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FEDERAL EMERGENCY MANAGEMENT AGENCY

Challenges for the National Flood Insurance Program

Statement of David M. Walker, Comptroller General of the United States

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Highlights

Highlights of GAO-06-335T, a testimony to the Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate

Why GAO Did This Study

The National Flood Insurance Program (NFIP), established in 1968, provides property owners with some insurance coverage for flood damage. The Federal Emergency Management Agency (FEMA) within the Department of Homeland Security is responsible for managing the NFIP.

The unprecedented magnitude and severity of the flood losses from hurricanes in 2005 challenged the NFIP to process a record number of claims. These storms also illustrated the extent to which the federal government has exposure for claims coverage in catastrophic loss years. FEMA estimates that Hurricanes Katrina, Rita, and Wilma will generate claims and payments of about $23 billion—far surpassing the total claims paid in the entire history of the NFIP.

This testimony provides information from past and ongoing GAO work on issues including: (1) NFIP's financial structure; (2) the impact of properties with repetitive flood losses on NFIP's resources; (3) proposals to increase the number of policies in force; and (4) the status of past GAO recommendations.

What GAO Recommends

In past work, GAO recommended that FEMA strengthen its oversight of the NFIP and develop plans to implement requirements of the Flood Insurance Reform Act of 2004. FEMA disagreed with those recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-06-335T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact William O. Jenkins, Jr., at (202) 512-8777 or jenkinswoj@gao.gov.

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Challenges for the National Flood Insurance Program

What GAO Found

The NFIP, by design, is not actuarially sound. The program does not collect sufficient premium income to build reserves to meet long-term future expected flood losses. In November 2005, FEMA's authority to borrow from the Treasury was increased from $1.5 billion to $18.5 billion through fiscal year 2008 to help pay claims from the 2005 hurricane season. It is highly unlikely that the NFIP as presently funded could generate sufficient revenues to repay a debt of this size.

One reason the NFIP is not actuarially sound is because a number of its policies on dwellings that were built before flood plain management regulations were established in their communities are subsidized and pay premiums of 35-40 percent of the true risk premium. In January 2006, FEMA estimated an annual shortfall in premium income of $750 million because of such policy subsidies. Some subsidized properties, called repetitive loss properties, also suffer repetitive flood losses, which accounted for about $4.6 billion in claims payments from 1978 to March 2004. We need to analyze the progress made to reduce the inventory of subsidized repetitive-loss properties and determine whether additional regulatory or congressional action is needed.

A challenge for FEMA is to expand the NFIP policyholder base by enforcing mandatory purchase requirements and encouraging voluntary purchase by homeowners who live in areas at lower risk of flooding. The extent of noncompliance with current mandatory purchase requirements for property owners in special flood hazard areas is unknown. There has been some congressional interest in the feasibility of expanding mandatory purchase requirements beyond the current special high-risk areas, however, there are a number of difficulties to assessing the impacts, effectiveness, and feasibility of such a change in the structure of the NFIP, as well as concerns related to enforcing and assessing compliance. For example, more precise flood mapping of areas outside the current high-risk areas would be required to accurately identify affected property owners. FEMA and its private insurance partners also have efforts underway to increase NFIP participation by marketing policies in areas where purchase is not mandatory.

FEMA has not yet fully implemented provisions of the Flood Insurance Reform Act of 2004 requiring the agency to develop new materials to explain coverage and the claims process to policyholders, establish an appeals process for claimants, and provide insurance agent education and training requirements. The statutory deadline for implementing these changes was December 30, 2004, and, as of January 2006, FEMA had not developed documented plans with milestones for meeting the provisions of the act, as recommended by GAO.

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to participate in today's hearing on the future of the National Flood Insurance Program (NFIP) to discuss issues related to the future financial stability of the NFIP and recommendations we have made for improvements to the management and oversight of the program. The NFIP combines property insurance for flood victims, mapping to identify the boundaries of the areas at highest risk of flooding, and incentives for communities to adopt and enforce floodplain management regulations and building standards to reduce future flood damage. The effective integration of all three of these elements is needed for the NFIP to achieve its goals of:

- providing property flood insurance coverage for a high proportion of property owners who would benefit from such coverage;
- reducing, through this insurance coverage, taxpayer-funded disaster assistance for property damage when flooding strikes; and
- reducing property flood damage through flood plain management based on accurate, useful flood maps and the enforcement of building standards (such as elevating structures).

Hurricanes Katrina and Rita represent a tragedy for hundreds of thousands of our fellow Americans. Their lives have been turned upside down, and many who would have benefited from flood insurance did not have it. This tragedy offers an opportunity to fundamentally rethink the flood insurance program and how it can best be structured to provide financial protection from flooding for those who need and would benefit from flood insurance while enhancing the program's financial foundation.

The Federal Emergency Management Agency (FEMA) within the Department of Homeland Security (DHS) is responsible for the oversight and management of the program.[1] Under the program, the federal government assumes the liability for the insurance coverage and sets rates and coverage limitations, among other responsibilities.

Floods are the most common and destructive natural disaster in the United States. According to NFIP statistics, 90 percent of all natural disasters in the United States involve flooding. However, flooding is

[1] In March 2003, FEMA and its approximately 2,500 staff became part of DHS. FEMA retained its name and individual identity within the department.

