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NATIONAL FLOOD INSURANCE PROGRAM

Continued Actions Needed to Address Financial and Operational Issues

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Highlights

Highlights of GAO-10-631T, a testimony before the Subcommittee on Housing and Community Opportunity, Committee on Financial Services, House of Representatives

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Why GAO Did This Study

The National Flood Insurance Program (NFIP), established in 1968, provides policyholders with insurance coverage for flood damage. The Federal Emergency Management Agency (FEMA) within the Department of Homeland Security is responsible for managing NFIP. Unprecedented losses from the 2005 hurricane season and NFIP's periodic need to borrow from the U.S. Treasury to pay flood insurance claims have raised concerns about the program's long-term financial solvency. Because of these concerns and NFIP's operational issues, NFIP has been on GAO's high-risk list since March 2006. As of April 2010, NFIP's debt to Treasury stood at $18.8 billion.

The Subcommittee asked GAO to discuss (1) NFIP's financial challenges, (2) FEMA's operational and management challenges, and (3) actions needed to address these challenges. In preparing this statement, GAO relied on its past work on NFIP and GAO's ongoing review of FEMA's management of NFIP focused on information technology and contractor oversight issues.

What GAO Recommends

In past work, GAO recommended, among other things, that FEMA take steps to help ensure that premium rates are more reflective of flood risks; strengthen its oversight of NFIP and insurance companies responsible for selling and servicing flood policies; and strengthen its internal controls and the quality of its data.

View GAO-10-631T or key components.
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What GAO Found

While Congress and FEMA intended that NFIP be funded with premiums collected from policyholders rather than with tax dollars, the program is, by design, not actuarially sound. NFIP cannot do some of the things that private insurers do to manage their risks. For example, NFIP is not structured to build a capital surplus, is likely unable to purchase reinsurance to cover catastrophic losses, cannot reject high-risk applicants, and is subject to statutory limits on rate increases. In addition, its premium rates do not reflect actual flood risk. For example, nearly one in four property owners pay subsidized rates, "full-risk" rates may not reflect the full risk of flooding, and NFIP allows "grandfathered" rates, which allow some property owners to continue paying rates that do not reflect reassessments of their properties' flood risk. Further, NFIP cannot deny insurance on the basis of frequent losses and thus provides policies for repetitive loss properties, which represent only 1 percent of policies but account for 25 to 30 percent of claims. NFIP's financial condition has improved slightly due to an increase in the number of policyholders and moderate flood losses, and since March 2009, FEMA has taken some encouraging steps toward improving its financial position, including making $600 million in interest payments to Treasury without increasing its borrowings. However, it is unlikely to pay off its full $18.8 billion debt, especially if it faces catastrophic loss years.

Operational and management issues may also limit efforts to address NFIP's financial challenges and meet program goals. Payments to write-your-own (WYO) insurers, which are key to NFIP operations, represent one-third to two-thirds of the premiums collected. But FEMA does not systematically consider actual flood insurance expense information when calculating these payments and has not aligned its WYO bonus structure with NFIP goals or implemented all of its financial controls for the WYO program. GAO also found that FEMA did not consistently follow its procedures for monitoring non-WYO contractors or coordinate contract monitoring responsibilities among departments on some contracts. Some contract monitoring records were missing, and no system was in place that would allow departments to share information on contractor deficiencies. In ongoing GAO work examining FEMA's management of NFIP, some similar issues are emerging. For example, FEMA still lacks an effective system to manage flood insurance policy and claims data, despite investing roughly 7 years and $40 million on a new system whose development has been halted. However, FEMA has begun to acknowledge its management challenges and develop a plan of action.

Addressing the financial challenges facing NFIP would likely require actions by both FEMA and Congress that involve trade-offs, and the challenges could be difficult to remedy. For example, reducing subsidies could increase collected premiums but reduce program participation. At the same time, FEMA must address its operational and management issues. GAO has recommended a number of actions that FEMA could take to improve NFIP operations, and ongoing work will likely identify additional issues.

Chairwoman Waters, Ranking Member Capito, and Members of the Subcommittee:

I appreciate the opportunity to participate in today's hearing on the National Flood Insurance Program (NFIP) and the challenges that the Federal Emergency Management Administration (FEMA) faces in administering it. As you know, NFIP is a key component of the federal government's efforts to minimize the damage and financial impact of floods and is the only source of insurance against flood damage for most residents in flood-prone areas. GAO placed NFIP on its high-risk list in March 2006, not only because of the program's potential to incur billions of dollars in losses and the many financial challenges it faces, but also because of operational and management challenges within FEMA, many of which we have identified in previous reports to Congress.

As of April 2010, NFIP owed approximately $18.8 billion to the U.S. Treasury, primarily as a result of loans the program received to pay claims from the 2005 hurricane season. NFIP borrowed additional funds from Treasury to make interest payments on this debt and is unlikely ever to be able to repay the entire amount. These revenue shortfalls reflect both the devastating effects of catastrophic hurricanes and structural weaknesses in the way the program is funded. Our previous reports identified many of these weaknesses, including subsidized premium rates, rate-setting methods that do not reflect the actual risk of losses due to flooding, and claims arising from a small number of repetitive loss properties.[1] We have also previously identified management issues, particularly with respect to FEMA's oversight of write-your-own (WYO) insurers. We are currently conducting a comprehensive review of NFIP management and other ongoing challenges that FEMA faces in administering the program.

