

April 2008

**NATURAL
CATASTROPHE
INSURANCE**

**Analysis of a Proposed
Combined Federal
Flood and Wind
Insurance Program**





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.

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.

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Abbreviations

AAA	American Academy of Actuaries
AIA	American Insurance Association
ASFPM	Association of State Flood Plain Managers
CBO	Congressional Budget Office
CRS	NFIP Community Rating System
FEMA	Federal Emergency Management Agency
NAIC	National Association of Insurance Commissioners
NFDA	National Flood Determination Association
NFIP	National Flood Insurance Program
WYO	Write Your Own

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United States Government Accountability Office
Washington, DC 20548

April 25, 2008

The Honorable Barney Frank
Chairman, Committee on Financial Services
House of Representatives

The Honorable Ginny Browne-Waite
House of Representatives

Hurricanes can cause extensive wind and flood damage that can be devastating to property owners. Determining the extent of the damage caused by each peril can be difficult, leading to disputes between policyholders and private insurers and delays in payments that property owners need for living and rebuilding expenses. For example, in the aftermath of the unprecedented damage as a result of the 2005 hurricanes, disputes emerged between policyholders and insurers over the extent to which damages would be covered under a homeowner's policy when both high winds and flooding occurred. As of November 2007, some of these disputes had yet to be resolved.

Such disputes arise because events such as hurricanes are multiperil events, making determinations of the cause of damage difficult. Private property-casualty insurance policies may cover wind damage but exclude flood damage, and in some cases, the presence of flood damage in addition to wind damage may raise questions about the extent to which wind damage is covered. Adjusters face several challenges in their efforts to determine the cause of damages after multiperil events. For example, the scope of damage following Hurricane Katrina meant that not enough adjusters were available, that the available adjusters had difficulty reaching the properties, and that evidence at the damage scenes was often limited or compromised.

The potential for extensive damages following hurricanes can also mean that insurance in hurricane prone areas (primarily on the eastern and Gulf coasts of the United States) may not be widely available and, when it is, may be unaffordable. In some high-risk areas, insurers have sought to increase their premium rates and reduce their exposure. To address these issues, a number of coastal states have created programs to sell wind insurance in the highest-risk areas within their states. In some states, such as Florida, Mississippi, and North and South Carolina, participation in

these programs has grown tremendously since 2004, exposing the programs to potentially large losses.

In response to these and other concerns, the House of Representatives passed H.R. 3121, the Flood Insurance Reform and Modernization Act of 2007, in September 2007. H.R. 3121 would, among other things, create a federal program to provide coverage for both wind and flood damage.¹ You asked us to evaluate this program in light of current deliberations about the future of the National Flood Insurance Program (NFIP). This report discusses (1) the resources and processes that the Federal Emergency Management Agency (FEMA) would need to implement the program; (2) the steps that FEMA would need to take to determine premium rates that adequately reflected all expected costs; and (3) the possible effects of the program on policyholders, insurance market participants, and the federal government.

To complete our work, we analyzed the provisions of H.R. 3121 that were related to the establishment of a federal flood and wind insurance program. We discussed the potential implications and effects of these provisions with officials from FEMA, the NFIP, the National Association of Insurance Commissioners (NAIC), state insurance regulators, state wind insurance program operators, insurers, reinsurers, insurance and reinsurance associations, insurance agent associations, risk-modeling organizations, actuarial consultants, the American Academy of Actuaries, and others. We also obtained information on state-sponsored wind insurance programs in three coastal states and one inland state and talked with program officials as well as the insurance regulators within those states. In addition, we reviewed academic and other studies of coastal wind insurance issues, Congressional Budget Office (CBO) reviews, and hurricane loss data. Appendix I contains additional information concerning the scope and methodology of our work. We conducted this performance audit from September 2007 to April 2008 in accordance with generally accepted government auditing standards. Those standards 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 obtained

¹ H.R. 3121 uses the term “multiperil coverage,” which it defines as covering losses from physical damage resulting only from flooding or windstorm. For purposes of this report we will use the term “flood and wind coverage” to more specifically indicate the nature of the coverage provided.

provides a reasonable basis for our findings and conclusions based on our audit objectives.