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.

The NFIP was established by the National Flood Insurance Act of 1968[2] 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. 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."[3] In keeping with this purpose, FEMA has contractual agreements with 95 private insurance company partners to sell policies and adjust and process claims.

As of November 2005, the NFIP was estimated to have approximately 4.8 million policyholders in about 20,000 communities. According to FEMA, every $3 in flood insurance claims payments saves about $1 in disaster assistance payments, and the combination of flood plain management and mitigation efforts save about $1 billion in flood damage each year.

Flood maps identify the boundaries of the areas at the greatest risk of flooding. These areas are called special high-risk flood hazard areas, often referred to as the 100-year flood plain, that area in which there is a 1 percent chance of flooding each year, or a 30 percent chance of flooding over the period of a 30-year mortgage. Property owners whose properties are within the 100-year flood plain, as identified on the flood maps, and whose mortgages are from a federally regulated lender, are required to purchase flood insurance for the amount of their outstanding mortgage balance, up to the maximum policy limit of $250,000 in coverage for single family homes. The owners of properties with no mortgages or properties with mortgages held by lenders who are not federally regulated were not, and still are not, required to buy flood insurance, even if the properties are in the 100-year flood plain. Optional, lower-cost coverage is available under the NFIP to protect homes in areas of low to moderate risk that are

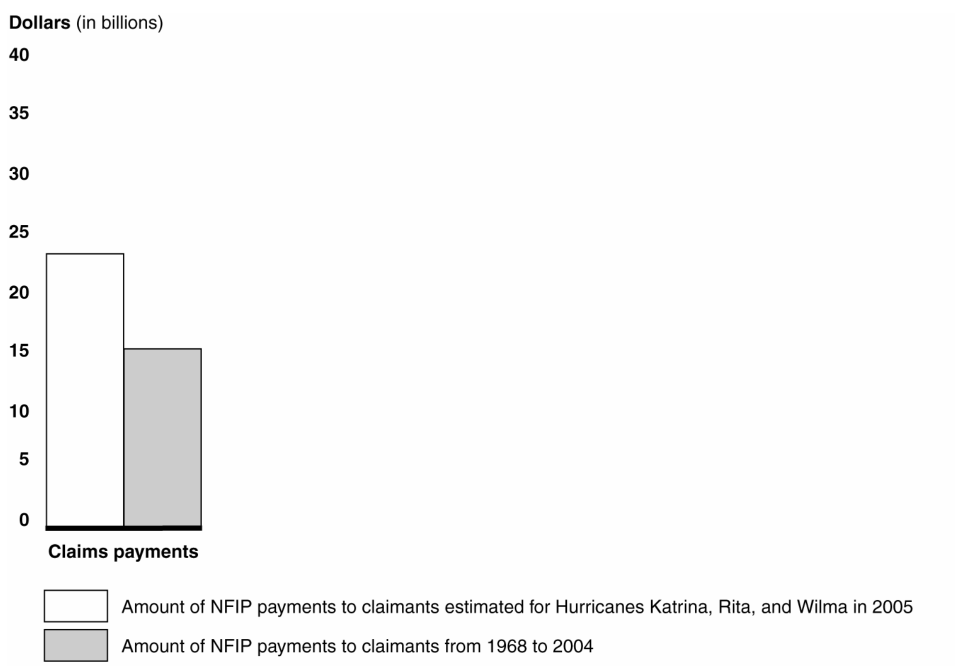
[2]The National Flood Insurance Act of 1968, as amended, is codified at 42 U.S.C. 4001 to 4129.

[3]42 U.S.C. 4001(b)(2).

outside the 100-year flood plain, but owners of properties in these lower-risk areas are not required to purchase flood insurance.

The unprecedented magnitude and severity of the flood losses in 2005 placed unprecedented challenges on the NFIP to process a record number of claims, many in properties flooded by Hurricanes Katrina and Rita that were inaccessible for weeks after the flooding occurred. These storms also illustrated the extent to which the federal government has exposure for claims coverage in catastrophic loss years. From its inception in 1968 until August 2005, the NFIP paid about $14.6 billion in insurance claims, primarily from policyholder premiums that otherwise would have been paid through taxpayer-funded disaster relief or borne by home and business owners themselves. As shown in figure 1, FEMA estimates that Hurricanes Katrina, Rita, and Wilma are likely to generate claims and associated payments of about $23 billion— far surpassing the total about $15 billion in claims paid in the entire history of the NFIP up to those events.

Figure 1: NFIP Claims Payments from 1968 to 2004 and Estimated for Hurricanes Katrina, Rita, and Wilma



Source: GAO analysis of FEMA data.

The NFIP cannot absorb the total costs of paying these claims. On November 21, 2005, FEMA's authority to borrow from the Treasury was increased from $1.5 billion to $18.5 billion through fiscal year 2008.[4] The acting director of FEMA's Mitigation Division said this borrowing authority will pay NFIP claims and expenses into February 2006, when additional legislative action to increase the borrowing authority will likely be required. He also said that it is highly unlikely that the program could generate sufficient revenues to cover a debt of this size. FEMA estimates that given its current income—about $2 billion annually---and average historical loss levels, it could expect to handle up to about $1.5 billion in debt and still have a reasonable chance to repay it within a 3- to 5-year time period.