My testimony today will revisit and update the challenges we identified in previous reports, specifically (1) NFIP's financial challenges, (2) FEMA's operational and management challenges relating to NFIP, and (3) actions needed to address these challenges. My statement is based largely on completed work on the oversight of the WYO program, the financial impact of subsidized premium rates, and the rate-setting process for flood insurance premiums. We performed our work in accordance with generally accepted government auditing standards. Those standards

[1]Repetitive loss properties are properties that have had two or more paid NFIP claims in a 10-year period.

require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence we obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Summary

Congress and FEMA intended that the NFIP's operating expenses and flood insurance claims would be paid with premiums collected by the program rather than with tax dollars. But the program is, by design, not actuarially sound, for several reasons. First, NFIP does not operate like private insurance companies. For example, FEMA is not structured to build a capital surplus, is likely unable to purchase reinsurance to cover high or catastrophic losses, cannot accept or reject applicants to help manage risk, and is subject to statutory limits on rate increases. Second, many property owners are paying premium rates that do not reflect the full, long-term risk of flooding. Almost 25 percent of property owners pay subsidized premium rates, and even "full-risk" premium rates may not reflect the actual risk of flooding. Further NFIP allows some property owners to continue to pay rates that do not reflect reassessments of their properties' flood risk ("grandfathered" rates). Finally, NFIP must continue to insure repetitive loss properties, which represent only 1 percent of flood insurance policies but account for 25 to 30 percent of claims. FEMA has taken some encouraging steps toward improving its financial position, including making nearly $600 million in interest payments to the U.S. Treasury since March 2009 without increasing its borrowing. It has also increased its collected premiums by 28 percent since September 2006 and expanded its policy base by more than 25 percent, due at least in part to its FloodSmart program.[2]

Several operational and management issues may limit FEMA's progress in addressing NFIP's financial challenges and achieving the program's goals. For example, WYO insurers play a key role in NFIP operations, and payments to them represent from one-third to two-thirds of premiums received. But in previous reports we found that, among other internal control weaknesses, FEMA did not systematically consider actual flood insurance expense information when determining payments to WYO insurers, had not aligned its WYO bonus structure with NFIP's goals, and

[2]FloodSmart is an integrated mass marketing campaign FEMA launched in 2004 to educate the public about the risks of flooding and to encourage the purchase of flood insurance.

had not implemented many of its planned financial controls for the WYO program.[3] Further, contractors other than WYO insurers are responsible for performing key NFIP functions, such as collecting NFIP data and marketing the program. However, we have also found problems with oversight of these contractors. Specifically, FEMA did not consistently follow its procedures for monitoring contractors, did not always coordinate contract monitoring responsibilities among various agency departments on some of the contracts we reviewed, lacked contract monitoring records, and did not have a system in place that would allow various departments to share information relating to contractor deficiencies. Further, preliminary results of our ongoing work revealed that FEMA continues to lack an effective system to manage flood insurance policy and claims data, despite having invested roughly 7 years and $40 million in a new system whose development has been halted because it did not meet user needs and was not ready to replace the legacy system.

Addressing the financial and operational challenges facing NFIP would require actions from both Congress and FEMA. We recognize that any such actions would involve significant trade-offs and that some financial challenges would be difficult to remedy. For instance, possible reform options to make premium rates more reflective of long-term flood risks include eliminating, reducing, or targeting premium subsidies based on need. But taking any of these steps would raise rates and potentially reduce participation in NFIP. FEMA and Congress could also address the impact of repetitive loss properties by expanding mitigation efforts to target those properties that are at highest risk.[4] However, doing so would include actions such as elevation, relocation, and demolition that would be costly to taxpayers and could take years. Congress could also amend laws regarding coverage for homeowners who refuse to mitigate and streamline the various mitigation grant programs within FEMA. In our past work, we also identified a number of management challenges that FEMA would have to address, including improvements to oversight of WYO insurers and its payments to them, updating the NFIP rate-setting process, fully applying internal controls, and strengthening oversight of its contractors, among others.

[3] See GAO, *Flood Insurance: Opportunities Exist to Improve Oversight of the WYO Program*, GAO-09-455 (Washington, D.C.: Aug. 21, 2009).

[4] Mitigation involves taking steps to reduce a property's flood risk—for example, elevating a house above a certain flood level.

Background

The National Flood Insurance Act of 1968 established NFIP as an alternative to providing direct disaster assistance after floods.[5] NFIP, which provides government-guaranteed flood insurance to homeowners and businesses, was intended to reduce the federal government's escalating costs for repairing flood damage after disasters. FEMA, which is within the Department of Homeland Security (DHS), is responsible for the oversight and management of NFIP. Since the program's inception, Congress has enacted several pieces of legislation to strengthen it. The Flood Disaster Protection Act of 1973 made flood insurance mandatory for owners of properties in vulnerable areas who had mortgages from federally regulated lenders and provided additional incentives for communities to join the program.[6] The National Flood Insurance Reform Act of 1994 strengthened the mandatory purchase requirements for owners of properties located in special flood hazard areas (SFHA) with mortgages from federally regulated lenders.[7] Finally, the Bunning-Bereuter-Blumenauer Flood Insurance Reform Act of 2004 authorized grant programs to mitigate properties that experienced repetitive flood losses. Owners of these repetitive loss properties who do not mitigate face higher premiums.[8]