Result in Brief

To implement a combined federal flood and wind insurance program, FEMA would need to complete a number of steps, similar to those undertaken to establish the NFIP, which would require the agency to address several challenges. First, FEMA would need to determine appropriate building codes that communities would be required to adopt in order to participate in the combined program. Second, FEMA would need to adapt existing processes under the NFIP flood program to accommodate the addition of wind coverage. For example, revisions to the Write Your Own (WYO) program, which uses private insurers to sell and underwrite NFIP policies, would need to address the conflict of interest inherent in having these companies sell a federal wind product and their own wind coverage. Third, FEMA would need to create a rate-setting mechanism and process for wind insurance that, according to FEMA officials, would require contractor support. Fourth, promoting the combined 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 is facing a \$17.3 billion deficit and attempting to address several management and oversight challenges associated with the NFIP, and balancing those demands with expanding current staffing capacity and contractor services to administer, operate, and monitor and oversee a new program could further strain FEMA's ability to effectively manage the NFIP.

Setting premium rates that would adequately reflect all expected costs without borrowing from the U.S. Department of the Treasury (Treasury) would require FEMA to make a number of sophisticated determinations. To begin with, FEMA would need to determine what those future costs are likely to be, including costs in years with catastrophic losses. Such determinations can be difficult, particularly in the early years of a program's operations, when little is known about the properties that might be insured, and can have a significant impact on premium rates. Once FEMA has determined the expected future costs of the program, it would need to determine premium rates adequate to cover those costs. Such determinations could be challenging for several reasons. First, the rate would need to be sufficient to pay claims in years with such catastrophic losses without borrowing funds from the Treasury. Under the proposed legislation, if FEMA ever needed to borrow to pay claims—something that could occur in any year given the variability of wind and flood losses regardless of the rate setting process—the program would have to stop

renewing or selling new policies and thus would effectively terminate. Private sector insurers generally use reinsurance—insurance for insurers—to cover potential catastrophic losses, but it is not clear that reinsurers would be willing to sell such coverage to a federal program because of the potential for a large concentration of high-risk properties. The program could attempt to build a surplus large enough to pay catastrophic losses, but doing so would require high premium rates compared to the size of expected claims and an unknown number of years without larger than average losses, over which FEMA has no control. Second, rate setting would have to account for two factors: adverse selection, or the likelihood that the program would insure only the highest-risk properties, and potentially limited participation because of comparatively low coverage limits. Both of these factors would necessitate higher premium rates, which in turn could further limit participation and require even higher premium rates. This circular process, known as an adverse selection spiral, could make rate setting very difficult. Finally, although no distinction between flood and wind damage would be necessary for property owners to receive payment on claims, such a distinction would still be necessary for rate-setting purposes.

A federal flood and wind insurance program could benefit some property owners, state wind insurance programs, and private insurers, but these potential benefits involve trade-offs. For property owners, the program could reduce potential delays in claim payments for wind damage by not requiring adjusters to distinguish between wind and flood damage, potentially avoiding the wind-related payment delays and disputes that followed the hurricanes of 2005. In addition, the program could help ensure that property owners had access to wind coverage in high-risk areas. However, these benefits could be limited if FEMA needed to borrow money to pay claims, potentially shutting down the program and leaving property owners without coverage following a catastrophic event. In addition, comparatively low policy limits could leave some property owners underinsured. The program could also allow private insurers to further reduce their exposure to loss in some high-risk coastal areas, something that several insurers have been attempting to do since the 2005 hurricanes. However, this benefit for insurers could further limit market participation in the provision of catastrophe insurance.² These possible benefits also need to be balanced against the potential for a federal flood

²GAO, *Natural Disasters: Public Policy Options for Changing the Federal Role in Natural Catastrophe Insurance*, [GAO-08-7](#) (Washington, D.C.: Nov. 26, 2007).

and wind program to create an increased exposure for the federal government. Because of the potential for the program to insure only the highest-risk properties, this exposure could be very large. While H.R. 3121 would require premium rates be determined on an actuarial basis—that is, adequate to cover expected costs—estimating future losses is challenging and the potential exists for losses to exceed expectations by a large amount even if the rates are actuarially based, as happened when losses from Hurricane Katrina in 2005 were well beyond what was expected by the NFIP and private sector insurers. If losses for a combined flood and wind program did exceed the premiums collected by the program, FEMA would be forced to borrow from the Treasury to pay those losses, potentially adding to FEMA’s total debt, which as of December 2007 was about \$17.3 billion.