GAO has a body of work underway on the preparation for, response to, and recovery from Hurricanes Katrina and Rita, including how the NFIP was implemented. We have had teams in the Gulf Coast states since the weeks immediately following the hurricanes collecting data and observations from hurricane victims and federal, state, local, and private participants in the preparation for, response to, and recovery from the extensive damages. I have also visited the region and spoken with governors in some of the affected states, military and civilian officials leading the recovery efforts, and others to help inform our work. One objective of the work we have underway on the NFIP is to assess what changes, if any, could be made to strengthen the NFIP's fiscal solvency. To this end, we will review proposals to increase revenues, reduce costs, or otherwise make the NFIP more actuarially sound. We expect to report on this matter later this year.

As GAO moves forward with this work, we will continue to coordinate with this and other congressional committees and the accountability community—federal inspector generals, state and city auditors—regarding the scope of our future work on emergency management issues, including the NFIP. Our goal is to apply our resources and expertise to address long-term concerns, such as those we are discussing today, and to avoid duplicating the work of others.

Past experience can provide context for considering future policy options. In this spirit, my testimony today is based on a body of work that GAO has

[4]National Flood Insurance Program Further Enhanced Borrowing Authority Act of 2005, Pub. L. No. 109-106, 119 Stat. 2288 (2005).

done over the past several years before the nation began the struggle to respond to the devastating effects of Hurricanes Katrina and Rita in our Gulf Coast states, as well as some preliminary results of interviews and review of documentation for work in progress on how the NFIP was implemented for these storms. Our prior work has addressed the issues of the program's structure and financing, oversight and management, repetitive loss properties, mandatory and voluntary purchase of flood insurance, and revising and improving the nation's flood maps. Together the prior work and work in process provide information useful in assessing efforts over the NFIP's history to enhance the program's financial stability and effectiveness. Most recently, we issued a report in October 2005 on FEMA's management and oversight of the flood insurance program that includes several recommendations for improvement.[5] This report was mandated by the Flood Insurance Reform Act of 2004.[6] It includes recommendations on two pre-Hurricane Katrina flood-insurance related issues that pose a challenge for FEMA. These are (1) improving FEMA's management and oversight of the NFIP and (2) improving FEMA's implementation of provisions of the Flood Insurance Reform Act of 2004 to provide policyholders a flood insurance claims handbook that meets statutory requirements, to establish a regulatory appeals process, and to ensure that flood insurance agents meet minimum NFIP education and training requirements.

That report was based on interviews with FEMA officials, documentation of its monitoring and oversight processes, and our field observations of FEMA's monitoring and oversight activities. In addition, we analyzed the National Flood Insurance Act of 1968, as amended, its legislative history, and FEMA's implementing regulations, and we examined documentation and interviewed officials about FEMA's efforts to comply with provisions of the 2004 Flood Insurance Reform Act. We did our work from December 2004 to August 2005 in accordance with generally accepted government auditing standards.

[5]GAO, *Federal Emergency Management Agency: Improvements Needed to Enhance Oversight and Management of the National Flood Insurance Program*, GAO-06-119 (Washington, D.C.: Oct. 18, 2005).

[6]Bunning-Bereuter-Blumenauer Flood Insurance Reform Act of 2004, Pub. L. No. 108-264, 118 Stat. 712, 727 (2004).

Major Program Issues –a Summary

A key characteristic of the NFIP is the extent to which FEMA must rely on others to achieve the program's goals. FEMA's role for the NFIP is principally one of establishing policies and standards that others generally implement on a day-to-day basis and providing financial and management oversight of those who carry out those day-to-day responsibilities. These responsibilities include ensuring that property owners who are required to purchase flood insurance do so, enforcing flood plain management and building regulations, selling and servicing flood insurance policies, and updating and maintaining the nation's flood maps. In our prior work, we have identified several major challenges facing the NFIP:

- Reducing losses to the program resulting from policy subsidies and repetitive loss properties.[7] The program is not actuarially sound because of the number of policies in force that are subsidized—about 29 percent at the time of our 2003 report. As a result of these subsidies, some policyholders with dwellings that were built before flood plain management regulations were established in their communities pay premiums that represent about 35 to 40 percent of the true risk premium. In January 2006, FEMA estimated a shortfall in annual premium income because of policy subsidies at $750 million. Moreover, at the time of our 2004 report, there were about 49,000 repetitive loss properties—those with two or more losses of $1,000 or more in a 10-year period—representing about 1 percent of the 4.4 million buildings insured under the program. From 1978 until March 2004, these repetitive loss properties represented about $4.6 billion in claims payments.

- Increasing property owner participation in the program. The extent of noncompliance with current mandatory purchase requirements by affected property owners is unknown. Some interest has been expressed in Congress in assessing the feasibility of expanding mandatory purchase requirements beyond current special high-risk flood hazard areas. FEMA and its private insurance partners also have efforts underway to increase participation in the NFIP by marketing flood insurance policies in areas where purchase is not mandatory.

[7] GAO, *Flood Insurance: Challenges Facing the National Flood Insurance Program*, (GAO-03-606T (Washington, D.C.: Apr. 1, 2003); *National Flood Insurance Program: Actions to Address Repetitive Loss Properties*, (GAO-04-401T (Washington, D.C.: Mar. 25, 2004).