To participate in NFIP, communities agree to enforce regulations for land use and new construction in high-risk flood zones and to adopt and enforce state and community floodplain management regulations to reduce future flood damage. Currently, more than 20,000 communities participate in NFIP. NFIP has mapped flood risks across the country, assigning flood zone designations based on risk levels, and these designations are a factor in determining premium rates. NFIP offers two types of flood insurance premiums: subsidized and full-risk. The National Flood Insurance Act of 1968 authorizes NFIP to offer subsidized premiums to owners of certain properties. These subsidized premium rates, which represent only about 35 to 40 percent of the cost of covering the full risk of flood damage to the properties, account for about 22 percent of all NFIP policies. To help reduce or eliminate the long-term risk of flood damage to buildings and other structures insured by NFIP, FEMA has used a variety of mitigation efforts, such as elevation, relocation, and demolition. Despite

[5] Pub. L. No. 90-448, Title XIII, 82 Stat. 476 (1968).

[6] Pub. L. No. 93-234, § 102, 87 Stat. 975, 978 (1973).

[7] Pub. L. No. 103-325, 108 Stat. 2255 (1994).

[8] Pub. L. No. 108-264, §§ 102, 104, 118 Stat. 712, 714, 722 (2004).

these efforts, the inventories of repetitive loss properties and policies with subsidized premium rates have continued to grow. In response to the magnitude and severity of the losses from the 2005 hurricanes, Congress increased NFIP's borrowing authority from the Department of the Treasury (Treasury) to $20.775 billion. As of April 2010, FEMA owed Treasury $18.8 billion, and the program as currently designed will likely not generate sufficient revenues to repay this debt.

NFIP's Financial Challenges Have Increased the Federal Government's and U.S. Taxpayers' Financial Exposure from Flood Losses

By design, NFIP is not an actuarially sound program, in part because it does not operate like many private insurance companies. As a government program, its primary public policy goal is to provide flood insurance in flood-prone areas to property owners who otherwise would not be able to obtain it. Yet NFIP is also expected to cover its claims losses and operating expenses with the premiums it collects, much like a private insurer. In years when flooding has not been catastrophic, NFIP has generally managed to meet these competing goals. In years of catastrophic flooding, however, and especially during the 2005 hurricane season, it has not.

NFIP's operations differ from those of most private insurers in a number of ways. First, it operates on a cash-flow basis and has the authority to borrow from Treasury. As of April 2010, NFIP owed approximately $18.8 billion to Treasury, primarily as a result of loans that the program received to pay claims from the 2005 hurricane season. NFIP will likely not be able to meet its interest payments in most years, and the debt may continue to grow as the program may need to borrow to meet the interest payments and potential future flood losses. Also unlike private insurance companies, NFIP assumes all the risk for the policies it sells. Private insurers typically retain only part of the risk that they accept from policyholders, ceding a portion of the risk to reinsurers (insurance for insurers). This mechanism is particularly important in the case of insurance for catastrophic events, because the availability of reinsurance allows an insurer to limit the possibility that it will experience losses beyond its ability to pay. NFIP's lack of reinsurance, combined with the lack of structure to build a capital surplus, transfers much of the financial risk of flooding to Treasury and ultimately the taxpayer.

NFIP is also required to accept virtually all applications for insurance, unlike private insurers, which may reject applicants for a variety of reasons. For example, FEMA cannot deny insurance on the basis of frequent losses. As a result, NFIP is less able to offset the effects of adverse selection—that is, the phenomenon that those who are most likely to purchase insurance are also the most likely to experience losses. Adverse selection may lead to a concentration of policyholders in the riskiest areas. This problem is further compounded by the fact that those at greatest risk are required to purchase NFIP insurance if they have a mortgage from a federally regulated lender. Finally, by law, FEMA is prevented from raising rates on each flood zone by more than 10 percent each year. While most states regulate premium prices for private insurance companies on other lines of insurance, they generally do not set limits on premium rate increases, instead focusing on whether the resulting premium rates are justified by the projected losses and expenses.

NFIP's Premium Rates Do Not Reflect the Full Risk of Flooding

As we have seen, NFIP does not charge rates that reflect the full risk of flooding. NFIP could be placed on a sounder fiscal footing by addressing several elements of its premium structure. For example, as we have pointed out in previous reports, NFIP provides subsidized and grandfathered rates that do not reflect the full risk of potential flood losses to some property owners, operates in part with unreliable and incomplete data on flood risks that make it difficult to set accurate rates, and has not been able to overcome the challenge of repetitive loss properties.[9] Subsidized rates, which are required by law, are perhaps the best-known example of premium rates that do not reflect the actual risk of flooding. These rates, which were authorized from when the program began, were intended to help property owners during the transition to full-risk rates. But today, nearly one out of four of NFIP policies continue to be based on a subsidized rate. These rates allow policyholders with structures that were built before floodplain management regulations were established in their communities to pay premiums that represent about 35 to 40 percent of the actual risk premium. Moreover, FEMA estimates that properties covered by policies with subsidized rates experience as much as five times more flood damage than compliant new structures that are charged full-risk rates. As we have pointed out, the number of policies receiving subsidized rates has grown steadily in recent years and without changes to the program will likely continue to grow, increasing the potential for future NFIP operating deficits.