We requested comments on a draft of this report from FEMA and NAIC. FEMA provided written comments that are reprinted in appendix II. NAIC provided oral comments. FEMA and NAIC generally agreed with our report findings. Overall, FEMA commended the report and stressed the challenges it would face in addressing several key issues. Finally FEMA provided technical comments, which we incorporated as appropriate.

Background

Coastal properties in the United States that lie on the Atlantic Ocean and the Gulf of Mexico are at risk of both flood and wind damage from hurricanes. One study put the estimated insured value of coastal property in states on these coasts at \$7.2 trillion as of December 2004, and populations in these areas are growing.³ Property owners can obtain insurance against losses from wind damage through private insurance markets or, in high-risk coastal areas in some states, through state wind insurance programs. Flood insurance is generally excluded from such coverage, but property owners can obtain insurance against losses from flood damage through NFIP, which was established by the National Flood Insurance Act of 1968.⁴

As we have reported, insurance coverage gaps and claims uncertainties can arise when coverage for hurricane damage is divided among multiple

³ Karen M. Clark, “The Coastline at Risk: Estimated Insured Value of Coastal Properties,” AIR Worldwide Corporation (Boston, Massachusetts: Sept. 2005).

⁴ The National Flood Insurance Act of 1968, as amended, is codified at 42 U.S.C. §§ 4001 et seq.

policies because the extent of coverage under each policy depends on the cause of the damages, as determined through the claims adjustment process and the policy terms that cover a particular type of damage.⁵ This adjustment process is complicated when a damaged property has been subjected to a combination of high winds and flooding and evidence at the damage scene is limited. Other claims concerns can arise on such properties when the same insurer serves as both the NFIP's WYO insurer and the property-casualty (wind) insurer. In such cases, the same company is responsible for determining damages and losses to itself and to the NFIP, creating an inherent conflict of interest.

H.R. 3121 Would Create a Combined Federal Flood and Wind Insurance Program

H.R. 3121, the Flood Insurance Reform and Modernization Act of 2007, set an effective date for its proposed flood and wind insurance program of June 28, 2008. A version of this bill, S. 2284, was introduced in the Senate in November of 2007, but this version did not include provisions that would establish a federal flood and wind program. As of March 2008, no additional action had been taken on S. 2284. In a September 26, 2007, Statement of Administration Policy regarding H.R. 3121, the Executive Office of the President stated that the Administration strongly opposes the expansion of NFIP to include coverage for windstorm damage.

H.R. 3121's provisions include the following:

- In order for individual property owners to be eligible to purchase federal flood and wind coverage, their communities must have adopted adequate mitigation measures that the Director of FEMA finds are consistent with the International Code Council's building codes for wind mitigation.⁶
- The Director of FEMA is expected to carry out studies and investigations to determine appropriate wind hazard prevention measures, including laws and regulations relating to land use and zoning; establish criteria based on this work to encourage adoption of adequate state and local measures to help reduce wind damage; and work closely with and provide any technical assistance to state and local governmental agencies to

⁵ GAO, *National Flood Insurance Program: Greater Transparency and Oversight of Wind and Flood Damage Determinations are Needed*, [GAO-08-28](#) (Washington, D.C.: Dec. 28, 2007).

⁶ The International Code Council is a membership association dedicated to building safety and fire prevention. It develops the codes used to construct residential and commercial buildings, including homes and schools.

encourage the application of these criteria and the adoption and enforcement of these measures.