- Developing accurate, digital flood maps.[8] The impact of Hurricanes Katrina, Rita, and Wilma on homeowners has highlighted the importance of having accurate, up-to-date flood maps that identify the areas at risk of flooding and, thus, the areas in which homeowners would benefit from purchasing flood insurance. In our report on the NFIP's flood map modernization program, we discussed the multiple uses and benefits of accurate, digital flood plain maps. However, the NFIP faces a major challenge in working with its contractor and state and local partners of varying technical capabilities and resources to produce accurate, digital flood maps. In developing those maps, we recommended that FEMA develop and implement data standards that will enable FEMA, its contractor, and its state and local partners to identify and use consistent data collection and analysis methods for developing maps for communities with similar flood risk.

- Providing effective oversight of flood insurance operations. In our October 2005 report, we said that FEMA faces a challenge in providing effective oversight of the 95 insurance companies and thousands of insurance agents and claims adjusters who are primarily responsible for the day-to-day process of selling and servicing flood insurance policies.

The NFIP Pays Expenses and Claims with Premiums to the Extent Possible, but Its Financial Structure Is Not Designed to Be Actuarially Sound

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 with tax dollars. However, as we have reported, the program, by design, is not actuarially sound because Congress authorized subsidized insurance rates to be made available for policies covering some properties to encourage communities to join the program. As a result, the program does not collect sufficient premium income to build reserves to meet the long-term future expected flood losses.[9] FEMA has statutory authority to borrow funds from the Treasury to keep the NFIP solvent.[10]

Until the 2004 hurricane season, FEMA had been generally successful in keeping the NFIP on sound financial footing, exercising its borrowing authority three times in the last decade when losses exceeded available

[8] GAO, *Flood Map Modernization: Program Strategy Shows Promise, but Challenges Remain*, GAO-04-417 (Washington, D.C.: Mar. 31, 2004).

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

[10] See 42 U.S.C. 4016.

fund balances. In each instance, FEMA repaid the funds with interest. According to FEMA officials, as of August 31, 2005, FEMA had outstanding borrowing of $225 million with cash on hand totaling $289 million. FEMA had substantially repaid the borrowing it had undertaken to pay losses incurred for the 2004 hurricane season that, until Hurricane Katrina struck, was the worst hurricane season on record for the NFIP. FEMA's current debt with the Treasury is almost entirely for payment of claims from Hurricanes Katrina and Rita and other flood events that occurred in 2005.

Premium Subsidies and Repetitive-Loss Properties Affect NFIP's Actuarial Soundness

As the destruction caused by horrendous 2004 and 2005 hurricanes are a driving force for improving the NFIP today, devastating natural disasters in the 1960s were a primary reason for the national interest in creating a federal flood insurance program. In 1963 and 1964, Hurricane Betsy and other hurricanes caused extensive damage in the South, and, in 1965, heavy flooding occurred on the upper Mississippi River. In studying insurance alternatives to disaster assistance for people suffering property losses in floods, a flood insurance feasibility study found that premium rates in certain flood-prone areas could be extremely high. As a result, the National Flood Insurance Act of 1968, which created the NFIP, mandated that existing buildings in flood-risk areas would receive subsidies on premiums because these structures were built before the flood risk was known and identified on flood insurance rate maps.[11] Owners of structures built in flood-prone areas on or after the effective date of the first flood insurance rate maps in their areas or after December 31, 1974, would have to pay full actuarial rates.[12] Because many repetitive loss properties were built before either December 31, 1974, or the effective date of the first flood insurance rate maps in their areas, they were eligible for subsidized premium rates under provisions of the National Flood Insurance Act of 1968.

The provision of subsidized premiums encouraged communities to participate in the NFIP by adopting and agreeing to enforce state and community floodplain management regulations to reduce future flood damage. In April 2005, FEMA estimated that floodplain management regulations enforced by communities participating in the NFIP have prevented over $1.1 billion annually in flood damage.

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[11] 42 U.S.C. 4014(a)(2), 4015(a), (b).

[12] 42 U.S.C. 4014(a)(1), 4015(c).

However, the policy subsidies reduce premium income and add risk to the NFIP. In January 2006, FEMA estimated an annual shortfall in premium income of $750 million because of policy subsidies. FEMA estimated that phasing out subsidized rates for non-primary residences and nonresidential properties alone would affect about 400,000 properties currently insured by the NFIP. Some have questioned whether providing flood insurance for second homes in high risk areas—such as barrier islands—encourages development in areas at high risk of flooding.