[9]See GAO, *Flood Insurance: FEMA's Rate-Setting Process Warrants Attention*, GAO-09-12 (Washington, D.C.: Oct. 31, 2008); and *Flood Insurance: Options for Addressing the Financial Impact of Subsidized Premium Rates on the National Flood Insurance Program*, GAO-09-20 (Washington, D.C.: Nov. 14, 2008).

Further, potentially outdated and inaccurate data about flood probabilities and damage claims, as well as outdated flood maps, raise questions about whether full-risk premiums fully reflect the actual risk of flooding. First, some of the data used to estimate the probability of flooding have not been updated since the 1980s. Similarly, the claims data used as inputs to the model may be inaccurate because of incomplete claims records and missing data. Further, some of the maps FEMA uses to set premium rates remain out of date despite recent modernization efforts. For instance, as FEMA continues these modernization efforts, it does not account for ongoing and planned development, making some maps outdated shortly after their completion. Moreover, FEMA does not map for long-term erosion, further increasing the likelihood that data used to set rates are inaccurate. FEMA also sets flood insurance rates on a nationwide basis, failing to account for many topographic factors that are relevant to flood risk for individual properties. Some patterns in historical claims and premium data suggest that NFIP's rates may not accurately reflect individual differences in properties' flood risk. Not accurately reflecting the actual risk of flooding increases the risk that full-risk premiums may not be sufficient to cover future losses and add to concerns about NFIP's financial stability.

Further contributing to NFIP's financial challenges, FEMA made a policy decision to allow certain properties remapped into riskier flood zones to keep their previous lower rates. Like subsidized rates, these "grandfathered" rates do not reflect the actual risk of flooding to the properties and do not generate sufficient premiums to cover expected losses. FEMA officials told us that the decision to grandfather rates was based on considerations of equity, ease of administration, and goals of promoting floodplain management. However, FEMA does not collect data on grandfathered properties or measure their financial impact on the program. As a result, it does not know how many such properties exist, their exact location, or the volume of losses they generate. As FEMA continues its efforts to modernize flood maps across the country, it has continued to face resistance from communities and homeowners when remapping places properties into higher-risk flood zones with higher rates. As a result, FEMA has often grandfathered in previous premium rates that are lower than the remapped rates. However, homeowners who are remapped into high-risk areas and do not currently have flood insurance may be required to purchase it at the full-risk rate.

In reauthorizing NFIP in 2004, Congress noted that repetitive loss properties—those that have had two or more flood insurance claims payments of $1,000 or more over 10 years—constituted a significant drain on NFIP resources. These properties account for about 1 percent of all policies but are estimated to account for up to 30 percent of all NFIP losses. Not all repetitive loss properties are part of the subsidized property inventory, but a high proportion receive subsidized rates, further contributing to NFIP's financial risks. While Congress has made efforts to target these properties, the number of repetitive loss properties has continued to grow, making them an ongoing challenge to NFIP's financial stability.

Despite Its Financial Challenges, NFIP Has Experienced Some Positive Developments

According to FEMA, expanded marketing efforts through its FloodSmart campaign have contributed to an increase in NFIP policies. This program was designed to educate and inform partners, stakeholders, property owners, and renters about insuring their homes and businesses against flood damage. Since the start of the FloodSmart campaign in 2004, NFIP has seen policy growth of more than 25 percent and as of February 2010 had 5.6 million policies in force. Moreover, despite the economic downturn, both policy sales and retention grew in 2009. Correspondingly, NFIP's collected premiums have risen 28 percent since September 2006. This increase, combined with a relatively low loss experience in recent years, has enabled FEMA to make nearly $600 million in interest payments to Treasury with no additional borrowing since March 2009. FEMA has also adjusted its expense reimbursement formula. While these are all encouraging developments, FEMA is still unlikely to ever pay off its current $18.8 billion debt.

FEMA's Operational and Management Issues May Further Limit Progress in Achieving NFIP Goals

We have identified a number of operational issues that affect NFIP, including weaknesses in FEMA's oversight of WYO insurers and shortcomings in its oversight of other contractors, as well as new issues from ongoing work. For example, we found that FEMA does not systematically consider actual flood insurance expense information when determining the amount it pays WYO insurers for selling and servicing flood insurance policies and adjusting claims. Instead, FEMA has used proxies, such as average industry operating expenses for property insurance, to determine the rates at which it pays these insurers, even though their actual flood insurance expense information has been available since 1997. Because FEMA does not systematically consider these data when setting its payment rates, it cannot effectively estimate how much insurers are spending to carry out their obligations to FEMA. Further, FEMA does not compare the WYO insurers' actual expenses to the payments they receive each year and thus cannot determine whether the payments are reasonable in terms of expenses and profits. When GAO compared payments FEMA made to six WYO insurers to their actual expenses for calendar years 2005 through 2007, we found that the payments exceeded actual expenses by $327.1 million, or 16.5 percent of total payments made. By considering actual expense information, FEMA could provide greater transparency and accountability over payments to WYO insurers and potentially save taxpayer money.