- Property owners who purchase a combined federal flood and wind insurance policy cannot also purchase an NFIP flood insurance policy.
- Federal flood and wind insurance will cover losses only from physical damage from flood and windstorm (including hurricanes, tornadoes, and other wind events), but no distinction between flood and wind damage need be made in order for claims to be paid.
- Premium rates are to be based on risk levels and accepted actuarial principles and will include all operating costs and administrative expenses.
- Residential property owners can obtain up to \$500,000 in coverage for damages to any single-family structure and up to \$150,000 in coverage for damage to contents and any necessary increases in living expenses incurred when losses from flooding or windstorm make the residence unfit to live in.
- Nonresidential property owners can obtain up to \$1,000,000 in coverage for damages to any single structure and up to \$750,000 in coverage for damage to contents and for losses resulting from an interruption of business operations caused by damage to, or loss of, the property from flooding or windstorm;
- If at any time FEMA borrows funds from the Treasury to pay claims under the federal flood and wind program, until those funds are repaid the program may not sell any new policies or renew any existing policies.

NFIP Is Designed to Offer Federally Backed Flood Insurance but Not to Be Actuarially Sound

Over 20,000 communities across the United States and its territories participate in the NFIP by adopting and agreeing to enforce state and community floodplain management regulations to reduce future flood damage. In exchange, the NFIP makes federally backed flood insurance available to homeowners and other property owners in these communities. Homeowners with mortgages from federally regulated lenders on property in communities identified to be in special high-risk flood hazard areas are required to purchase flood insurance on their dwellings. Optional, lower-cost coverage is also available under the NFIP to protect homes in areas of low to moderate risk. Premium amounts vary according to the amount of coverage purchased and the location and characteristics of the property to be insured.

When the NFIP was created, Congress mandated that it was to be implemented using “workable methods of pooling risks, minimizing costs, and distributing burdens equitably” among policyholders and taxpayers in general.⁷ The program aims to make reasonably priced coverage available to those who need it.⁸ The NFIP attempts to strike a balance between the scope of the coverage provided and the premium amounts required to provide that coverage and, to the extent possible, the program is designed to pay operating expenses and flood insurance claims with premiums collected on flood insurance policies rather than tax dollars. However, as we have reported before, the program, by design, is not actuarially sound because Congress authorized subsidized insurance rates for some policies 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 In 2005, Hurricanes Katrina, Rita, and Wilma had a far-reaching impact on NFIP’s financial solvency. Legislation incrementally increased FEMA’s borrowing authority from a total of \$1.5 billion prior to Hurricane Katrina to \$20.8 billion by March 2006, and as of December 2007, FEMA’s outstanding debt to the Treasury was \$17.3 billion. As we have reported, it is unlikely that FEMA can repay a debt of this size and pay future claims in a program that generates premium income of about \$2 billion per year.¹¹

⁷ National Flood Insurance Act of 1968, Pub.L No. 90-448, § 1302 (d), 82 Stat. 476, 572 (1968), codified at 42 U.S.C. § 4001(d).

⁸ *Id.*, at Section 1302(a)(4), codified at 42 U.S.C. § 4001(a)(4).

⁹ GAO, *Flood Insurance: Information on the Financial Condition of the National Flood Insurance Program*, [GAO-01-992T](#) (Washington, D.C.: July 19, 2001).

¹⁰ See 42 U.S.C. § 4016.

¹¹ See GAO, *Federal Emergency Management Agency: Challenges for the National Flood Insurance Program*, [GAO-06-335T](#) (Washington, D.C.: Jan. 25, 2006).

Implementing a Combined Federal Flood and Wind Insurance Program Would Require FEMA to Address Several Management Challenges

To implement a combined federal flood and wind insurance program, FEMA would need to complete a number of steps, similar to those undertaken to establish the NFIP, which would require the agency to address several challenges. First, FEMA would need to undertake studies in order to determine appropriate building codes that communities would be required to adopt in order to participate in the combined program. Second, FEMA would need to adapt existing processes under the NFIP flood program to accommodate the addition of wind coverage. For example, FEMA could leverage current processes under the WYO program and the Direct Service program to perform the administrative functions of selling and servicing the combined federal flood and wind insurance policy. Third, to set wind rates, FEMA would have to create a rate-setting structure, which would require contractor support. Fourth, promoting the combined federal flood and wind insurance 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 is facing a \$17.3 billion deficit and attempting to address several management and oversight challenges associated with the NFIP, and balancing those demands with expanding staffing capacity to adjust existing administrative, operational, monitoring, and oversight processes and establish new ones to accommodate wind coverage could further strain FEMA's ability to effectively manage the NFIP.

