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Highlights

Highlights of GAO-08-504, a report to congressional requesters

Why GAO Did This Study

Disputes between policyholders and insurers after the 2005 hurricanes highlight the challenges of determining the cause and extent of damages when properties are subject to both high winds and flooding. Additionally, insurers want to reduce their exposure in high-risk areas, and state wind insurance programs have grown significantly. H.R. 3121, the Flood Insurance Reform and Modernization Act of 2007, would create a combined federal insurance program with coverage for both wind and flood damage. GAO was asked to evaluate this potential program in terms of (1) what would be required to implement it; (2) the steps the Federal Emergency Management Agency (FEMA) would need to take to determine premium rates that reflect all future costs; and (3) how it could affect policyholders, insurance market participants, and the federal government. To address these questions, GAO analyzed state and federal programs, examined studies of coastal wind insurance issues, and interviewed federal and state regulatory officials as well as industry participants and analysts.

FEMA and the National Association of Insurance Commissioners generally agreed with GAO's report findings. FEMA emphasized the challenges it would face in addressing several key issues. FEMA also provided technical comments, which were incorporated as appropriate.

To view the full product, including the scope and methodology, click on GAO-08-504. For more information, contact Orice Williams at (202) 512-8678 or williamso@gao.gov.

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NATURAL CATASTROPHE INSURANCE

Analysis of a Proposed Combined Federal Flood and Wind Insurance Program

What GAO Found

To implement a combined federal flood and wind insurance program, FEMA would need to complete certain challenging steps. First, FEMA would need to determine wind hazard prevention standards that communities would have to adopt in order to receive coverage. Second, FEMA would need to adapt existing programs to accommodate wind coverage—for example, the Write Your Own program. Third, FEMA would need to create a new rate-setting process, as the process for setting flood insurance rates is different from what is needed for wind coverage. Fourth, promoting the new program in communities would require that FEMA staff raise awareness of the combined program's availability and coordinate enforcement of the new building codes. Finally, FEMA would need to put staff and procedures in place to administer and oversee the new program while it faces current management and oversight challenges with the National Flood Insurance Program (NFIP).

Setting premium rates adequate to cover all the expected costs of flood and wind damage would require FEMA to make sophisticated determinations. For example, FEMA would need to determine how the program would pay claims in years with catastrophic losses without borrowing from the Department of the Treasury. H.R. 3121 would require the program to stop renewing or selling new policies if it needed to borrow funds, effectively terminating the program. It is also unclear whether the program could obtain reinsurance to cover such losses, and attempting to fund losses by building up a surplus would potentially require high premium rates and an unknown number of years without large losses, something over which FEMA has no control. Further, FEMA would need to account for the likelihood that participation would be limited and only the highest-risk properties would be insured. These factors would further increase premium rates and make it difficult to set rates adequate to cover future costs.

A federal flood and wind insurance program could benefit some policyholders and market participants but would also involve trade-offs. For example, not requiring adjusters to distinguish between flood and wind damage could reduce both delays in reimbursing participants and the potential for litigation. However, borrowing restrictions could also leave property owners without coverage after a catastrophic event. In addition, the proposed coverage limits are relatively low compared with the coverage that is currently available, potentially leaving some properties underinsured. The program could also reduce the exposure of some insurers by insuring high-risk properties that currently have private sector coverage. However, an unknown portion of the exposure currently held by state wind programs—nearly $600 billion in 2007—could be transferred to the federal government. While H.R. 3121 would require premium rates to be adequate to cover any exposure and restrict borrowing by the program, the potential exists for losses to greatly exceed expectations, as happened with Hurricane Katrina in 2005. This could increase FEMA's total debt, which as of December 2007 was about $17.3 billion.