FEMA also has not aligned its bonus structure for WYO insurers with NFIP goals such as increasing penetration in low-risk flood zones and among homeowners in all zones that do not have mortgages from federally regulated lenders. FEMA uses a broad-based distribution formula that primarily rewards companies that are new to NFIP and can relatively easily increase their percentage of net policies from a small base. We also found that most WYO insurers generally offered flood insurance when it was requested but did not strategically market the product as a primary insurance line. FEMA has set only one explicit marketing goal—to increase policy growth by 5 percent each year—and does not review the WYO insurers' marketing plans. It therefore lacks the information needed to assess the effectiveness of either the WYO insurers' efforts to increase participation or the bonus program itself. For example, FEMA does not know the extent to which sales increases may reflect external factors such as flood events or its own FloodSmart marketing campaign rather than any effort on the part of the insurers. Having intermediate targeted goals could also help expand program participation, and linking such goals directly to the bonus structure could help ensure that NFIP and WYO goals are in line with each other.

Finally, FEMA has explicit financial control requirements and procedures for the WYO program but has not implemented all aspects of its Financial Control Plan. FEMA's Financial Control Plan provides guidance for WYO insurers to help ensure compliance with the statutory requirements for NFIP. It contains several checks and balances to help ensure that taxpayers' funds are spent appropriately. For an earlier report, we reviewed 10 WYO insurers and found that while FEMA performed most of the required biennial audits and underwriting and claims reviews required under the plan, it rarely or never implemented most of the required audits for cause, state insurance department audits, or marketing, litigation, and customer service operational reviews.[10] In addition, FEMA did not systematically track the outcomes of the various audits, inspections, and

[10]See GAO-09-455.

reviews that it performed. We also found that multiple units had responsibility for helping ensure that WYO insurers complied with each component of the Financial Control Plan; that FEMA did not maintain a single, comprehensive monitoring system that would allow it to ensure compliance with all components of the plan; and that there was no centralized access to all of the documentation produced. Because FEMA does not implement all aspects of the Financial Control Plan, it cannot ensure that WYO insurers are fully complying with program requirements.

In another review, we found that weak internal controls impaired FEMA's ability to maintain effective transaction-level accountability with WYO insurers from fiscal years 2005 through 2007, a period that included the financial activity related to the 2005 Gulf Coast hurricanes.[11] NFIP had limited assurance that its financial data for fiscal years 2005 to 2007 were accurate. This impaired data reliability resulted from weaknesses at all three levels of the NFIP transaction accountability and financial reporting process. At the WYO level, WYO insurer claims loss files did not include the documents necessary to support the claims, and some companies filed reports late, undermining the reliability of the data they did report. Second, contractor-level internal control activities were ineffective in verifying the accuracy of the data that WYO insurers submitted, such as names and addresses. Lastly, at the agency level, financial reporting process controls were not based on transaction-level data. Instead, FEMA relied primarily on summary data compiled using error-prone manual data entry.

FEMA's Oversight of Non-WYO Contractor Activities Is Also Lacking

Also in a previous report, we pointed out that FEMA lacked records of monitoring activities for other contractors, inconsistently followed its procedures for monitoring these contractors, and did not coordinate contract monitoring responsibilities for the two major contracts we reviewed.[12] At FEMA, a Contracting Officer's Technical Representative (COTR) and staff (referred to as "monitors") are responsible for, respectively, ensuring compliance with contract terms and regularly

[11]See GAO, *Financial Management: Improvements Needed in National Flood Insurance Program's Financial Controls and Oversight*, GAO-10-66 (Washington, D.C.: Dec. 22, 2009).

[12]See GAO, *Natural Flood Insurance Program: Financial Challenges Underscore Need for Improved Oversight of Mitigation Programs and Key Contracts*, GAO-08-437 (Washington, D.C.: June 16, 2008).

monitoring and reporting on the extent to which NFIP contractors meet standards in performance areas specified in the contracts. Internal control standards for the federal government state that records should be properly managed and maintained. But FEMA lacked records for the majority of the monitoring reports we requested and did not consistently follow the monitoring procedures for preparing, reviewing, and maintaining monitoring reports.

Further, FEMA offices did not coordinate information and actions relating to contractors' deficiencies and payments, and in some cases key officials were unaware of decisions that were made about contractors' performance. In particular, our review of monitoring reports for one contract revealed a lack of coordination between the COTR and the contracting officer. As a result, FEMA could not ensure that the contractor had adhered to the contract's requirements and lacked information critical to effective oversight of key NFIP data collection, reporting, and insurance functions. Given NFIP's reliance on contractors, it is important that FEMA have in place adequate controls that are consistently applied to all contracts. Consistent with our findings in prior work, the DHS inspector general has also identified weaknesses in FEMA's internal controls and financial reporting related to NFIP.[13]

FEMA Continues to Lack an Effective System to Manage Flood Insurance Policy and Claims Data

To manage the flood policy and claims information that it obtains from insurance companies, NFIP's Bureau and Statistical Agent (BSA) relies on a flood insurance management system from the 1980s that is difficult and costly to sustain and that does not adequately support NFIP's mission needs. This system consists of over 70 interfaced applications that utilize monthly tape and batch submissions of policy and claims data from insurance companies. The system also provides limited access to NFIP data. Further, identifying and correcting errors in submission requires between 30 days and 6 months, and the general claims processing cycle itself is 2 to 3 months.