FEMA Would Need to Determine Appropriate Building Codes

H.R. 3121 would require FEMA to determine appropriate wind mitigation measures that communities would be required to adopt in order to participate in the combined flood and wind program. For several reasons, this could be a challenging process. First, FEMA would have to determine how to most effectively integrate a new federal wind mitigation standard with existing building codes for wind resistance. As we discussed in a previous report, as of January 2007, the majority of states had adopted some version of a model building code for commercial and residential structures.¹² However, some local jurisdictions within states had not adopted a statewide model code and had modified the codes to reflect local hazards. Standards determined by FEMA to be appropriate for participation in the combined federal flood and wind program could

¹² GAO, *Natural Hazard Mitigation: Various Mitigation Efforts Exist, but Federal Efforts Do Not Provide a Comprehensive Strategic Framework*, [GAO-07-403](#) (Washington, D.C.: Aug. 22, 2007).

conflict with those currently used by some states and local jurisdictions, and resolving any such differences could be challenging.

Second, as it did with the NFIP, FEMA would have to address constitutional issues related to federal regulation of state and local code enforcement. Further, FEMA would need to establish regulations similar to those governing the flood program to allow for appeals by local jurisdictions, a process that could be time intensive. Third, as we have noted in a previous report, reaching agreement with communities on appropriate mitigation measures can be challenging, as communities often resist changes to building standards and zoning regulations because of the potential impact on economic development.¹³ For example, community goals such as housing and promoting economic development may be higher priorities for the community than formulating mitigation regulations that may include more rigorous developmental regulations and building codes. Fourth, according to FEMA officials, the agency would have to resolve potentially conflicting wind and flood standards. For example, they told us that flood building standards require some homes to be raised off the ground, but doing so can increase a building's susceptibility to wind damage because the buildings are then at a higher elevation.

FEMA Would Need to Adapt Existing NFIP Processes for Wind Coverage

While some of the NFIP's current processes could be leveraged to implement a combined federal flood and wind program, they would need to be revised, an action that could pose further challenges for FEMA. According to FEMA officials, both the NFIP's WYO and Direct Service programs could be used, with some revisions, to sell and underwrite the combined federal flood and wind insurance policy. The provision within H.R. 3121 that prevents FEMA from selling new policies or renewing existing policies if it borrows funds to pay claims would necessitate that the agency segregate funds collected from premiums under the new combined program and the flood program to ensure that it has sufficient funds to cover all future costs without borrowing, especially in catastrophic loss years. While the NFIP Community Rating System (CRS), a program that uses insurance premium discounts to incentivize flood damage mitigation activities by participating communities, could be adapted for combined federal flood and wind insurance coverage, it would

¹³ [GAO-07-403](#).

The WYO Program Could Be Used, but Would Need to Be Expanded

not be required for the new program to begin operations because community participation in CRS is voluntary.¹⁴

As part of the WYO program, private property-casualty insurers are responsible for selling and servicing NFIP policies, including performing the claims adjustment activities to assess the cause and extent of damages.¹⁵ FEMA is responsible for managing the program, including establishing and updating NFIP regulations, analyzing data to determine flood insurance rates, and offering training to insurance agents and adjusters. In addition, FEMA and its program contractor are responsible for monitoring and overseeing the quality of the performance of the WYO insurance companies to ensure that NFIP is administered properly. These duties under the WYO program would be amplified with the addition of wind coverage and, according to FEMA officials, would require FEMA to expand the staffing capacity to include those with wind peril insurance experience. In addition, FEMA would need to determine whether existing data systems would be adequate to manage an increased number of policies and track losses for the new program.

FEMA could face several challenges in expanding the WYO program. First, program staff would need to determine how to manage and mitigate the potential conflict of interest for those companies in the WYO program that could be selling both their own wind coverage and the combined federal flood and wind coverage. Current WYO arrangements with the NFIP prevent WYO insurers from offering flood-only coverage of their own unless it supplements NFIP coverage limits or is part of a larger policy in which flooding is one of the several perils covered. H.R. 3121, however, does not appear to prevent companies that might sell a combined federal flood and wind policy from also selling wind coverage, which may be part of a homeowners policy. Without this restriction, a conflict of interest could develop because insurers would have an incentive to sell the combined federal policy to its highest-risk customers and their own policies to lower-risk customers. FEMA officials agreed that this would be an inherent conflict and noted that it would be difficult to prevent this

¹⁴ The CRS is a voluntary incentive program that recognizes and encourages community floodplain management activities that exceed the minimum NFIP requirements, and as a result, flood insurance premium rates are discounted to reflect the reduced flood risk resulting from the community actions.