In addition, some of the properties that had received the initial rate subsidy are subject to repetitive flood losses, placing added financial strain on the NFIP. In reauthorizing the NFIP in 2004, Congress noted that "repetitive-loss properties"—those that had resulted in two or more flood insurance claims payments of $1,000 or more over 10 years—constituted a significant drain on the resources of the NFIP. [13] These repetitive loss properties are problematic not only because of their vulnerability to flooding but also because of the costs of repeatedly repairing flood damages. While these properties make up only about 1 percent of the properties insured under the NFIP, they account for 25 to 30 percent of all claims losses. At the time of our March 2004 report on repetitive loss properties, there were about 49,000 repetitive loss properties, representing about $4.6 billion in claims payments from 1978 until March 2004. As of March 2004, nearly half of all nationwide repetitive loss property insurance payments had been made in Louisiana, Texas, and Florida. According to a recent Congressional Research Service report, as of December 31, 2004, FEMA had identified 11,706 "severe repetitive loss" properties, defined as those with four or more claims or two or three losses that exceeded the insured value of the property.[14] Of these 11,706 properties almost half (49 percent) were in three states—3,208 (27 percent) in Louisiana, 1,573 (13 percent) in Texas, and 1,034 (9 percent) in New Jersey. A significant number of repetitive loss properties were affected by Hurricanes Katrina and Rita. According to NFIP statistical data through November 30, 2005, 4,835 repetitive loss properties, including 3,183 in Louisiana, had substantial damage from Hurricane Katrina.[15] Two hundred and forty-three

[13]Flood Insurance Reform Act of 2004, Pub. L. No. 108-264, section 2(3),(4), (5), 118 Stat. 712, 713 (2004).

[14]Congressional Research Service, *Federal Flood Insurance: The Repetitive Loss Problem*, RL32972 (Washington, D.C.: June 30, 2005).

[15]The term "substantial damage" means the cost of repairing the damaged building exceeds 50 percent of its market value (or a lower trigger if adopted locally).

repetitive loss properties had substantial damage from Hurricane Rita. Of these properties, 213 were located in Louisiana and 30 were located in Texas.

For over a decade, FEMA has pursued a variety of strategies to reduce the number of repetitive loss properties in the NFIP inventory. In a 2004 testimony, we noted that congressional proposals have been made to phase out coverage or begin charging full and actuarially based rates for repetitive loss property owners who refuse to accept FEMA's offer to purchase or mitigate the effect of floods on these buildings.[16] The 2004 Flood Insurance Reform Act created a 5-year pilot program to deal with repetitive-loss properties in the NFIP. In particular, the act authorized FEMA to provide financial assistance to participating states and communities to carry out mitigation activities or to purchase "severe repetitive loss properties."[17] During the pilot program, policyholders who refuse a mitigation or purchase offer that meets program requirements will be required to pay increased premium rates. Specifically, the premium rates for these policyholders would increase by 150 percent following their refusal and another 150% following future claims of more than $1,500.[18] However, the rates charged cannot exceed the applicable actuarial rate.

Because of the financial drain that repetitive loss properties have posed for the program, it will be important in future studies of the NFIP to continue to analyze data on progress being made to reduce the inventory of subsidized NFIP properties, particularly those with repetitive losses; how the reduction of this inventory contributes to the financial stability of the program; and whether additional FEMA regulatory steps or congressional actions could contribute to the financial solvency of the NFIP, while meeting commitments made by the authorizing legislation.

[16]GAO, *National Flood Insurance Program: Actions to Address Repetitive Loss Properties*, GAO-04-401T (Washington, D.C.: Mar. 25, 2004).

[17]Flood Insurance Reform Act of 2004, Pub. L. No. 108-264, section 102, 118 Stat. 712, 714-721 (2004). The act defines a "severe repetitive loss property" to mean single-family properties that have received at least $20,000 in flood insurance payments based on four or more claims of at least $5,000 each. The act requires FEMA to define in future regulation which multi-family properties constitute "severe repetitive loss properties."

[18]*Id.*, 118 Stat. 712, 717-718 (2004).

Expansion of the NFIP Policyholder Base

Compliance with Mandatory Purchase Requirements Difficult to Determine

In 1973 and 1994, Congress enacted requirements for mandatory purchase of NFIP policies by some property owners in high-risk areas. From 1968 until the adoption of the Flood Disaster Protection Act of 1973, the purchase of flood insurance was voluntary. However, because voluntary participation in the NFIP was low and many flood victims did not have insurance to repair damages from floods in the early 1970s, the 1973 act required the mandatory purchase of flood insurance to cover some structures in special flood hazard areas of communities participating in the program. Homeowners with mortgages held by federally-regulated lenders on property in communities identified by FEMA to be in special flood hazard areas are required to purchase flood insurance on their dwellings for the amount of their outstanding mortgage balance, up to a maximum of $250,000 in coverage for single family homes. The owners of properties with no mortgages or properties with mortgages held by lenders who are not federally regulated were not, and still are not, required to buy flood insurance, even if the properties are in special flood hazard areas—the areas NFIP flood maps identify as having the highest risk of flooding.

FEMA determines flood risk and actuarial ratings on properties through flood insurance rate mapping and other considerations, including the elevation of the lowest floor of the building, the type of building, the number of floors, and whether or not the building has a basement, among other factors. FEMA flood maps designate areas for risk of flooding by zones. For example, areas subject to damage by waves and storm surge are in the zone with the highest expectation for flood loss.

Between 1973 and 1994, many policyholders continued to find it easy to drop policies, even if the policies were required by lenders. Federal agency lenders and regulators did not appear to strongly enforce the mandatory flood insurance purchase requirements.[19] According to a recent

[19]The federal entities for lending regulation are the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Farm Credit Administration.

