Homeland Security
Washington, DC 20528

Homeland Security

August 29, 2007

William O. Jenkins, Jr.
Director, Homeland Security and Justice Issues
441 G Street, NW
Washington, DC 20548

Dear Mr. Jenkins:

Thank you for providing draft report GAO-07-1078 "*National Flood Insurance Program: FEMA's Management and Oversight of Payments for Insurance Company Services Should Be Improved*" to the Department of Homeland Security, Federal Emergency Management Agency (FEMA) for review and comment. FEMA completed its review and is providing the following comments on the report.

Operating Costs

FEMA believes it is inappropriate and misleading during such extremely large loss years to present the aggregate Write Your Own (WYO) expenses as a percentage of premium revenue, as was done in Table 1 of the report. WYO expenses primarily fall into two general categories: (1) selling and servicing policies and (2) adjusting and processing claims. The first category should be compared to premium income, while the second should be compared to incurred losses. When these comparisons are use, the WYO expense ratios for 2005 and 2006 are in line with the previous years. It is realistic to expect that when the number of flood claims increases more than eight-fold over the previous record, a commensurate increase in the expenses incurred in handling those claims will also occur.

FEMA believes the current methodology for compensating the WYO Companies is a reasonable estimate of the actual expenses the WYO Companies incur in selling and servicing flood insurance policies. FEMA has no indication that the cost of selling and servicing of flood insurance policies is substantially different from the five lines of property insurance which are included in the average industry expense ratios used by FEMA to compute the WYO Company compensation schedule. The Best Averages is an estimate of actual costs of handling the flood lines and this average is primarily driven by homeowner lines of business—costs for this line are generally lower than flood due to complexity and re-underwriting aspects of the flood program. FEMA believes the main advantage of using these five lines of insurance as a benchmark is the competition in the marketplace results in the companies closely controlling costs.

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Since the inception of the program in 1983, the expense allowance was based on A.M. Best "Net" Averages. Beginning in the year 2000, the expense allowance was based on A.M. Best "Direct" Averages. This basis reduces the average underwriting expenses because it does not include a company's expense to buy reinsurance. FEMA recognized that the WYO Companies did not need to buy reinsurance on the flood insurance it writes because it is "reinsured" by the Federal Government. The company data reported by A.M. Best prior to that time did not exclude the reinsurance expense portion of the underwriting expense. By using the average expenses of the five property lines, the expense allowance decreased by 4 percent between 1996 and 2005.

"Exhibit A illustrates decreased between 1996 and 2005 of the industry average "Other Underwriting Expenses" to premiums."

FEMA agrees actual flood expenses of the WYO Companies should be monitored. However, FEMA believes the best way to accomplish that is to use published cost data from the insurance industry that would include all lines of insurance including flood insurance. That approach is preferable to having FEMA directly collect the data from participating companies. By using the published cost data, it will have many benefits: (1) it increases the reliability of the data by assuring all company expenses are allocated to the appropriate line of insurance since it is also reviewed by the State regulators; (2) it minimizes Federal and company costs; and (3) by avoiding the creation of another level of costly and complex reporting requirements, it will encourage greater company participation in the NFIP.

The existing form FEMA will use to implement this recommendation is the Insurance Expense Exhibit (IEE) that is part of the Annual Statement that each insurance company files each year with State Insurance Departments. This form already contains a separate reporting line for the NFIP. The inclusion of this line is a result of previous efforts by FEMA. FEMA researched alternative sources of data on company operating costs and was instrumental in the National Association of Insurance Commissioners (NAIC) adoption in 1997 of a separate line for flood insurance on the Insurance Expense Exhibit which insurance companies submit annually to State Departments of Insurance. This data has the advantage of providing total expenses allocated to the appropriate category by line of insurance. Unfortunately, the lack of consistency in the companies reporting of the data has prevented FEMA from using it to calculate WYO company compensation. FEMA will continue to work with the NAIC to remedy the issues which prevent the use of flood insurance data reported on the Insurance Expense Exhibit.

The significant increase in payments to WYO companies in calendar years 2005 and 2006 is attributable to costs for adjusting the losses arising from Hurricane Katrina and the other six hurricanes that occurred in 2004 and 2005. As a result of the unprecedented losses from Hurricane Katrina, FEMA is evaluating approaches for capping the amount of claims expense allowances that will be paid in catastrophic loss years.

Financial Management Controls

FEMA acknowledges the need to improve its review and oversight of the biennial financial statement audits that are required by FEMA regulations and the WYO Financial Control Plan. FEMA has begun to develop a tracking system and put new procedures in place to improve oversight.

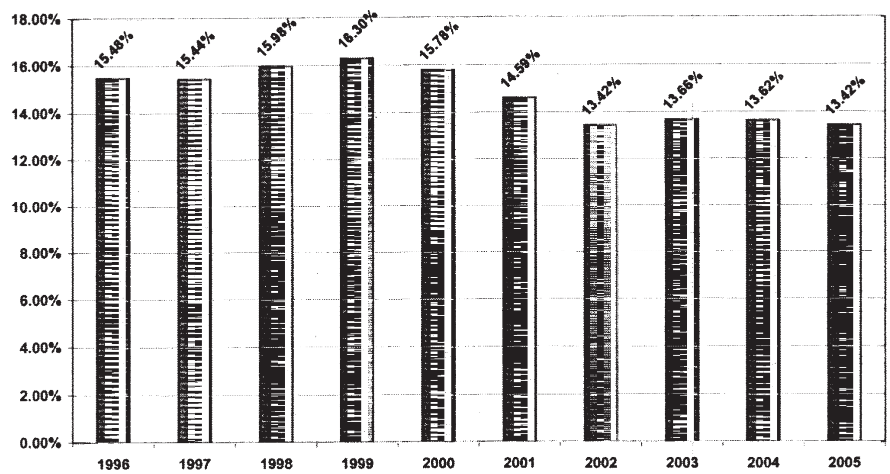
Thank you for the opportunity to review the draft report and provide comments.

Sincerely,

Steven J. Pecinovsky

Steven J. Pecinovsky
Director
Departmental GAO/OIG Liaison Office

EXHIBIT A
Average Underwriting Expenses
as a percentage of premium



Appendix IV: GAO Contact and Staff Acknowledgments

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