October 2008

FLOOD INSURANCE

FEMA's Rate-Setting Process Warrants Attention

GAO Accountability·Integrity·Reliability

Highlights

Highlights of GAO-09-12, a report to the Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

Why GAO Did This Study

Questions about the financial status of the National Flood Insurance Program (NFIP) have increased since the 2005 hurricanes, which left the program with an unprecedented $17.4 billion deficit—a debt that resulted in GAO placing NFIP on its high-risk list in March 2006. Among the concerns are the subsidized rates NFIP must provide for about 25 percent of the policies, mostly for older buildings in high-risk flood zones. And although fully risk-based rates are supposed to reflect actual flood risk, concerns have been raised that they do not. This report evaluates (1) the Federal Emergency Management Agency's (FEMA) process for setting full-risk rates to determine whether it produces rates that accurately reflect the risk of flooding and (2) the process that FEMA uses to set subsidized rates and their effect on the financial condition of NFIP. To do this work, GAO evaluated the NFIP rate model, examined data from FEMA, surveyed relevant literature, and interviewed other relevant agencies and risk-modeling firms.

What GAO Recommends

GAO recommends that FEMA (1) ensure that its rate-setting methods result in rates that accurately reflect flood risks and (2) collect data to analyze the impact of newly created grandfathered properties on the NFIP. FEMA generally concurred with both recommendations but expressed two reservations with our recommendation regarding rate setting.

To view the full product, including the scope and methodology, click on GAO-09-12. For more information, contact Orice M. Williams at (202) 512-8678 or williamso@gao.gov.

What GAO Found

FEMA's method for setting its full-risk rates may not ensure that the rates accurately reflect the actual risk of flood damage. The NFIP model combines estimated flood risk with expected flood damage, but a number of factors may affect the accuracy of the rates the model generates. First, some data inputs are outdated or inaccurate. FEMA relies on flood probabilities from the 1980s and damage estimates that do not fully reflect recent NFIP damage experience. Moreover, while FEMA has made updating its flood maps a priority, most of the maps used in rate setting have not yet been updated. Second, FEMA does not require all properties remapped into higher-risk areas to pay rates based on the new designation. This policy, known as grandfathering, erodes NFIP's ability to charge rates that reflect the risk of flooding. The policy is intended to increase participation, but FEMA does not track the number of grandfathered properties and cannot determine their financial impact on the program. Third, FEMA uses a nationwide rating system that combines flood zones across many geographic areas, so individual policies do not always reflect topographical features that affect flood risk. In fact, some patterns in historical claims and premium data suggest that NFIP's full-risk rates may not always reflect actual flood risk. Collectively, these factors increase the risk that premiums collected on full-risk policies may be insufficient to cover future losses, adding to concerns about NFIP's financial stability.

FEMA's rate-setting process for subsidized properties depends in part on the accuracy of the full-risk rates, raising concerns about how these rates are calculated as well. To set subsidized rates, FEMA first subtracts the total amount it expects to collect in full-risk premiums from the average historical loss year—that is, the minimum (target) amount that the program needs to collect from all premiums to cover at least average annual losses, as determined by historical data. The remainder becomes the aggregate target amount the program must collect in subsidized premiums. To set individual subsidized rates, FEMA officials then consider their knowledge of flood risk, previous rate increases for various locations, and statutory limits on increases. The resulting subsidized premiums continue to be a financial strain on the NFIP and contribute to its ongoing financial instability. Evidence suggests that flooding is likely to become more severe in the future, resulting in increased risk exposure, the potential for more catastrophic losses, and ongoing financial instability for the program. Currently, the annual amount that NFIP collects in both full-risk and subsidized premiums is not enough to cover its operating costs, claim losses, and principal and interest payments to the Department of the Treasury, thereby exposing the federal government and ultimately taxpayers to ever-greater financial risks, especially in years of catastrophic flooding.