Congressional Research Service study,[20] the Midwest flood of 1993 highlighted this problem and reinforced the idea that reforms were needed to compel lender compliance with the requirements of the 1973 Act. In response, Congress passed the National Flood Insurance Reform Act of 1994. Under the 1994 law, if the property owner failed to get the required coverage, federally-regulated lenders were required to purchase flood insurance on their behalf and then bill the property owners. Lenders became subject to civil monetary penalties for not enforcing the mandatory purchase requirement.

In June 2002, we reported that the extent to which lenders were enforcing the mandatory purchase requirement was unknown. Officials involved with the flood insurance program developed contrasting viewpoints about whether lenders were complying with the flood insurance purchase requirements primarily because the officials used differing types of data to reach their conclusions. Federal bank regulators and lenders based their belief that lenders were generally complying with the NFIP's purchase requirements on regulators' examinations and reviews conducted to monitor and verify lender compliance. In contrast, FEMA officials believed that many lenders frequently were not complying with the requirements, which was an opinion based largely on noncompliance estimates computed from data on mortgages, flood zones, and insurance policies; limited studies on compliance; and anecdotal evidence indicating that insurance was not always in place where required. Neither side, however, was able to substantiate its differing claims with statistically sound data that provide a nationwide perspective on lender compliance.[21]

Expansion of Mandatory Purchase Requirements Would Generate More Premiums, but Implementation Could Be Problematic

Under FEMA's current Mandatory Purchase of Flood Insurance Guidelines, properties in a 100-year flood plain with a statistical 1 in 100 chance of flooding in any given year or a 30 percent chance of flooding during the period of a 30-year mortgage are designated to be in special flood hazard areas. Within the boundaries of these areas, homeowners with mortgages from federal regulated lenders are required to purchase flood insurance for an amount equal to their outstanding mortgage balance, up to the maximum policy limit of $250,000 for a single-family home. To expand the NFIP policyholder base, there has been some

[20]Congressional Research Service, *Federal Flood Insurance: The Repetitive Loss Problem* (June 30, 2005).

[21]GAO, *Flood Insurance: Extent of Noncompliance with Purchase Requirements Is Unknown*, GAO-02-396 (Washington, D.C: June 21, 2002).

congressional interest in the feasibility of extending the current mandatory purchase requirement to properties in a 500-year flood plain, which statistically have a 1 in 500 chance of flooding in any given year.[22] FEMA has estimated that expanding NFIP mandatory purchase requirements to include structures in the 500-year flood plain would generate up to $700 million in additional premiums. The current annual premium for a structure in the 500-year flood plain is about $280. However, a FEMA official cautioned that the rate of compliance is an important component of any estimate of the amount of increase in NFIP premiums that would result from expanding mandatory purchase requirements.

It would be difficult to effectively assess the impacts, effectiveness, and feasibility of such a change in the structure of the NFIP. We share FEMA's concerns related to enforcing and assessing compliance. We also believe that it would be difficult to assess the impacts an expansion in the mandatory purchase requirements would have upon a range of stakeholders, including not only home and business owners, but lenders, mortgage servicers, builders, and local governments, among others.

We also recognize that it would be difficult and costly to determine the additional geographic area that would be encompassed in an expanded special flood hazard area. Current flood mapping focuses on the boundaries of the 100-year flood plain, and FEMA has not estimated the additional cost and time required to complete detailed, digitalized maps of areas outside of the current 100-year special flood hazard area.

FEMA Has a Marketing Campaign to Attract New Policyholders and Improve Rates of Renewal

In recent years, the number of NFIP policyholders did not grow substantially. FEMA officials reported a pattern in which at the start of each hurricane season, the number of polices in force was the same or less than the number of policies in previous years. During the hurricane season, the number of polices in force would increase slightly and then level off or decline again at the end of the season.

FEMA has efforts underway to increase NFIP participation by improving the quality of information that is available on the NFIP and flood risks and by marketing to retain policyholders currently in the program. In October 2003, FEMA let a contract for a new integrated marketing campaign called "FloodSmart." Marketing elements being used include direct mail, national

[22]National Flood Insurance Program Commitment to Policyholders and Reform Act of 2005, H.R. 4320, 109th Conress, section 3 (2005).

television commercials, print advertising, and websites designed for consumers and insurance agents. According to FEMA officials, in a little more than 2 years since the contract began, net policy growth was a little more than 7 percent and policy retention improved from 88 percent to 91 percent.

Accurate, Updated Flood Maps Are the Foundation of the NFIP

Accurate flood maps that identify the areas at greatest risk of flooding are the foundation of the NFIP. Flood maps must be periodically updated to assess and map changes in the boundaries of floodplains that result from community growth, development, erosion, and other factors that affect the boundaries of areas at risk of flooding. FEMA has embarked on a multi-year effort to update the nation's flood maps at a cost in excess of $1 billion. The maps are principally used by (1) the approximately 20,000 communities participating in the NFIP to adopt and enforce the program's minimum building standards for new construction within the maps' identified flood plains; (2) FEMA to develop accurate flood insurance policy rates based on flood risk; and (3) federal regulated mortgage lenders to identify those property owners who are statutorily required to purchase federal flood insurance.