To address the limitations of this system, NFIP launched a program in 2002 to acquire and implement a modernization and business improvement system, known as NextGen. As envisioned, NextGen was to accelerate

[13]See Department of Homeland Security, Office of the Inspector General, *Independent Auditor's Report on DHS' FY 2009 Financial Statements and Internal Control over Financial Reporting*, DHS-OIG-10-11 (Washington, D.C.: Nov. 13, 2009).

updates to information obtained from insurance companies, identify errors before flood insurance policies went into effect, and enable FEMA to expedite business transactions and responses to NFIP claims when policyholders required urgent support. As such, the system would support the needs of a wide range of NFIP stakeholders, including FEMA headquarters and regional staff, WYO insurers, vendors, state hazard mitigation officers, and NFIP state coordinators.

As part of our ongoing review of FEMA's management of NFIP, preliminary results reveal that despite having invested roughly $40 million over 7 years, FEMA had yet to implement NextGen. Initial versions of NextGen were first deployed for operational use in May 2008. However, shortly thereafter system users reported major problems with the system, including significant data and processing errors. As a result, use of NextGen was halted, and the agency returned to relying exclusively on its mainframe-based legacy system while NextGen underwent additional testing. In late 2009, after this testing showed that the system did not meet user needs and was not ready to replace the legacy system, further development and deployment of NextGen was stopped, and FEMA's Chief Information Officer began an evaluation to determine what, if anything, associated with the system could be salvaged. This evaluation is currently under way, and a date for completing it has yet to be established.

Our ongoing review of FEMA's management of NFIP includes identifying lessons learned about how NextGen was defined, developed, tested, and deployed, including weaknesses in requirements development and management, test management, risk management, executive oversight, and program office staffing that have collectively contributed to the program's failure. In completing its evaluation and deciding how to proceed in meeting its policy and claims processing needs, FEMA could benefit from correcting these weaknesses. In the interim, the agency continues to rely on its outdated legacy system and thus does not have the kind of robust analytical support and information needed to help address the reasons that NFIP remains on GAO's high-risk list of federal programs.

Addressing NFIP's Challenges Would Require Actions from FEMA and Congress

To address the challenges NFIP faces, FEMA would have to address its own operational and management challenges. Further, legislative reform would be needed to address structural issues. However, as you know addressing many of these issues involves public policy trade-offs that would have to be made by Congress. Moreover, part of this process requires determining whether NFIP is or should be structured as an insurance program and how much liability the government can and is willing to accept. For example, if Congress wants to structure NFIP as an insurance company and limit borrowing from Treasury in future high- or catastrophic loss years, NFIP would have to build a capital surplus fund. Our prior work has shown that building such a fund would require charging premium rates that, in some cases, could be more than double or triple current rates and would take a number of years without catastrophic losses to implement. Additionally, while private insurers generally use reinsurance to hedge their risk of catastrophic losses, it is unclear whether the private reinsurance market would be willing to offer coverage to NFIP. In the absence of reinsurance and a surplus fund, Treasury will effectively continue to act as the reinsurer for NFIP and be the financial backstop for the program.

Premium Rates Could Be Made More Reflective of Flood Risk

Making premium rates more reflective of flood risk would require actions by FEMA and Congress. Because subsidized premium rates are required by law, addressing their associated costs would require congressional action. As previously reported, two potential options would be to eliminate or reduce the use of the subsidies over time or target them based on need. However, these options involve trade-offs. For example, eliminating or reducing the subsidies would help ensure that premium rates more accurately reflected the actual risk of loss and could encourage mitigation efforts. But the resulting higher premiums could lead some homeowners to discontinue or not purchase coverage, thus reducing participation in NFIP and potentially increasing the costs to taxpayers of providing disaster assistance in the event of a catastrophe. Targeting subsidies based on need is an approach used by other federal programs and could help ensure that those needing the subsidy would have access to it and retain their coverage. Unlike other agencies that provide—and are allocated funds for—traditional subsidies, NFIP does not receive an appropriation to pay for shortfalls in collected premiums caused by its subsidized rates. However, one option to maintain the subsidies but improve NFIP's financial stability would be to rate all policies at the full-risk rate and to appropriate subsidies for qualified policyholders. In this way, the cost of such subsidies would be more transparent, and policyholders would be better informed of their flood risk. Depending on how such a program was implemented, NFIP might be able to charge more participants rates that more accurately reflected their risk of flooding. However, raising premium rates for some participants could also decrease program participation, and low-income property owners and renters could be discouraged from participating in NFIP if they were required to prove that they met the requirements for a subsidy. FEMA might also face challenges in implementing this option in the midst of other ongoing operational and management challenges.

NFIP's rate-setting process for full-risk premiums may not ensure that those premium rates reflect the actual risk of flooding and therefore may increase NFIP's financial risk. Moreover, FEMA's rate-setting process for subsidized properties depends, in part, on the accuracy of the full-risk rates, raising concerns about how subsidized rates are calculated as well. To address these concerns, we have identified actions that FEMA could take. For example, we recommended that FEMA take steps to help ensure that its rate-setting methods and the data it uses to set rates result in full-risk premium rates that accurately reflect the risk of losses from flooding. In particular, we pointed out that these steps should include verifying the accuracy of flood probabilities, damage estimates, and flood maps and reevaluating the practice of aggregating risks across zones. While FEMA disagreed with our analysis of its rate-setting methods, this area continues to warrant attention.