FEMA expects that by producing more accurate and accessible digital flood maps, the NFIP and the nation will benefit in three ways. First, communities can use more accurate digital maps to reduce flood risk within floodplains by more effectively regulating development through zoning and building standards. Second, accurate digital maps available on the Internet will facilitate the identification of property owners who are statutorily required to obtain or who would be best served by obtaining flood insurance. Third, accurate and precise data will help national, state, and local officials to accurately locate infrastructure and transportation systems (e.g., power plants, sewage plants, railroads, bridges, and ports) to help mitigate and manage risk for multiple hazards, both natural and man-made.

Success in updating the nation's flood maps requires clear standards for map development; the coordinated efforts and shared resources of federal, state, and local governments; and the involvement of key stakeholders who will be expected to use the maps. In developing the new data system to update flood maps across the nation, FEMA's intent is to develop and incorporate flood risk data that are of a level of specificity and accuracy commensurate with communities' relative flood risks. Not every community may need the same level of specificity and detail in its new flood maps. However, it is important that FEMA establish standards for the appropriate data and level of analysis required to develop maps for all communities of a similar risk level. In its November 2004 Multi-Year Flood Hazard Identification Plan, FEMA discussed the varying types of data collection and analysis techniques the agency plans to use to develop flood hazard data in order to relate the level of study and level of risk for each of 3,146 counties.

FEMA has developed targets for resource contributions (in-kind as well as dollars) by its state and local partners in updating the nation's flood maps. At the same time, it has developed plans for reaching out to and including the input of communities and key stakeholders in the development of the new maps. These expanded outreach efforts reflect FEMA's understanding that it is dependent upon others to achieve the benefits of map modernization.

As I have discussed, it is important when considering any expansion of mandatory purchase requirements for NFIP policies to understand that implementation would require the development of additional detailed flood maps. According to a FEMA official, digital mapping of areas outside of special flood hazard areas is currently being considered on only a selective basis for reasons such as potential changes in risk level or population growth.

Monitoring and Oversight of NFIP Identifies Specific Problems, but Does Not Provide Comprehensive Information on Overall Program Performance

To meet its monitoring and oversight responsibilities, FEMA is to conduct periodic operational reviews of the 95 private insurance companies that participate in the NFIP. In addition, FEMA's program contractor is to check the accuracy of claims settlements by doing quality assurance reinspections of a sample of claims adjustments for every flood event. For operational reviews, FEMA examiners are to do a thorough review of the companies' NFIP underwriting and claims settlement processes and internal controls, including checking a sample of claims and underwriting files to determine, for example, whether a violation of policy has occurred, an incorrect payment has been made, and if files contain all required documentation. Separately, FEMA's program contractor is responsible for conducting quality assurance reinspections of a sample of claims adjustments for specific flood events in order to identify, for example, whether an insurer allowed an uncovered expense or missed a covered expense in the original adjustment.

According to FEMA, these monitoring and oversight mechanisms will be in place to assess the implementation of the NFIP after Hurricanes Katrina and Rita. In addition, FEMA plans to do additional oversight of claims for these storms that were handled using expedited procedures. To try to assist NFIP policyholders despite obstacles in communicating with claimants, reaching flooded properties, and locating records, FEMA allowed expedited claims processing procedures that were unique to these storms. In some circumstances, claims were settled without site visits by certified flood claims adjusters. For flooding caused by the failure of the levees in the New Orleans area, resulting in flooding from Lake Pontchartrain, FEMA allowed the use of flood depth data to identify structures that had been severely affected. If data on the depth and duration of the water in the building showed that it was likely that covered damage exceeded policy limits, claims could be settled without a site visit by a claims adjuster. Similarly, losses in other areas of Louisiana and Mississippi were handled without a site visit where structures were washed off their foundations by flood waters and square-foot measurements of the dwellings were known.

The operational reviews and follow-up visits to insurance companies that we analyzed during 2005 followed FEMA's internal control procedures for identifying and resolving specific problems that may occur in individual insurance companies' processes for selling and renewing NFIP policies and adjusting claims. According to information provided by FEMA, the number of operational reviews completed between 2000 and August 2005 were done at a pace that allows for a review of each participating insurance company at least once every 3 years, as FEMA procedures require. In addition, the processes FEMA had in place for operational reviews and quality assurance reinspections of claims adjustments met our internal control standard for monitoring federal programs.

However, the process FEMA used to select a sample of claims files for operational reviews and the process its program contractor used to select a sample of adjustments for reinspections were not randomly chosen or statistically representative of all claims. We found that the selection processes used were, instead, based upon judgmental criteria including, among other items, the size and location of loss and complexity of claims. As a result of limitations in the sampling processes, FEMA cannot project the results of these monitoring and oversight activities to determine the overall accuracy of claims settled for specific flood events or assess the overall performance of insurance companies and their adjusters in fulfilling their responsibilities for the NFIP—actions necessary for FEMA to meet our internal control standard that it have reasonable assurance that program objectives are being achieved and that its operations are effective and efficient.

To strengthen and improve FEMA's monitoring and oversight of the NFIP, we recommended that FEMA use a methodologically valid approach for sampling files selected for operational reviews and quality assurance claims reinspections. We also plan to follow up on the results of the monitoring and oversight efforts for claims processed using expedited processes in our review of the implementation of the NFIP after Hurricanes Katrina and Rita.