Similarly, because NFIP allows grandfathered rates for those remapped into high-risk flood zones, it would also be in the position to address some of the challenges associated with this practice. FEMA could end grandfathered rates, but it decided to allow grandfathering after consulting with Congress, its oversight committees, and other stakeholders and considering issues of equity, fairness, and the goal of promoting floodplain management. We recommended that the agency take steps both to ensure that information was collected on the location, number, and losses associated with existing and newly created grandfathered properties in NFIP and to analyze the financial impact of these properties on the flood insurance program.[14] With such information, FEMA and Congress will be better informed on the extent to which these rates contribute to NFIP's financial challenges.

Another statutory requirement that could be revisited is the 10-percent cap on rate increases. As with all the potential reform options, determining whether such action is warranted would necessitate weighing the law's benefits—including limiting financial hardship to policyholders—against the benefits that increasing or removing such limits would provide to NFIP, Treasury, and ultimately the taxpayer. However, as long as caps on rate increases remain, FEMA will continue to face financial challenges.

[14]See GAO-09-12.

Solutions for addressing the impact of repetitive loss properties would also require action by both Congress and FEMA. For example, we have reported that one option for Congress would be to substantially expand mitigation efforts and target these efforts toward the highest-risk properties.[15] Mitigation criteria could be made more stringent—for example, by requiring all insured properties that have filed two or more flood claims (even for small amounts) to mitigate, denying insurance to property owners who refuse or do not respond to a mitigation offer, or some combination of these approaches. While these actions would help reduce losses from flood damage and could ultimately limit costs to taxpayers by decreasing the number of subsidized properties, they would require increased funding for FEMA's mitigation programs to elevate, relocate, or demolish the properties, would be costly to taxpayers, and could take years to complete. Congress could also consider changes to address loopholes in mitigation and repurchase requirements that allow policyholders to avoid mitigating by simply not responding to FEMA's requests that they do so. FEMA could be required to either drop coverage for such properties or use eminent domain to seize them if owners failed to respond to FEMA's mitigation requests. Moreover, Congress could streamline the various mitigation grant programs to make them more efficient and effective.[16]

FEMA Could Take Further Actions to Help Address Operational and Management Challenges

Over the last several years, we have made many recommendations for actions that FEMA could take to improve its management of NFIP. FEMA has implemented some recommendations, including, among other things, introducing a statistically valid method for sampling flood insurance claims for review, establishing a regulatory appeals process for policyholders, and ensuring that WYO insurance agents meet minimum education and training requirements.[17] FEMA has also taken steps to make analyzing the overall results of claims adjustments easier after future flood events. The efforts will help in determining the number and type of claims

[15] See GAO-09-20.

[16] FEMA has five different mitigation grant programs, each with different types of requirements, purposes, and appropriations: Flood Mitigation Assistance (FMA), Repetitive Flood Claims (RFC), Severe Repetitive Loss Pilot Program (SRL), Hazard Mitigation Grant Program (HMGP), and Pre-Disaster Mitigation (PDM).

[17] See 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).

adjustment errors made and deciding whether new, cost-efficient methods for adjusting claims that were introduced after Hurricane Katrina are feasible to use after other flood events.[18] However, as mentioned previously, many of our other previous recommendations have not yet been implemented. For example, we have recommended that FEMA:

- Address challenges to oversight of the WYO program, specifically the lack of transparency of and accountability for the payments FEMA makes to WYO insurers, by determining in advance the amounts built into the payment rates for estimated expenses and profit, annually analyzing the amounts of actual expenses and profit in relation to the estimated amounts used in setting payment rates, and by immediately reassessing the practice of paying WYO insurers an additional 1 percent of written premiums for operating expenses.

- Take steps to better oversee WYO insurers and ensure that they are in compliance with statutory requirements for NFIP and that taxpayers' funds are spent appropriately by consistently following the Financial Control Plan and ensuring that each component is implemented; ensuring that any revised Financial Control Plan covers oversight of all functions of participating WYO insurers, including customer service and litigation expenses; systematically tracking insurance companies' compliance with and performance under each component of the Financial Control Plan; and ensuring centralized access to all the audits, reviews, and data analyses performed for each participating insurance company under the Financial Control Plan.

- Improve NFIP's transaction-level accountability and assure that financial reporting is accurate and that insurance company operations conform to program requirements by augmenting NFIP policies to require contractors to develop procedures for analyzing financial reports in relation to the transaction-level information that WYO insurers submit for statistical purposes; revising required internal control activities for contractors to provide for verifying and validating the reliability of WYO-reported financial information based on a review of a sample of the underlying transactions or events; and obtaining verification that these objectives have been met through independent audits of the WYO insurers.

[18] 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).

- Address contract and management oversight issues that GAO has identified in previous reports, including determining the feasibility of integrating and streamlining numerous existing NFIP financial reporting processes to reduce the risk of errors inherent in the manual recording of accounting transactions into multiple systems; establishing and implementing procedures that require the review of available information, such as the results of biennial audits, operational reviews, and claim reinspections to determine whether the targeted audits for cause should be used; establishing and implementing procedures to schedule and conduct all required operational reviews within the prescribed 3-year period; and establishing and implementing procedures to select statistically representative samples of all claims as a basis for conducting reinspections of claims by general adjusters.

- Address challenges to oversight of contractor activities, including implementing processes to ensure that monitoring reports are submitted on time and systematically reviewed and maintained by the COTR and the Program Management Office; that staff clearly monitor each performance standard the contractor is required to meet in the specified time frames and clearly link monitoring reports and performance areas; that written guidance is implemented for all NFIP-related contracts on how to consistently handle the failure of a contractor to meet performance standards; that written policies and procedures are established governing coordination among FEMA officials and offices when addressing contractor deficiencies; and that financial disincentives are appropriately and consistently applied.

Building on our prior work and these recommendations, we are in the process of conducting a comprehensive review of FEMA's overall management of NFIP that could help FEMA develop a roadmap for identifying and addressing many of the root causes of its operational and management challenges. This review focuses on a wide range of internal management issues including acquisition, contractor oversight, information technology (NextGen), internal controls, human capital, budget and resources, records management, and financial management.[19] While our work is ongoing, we have observed some positive developments

[19]We plan to issue this report later this year. We also are currently reviewing FEMA's flood mapping program at the request of the Chairman of the Subcommittee on Economic Policy, Senator Sherrod Brown, as well as Senators Charles E. Schumer and Jeff Bingaman. In particular, we are determining the extent to which FEMA ensures that flood maps accurately reflect flood risk and how FEMA promotes the community acceptance of flood maps. We plan to issue this report in December 2010.

in the agency's willingness to begin to acknowledge its management issues and the need to address them. FEMA has also taken steps to improve our access to key NFIP staff and information by providing us with an on-site office at one of FEMA's locations, facilitating our ability to access and review documents.

Recent Proposals Could Provide Some Benefits but Also Raise Concerns

As part of our past work, we have also evaluated other proposals related to NFIP. Each of those proposals has potential benefits as well as challenges.

- In a previous report, we discussed some of the challenges associated with implementing a combined federal flood and wind insurance program.[20] While such a program could provide coverage for wind damage to those unable to obtain it in the private market and simplify the claims process for some property owners, it could also pose several challenges. For example, FEMA would need to determine wind hazard prevention standards, adapt existing programs to accommodate wind coverage, create a new rate-setting process, raise awareness of the program, enforce new building codes, and put staff and procedures in place. FEMA would also need to determine how to pay claims in years with catastrophic losses, develop a plan to respond to potential limited participation and adverse selection, and address other trade-offs, including delays in reimbursing participants, litigation, lapses in coverage, underinsured policyholders, and larger-than-expected losses.

- As we have previously reported, private business interruption coverage for flood damage is expensive and is generally purchased only by large companies.[21] Adding business interruption insurance to NFIP could help small businesses obtain coverage that they could not obtain in the private market, but NFIP currently lacks resources and expertise in this area. Adding business interruption insurance could increase NFIP's existing debt and potentially amplify its ongoing management and financial challenges. Insurers told us that underwriting this type of coverage, properly pricing the risk, and adjusting claims was complex.

[20]See GAO, *Natural Catastrophe Insurance: Analysis of a Proposed Combined Federal Flood and Wind Insurance Program*, GAO-08-504 (Washington, D.C.: Apr. 25, 2008).

[21]See GAO, *Information on Proposed Changes to the National Flood Insurance Program*, GAO-09-420R (Washington, D.C.: Feb. 27, 2009).

- Finally, we have reported that creating a catastrophic loss fund to pay larger-than-average annual losses would be challenging, for several reasons.[22] For example NFIP's debt to Treasury would likely prevent NFIP from ever being able to contribute to such a fund. Further, such a fund might not eliminate NFIP's need to borrow for larger-than-expected losses that occurred before the fund was fully financed. Building a fund could also require significant premium rate increases, potentially reducing participation in NFIP.

Closing Comments

FEMA faces a number of ongoing challenges in managing and administering NFIP that, if not addressed, will continue to work against improving the program's long-term financial condition. As you well know, improving NFIP's financial condition involves a set of highly complex, interrelated issues that are likely to involve many trade-offs and have no easy solutions, particularly when the solutions to problems involve balancing the goals of charging rates that reflect the full risk of flooding and encouraging broad participation in the program. In addition, addressing NFIP's current challenges will require the cooperation and participation of many stakeholders.

As we noted when placing NFIP on the high-risk list in 2006, comprehensive reform will likely be needed to address the financial challenges facing the program. In addressing these financial challenges, FEMA will also need to address a number of operational and management challenges before NFIP can be eligible for removal from the list. Our previous work has identified many of the necessary actions that FEMA should take, and preliminary observations from our ongoing work have revealed additional operational and management issues. By addressing both the financial challenges as well as the operational and management issues, NFIP will be in a much stronger position to achieve its goals and ultimately to reduce its burden on the taxpayer.

Chairwoman Waters and Ranking Member Capito, this concludes my prepared statement. I would be pleased to respond to any of the questions you or other members of the Subcommittee may have at this time.

[22] See GAO-09-420R.

GAO Contact and Staff Acknowledgments

Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. For further information about this testimony, please contact Orice Williams Brown at (202) 512-8678 or williamso@gao.gov. This statement was prepared under the direction of Patrick Ward. Key contributors were Tania Calhoun, Emily Chalmers, Nima Patel Edwards, Elena Epps, Christopher Forys, Randy Hite, Tonia Johnson, and Shamiah Kerney.

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