FEMA did not agree with our recommendation. It noted that its current sampling methodology of selecting a sample based on knowledge of the population to be sampled was more appropriate for identifying problems than the statistically random probability sample we recommended. Although FEMA's current nonprobability sampling strategy may provide an opportunity to focus on particular areas of risk, it does not provide management with the information needed to assess the overall performance of private insurance companies and adjusters participating in the program—information that FEMA needs to have reasonable assurance that program objectives are being achieved.

FEMA Has Not Fully Implemented NFIP Program Changes Mandated by the Flood Insurance Reform Act of 2004

As of January 2006, FEMA had not yet fully implemented provisions of the Flood Insurance Reform Act of 2004. Among other things, the act requires FEMA to provide policyholders a flood insurance claims handbook; to establish a regulatory appeals process for claimants; and to establish minimum education and training requirements for insurance agents who sell NFIP policies.[23] The 6-month statutory deadline for implementing these changes was December 30, 2004.

In September 2005, FEMA posted a flood insurance claims handbook on its Web site. The handbook contains information on anticipating, filing and appealing a claim through an informal appeals process, which FEMA intends to use pending the establishment of a regulatory appeals process. However, because the handbook does not contain information regarding the appeals process that FEMA is statutorily required to establish through regulation, it does not yet meet statutory requirements.

With respect to this appeals process, FEMA has not stated how long rulemaking might take to establish the process by regulation, or how the process might work, such as filing requirements, time frames for considering appeals, and the composition of an appeals board. In January 2006, the acting director of FEMA's Mitigation Division said that FEMA

[23] Flood Insurance Reform Act of 2004, Pub. L. No. 108-264, sections 204, 205, and 207.

had submitted a draft rule to DHS. However, milestones for future actions were not established. Claimants who wish to appeal decisions made on their claims for damage from Hurricanes Katrina and Rita can follow a process described by FEMA as an “informal” appeals process. As outlined in the Flood Insurance Claims Handbook, to appeal, policyholders are to submit statements of their concerns and supporting documentation to the director of claims in FEMA’s Mitigation Division, Risk Insurance Branch.

With respect to minimum training and education requirements for insurance agents who sell NFIP policies, FEMA published a Federal Register notice on September 1, 2005, which included an outline of training course materials. In the notice, FEMA stated that, rather than establish separate and perhaps duplicative requirements from those that may already be in place in the states, it had chosen to work with the states to implement the NFIP requirements through already established state licensing schemes for insurance agents. The notice did not specify how or when states were to begin implementing the NFIP training and education requirements. Thus, it is too early to tell the extent to which insurance agents will meet FEMA’s minimum standards. FEMA officials said that, because changes to the program could have broad reaching and significant effects on policyholders and private-sector stakeholders upon whom FEMA relies to implement the program, the agency is taking a measured approach to addressing the changes mandated by Congress. Nonetheless, without plans with milestones for completing its efforts to address the provisions of the act, FEMA cannot hold responsible officials accountable or ensure that statutorily required improvements are in place to assist victims of future flood events.

We recommended that FEMA develop documented plans with milestones for implementing requirements of the Flood Insurance Reform Act of 2004 to provide policyholders a flood insurance claims handbook that meets statutory requirements, to establish a regulatory appeals process, and to ensure that flood insurance agents meet minimum NFIP education and training requirements. We will continue to monitor progress being made.

FEMA disagreed with our recommendation and characterization of the extent to which FEMA has met provisions of the Flood Insurance Reform Act of 2004. We believe that our description of those efforts and our recommendations with regard to implementing the act’s provisions are valid. For example, although FEMA commented that it was offering claimants an informal appeals process in its flood insurance claims handbook, it must establish regulations for this process, and those are not yet complete.

Concluding Observations

The most immediate challenge for the NFIP is processing the flood insurance claims resulting from Hurricanes Katrina and Rita. Progress is being made in that area. In December 2005, according to FEMA, more than 70 percent of Hurricane Katrina claims had been paid, totaling more than $11 billion, some of them using expedited procedures to assist policyholders who were displaced from their homes.

In the longer term, Congress and the NFIP face a complex challenge in assessing potential changes to the program that would improve its financial stability, increase participation in the program by property owners in areas at risk of flooding, reduce the number of repetitive loss properties in the program, and maintain current and accurate flood plain maps. These issues are complex, interrelated, and are likely to involve trade-offs. For example, increasing premiums to better reflect risk may reduce voluntary participation in the program or encourage those who are required to purchase flood insurance to limit their coverage to the minimum required amount (i.e., the amount of their outstanding mortgage balance). This in turn can increase taxpayer exposure for disaster assistance resulting from flooding. There is no "silver bullet" for improving the current structure and operations of the NFIP. It will require sound data and analysis and the cooperation and participation of many stakeholders.

Mr. Chairman and Members of the Committee, this concludes my prepared statement. I would be pleased to respond to any questions you and the Committee Members may have.

GAO Contact and Staff Acknowledgments

Contact point for our Office of Congressional Relations and Public Affairs may be found on the last page of this statement. For further information about this testimony, please contact Norman Rabkin at (202) 512-8777 or rabkinn@gao.gov, or William O. Jenkins Jr. at (202) 512-8757 or jenkinswo@gao.gov. This statement was prepared under the direction of Christopher Keisling. Key contributors were John Bagnulo, Christine Davis, and Deborah Knorr.

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