¹⁵ NFIP contracts with private insurers to sell and administer flood insurance policies through the WYO arrangement, allowing the insurers to write flood policies backed by the federal government.

from occurring without precluding the WYO insurers from selling their wind policies. Moreover, according to a WYO insurer with whom we spoke, attempting to eliminate the conflict by either restricting a WYO insurer from selling its own wind coverage or requiring it to sell both flood-only and the combined policy could discourage participation in the WYO program. As noted in a previous report, private sector WYO program managers have said that while NFIP has many positive aspects, working with it is complex for policyholders, agents, and adjusters.¹⁶ According to another WYO insurer we spoke with, adding wind coverage could increase these complexities.

NFIP's Direct Service Program Could Also Be Used, but Would Need to Be Expanded

FEMA officials told us that the agency could also sell and service the combined flood and wind insurance policies through its Direct Service program, which is designed for agents who do not have agreements or contracts with insurance companies that are part of the WYO program. According to FEMA officials, the Direct Service program of NFIP currently writes about 3 percent of the more than 5.5 million NFIP policies sold. Further, as with the WYO program, FEMA may have to contend with an inherent conflict of interest, and expand staffing capacity including adding staff with wind peril insurance expertise in the Direct Service program to administer, monitor, and oversee the sale of the new product.

The CRS Program, while Not Necessary to Initiate the Program, Would Also Need to Be Expanded

H.R. 3121 calls for FEMA to establish comprehensive criteria designed to encourage communities to participate in wind mitigation activities. As previously noted, the CRS program would be an important means of incentivizing wind mitigation activities in communities, but would not be necessary for the combined federal flood and wind insurance program to operate. According to FEMA, while the CRS process could be adapted for wind coverage, the agency would have to assess current practices, evaluate standards, and devise an appropriate rating system; a developmental process similar to what occurred for the NFIP. FEMA officials told us that it took approximately 5 years to develop the program, during which time extensive evaluation, research, and concept testing occurred. They estimate that replicating a similar approach for wind hazard would require at least the same number of years if not more, recognizing the complexities of current insurance industry experience associated with the wind peril and the complexities involved with

¹⁶ GAO, *NFIP: Oversight of Policy Issuance and Claims*, [GAO-05-532T](#) (Washington, D.C. Apr. 14, 2005)

evaluating current building code practices related to wind and other wind mitigation techniques.

NFIP Would Need to Establish a New Rate-Setting Structure for Combined Flood and Wind Premiums

Establishing a new rate-setting structure for a combined federal flood and wind insurance program could pose another challenge for FEMA. According to several insurers and modeling consultants, wind modeling is the accepted method of determining wind-related premium rates, and FEMA does not have the necessary in-house wind modeling and actuarial expertise needed to develop and interpret wind models and translate the model's output into premium rates.¹⁷ They told us that modeling has several advantages in rate setting over methods that place greater emphasis on loss data from past catastrophic events, such as the method used by NFIP to determine flood insurance premium rates. For example, modeling uses wind speed maps and other data to account for the probability that properties in a certain geographic area might experience losses in the future, regardless of whether those properties have experienced losses in the past. In addition, according to a modeling expert, wind modeling incorporates mitigation efforts at the property level because it can estimate the potential reductions in damage without waiting to see how the efforts actually affect losses during a storm or other event. While several modeling companies that are already providing wind modeling to private sector insurers and state wind insurance programs exist, it is not clear how much such services would cost FEMA. And while FEMA officials told us that the agency would have to contract out for wind-modeling services because it lacks the necessary wind and actuarial expertise, the agency could benefit from at least some in-house expertise in these areas in order to oversee the contractors that will provide these services.

FEMA would also need to determine to what extent it might need to use wind speed maps in its rate determination process. Flood maps are

¹⁷ According to insurance market participants, many, if not all, insurance companies and state authorities currently use computer programs offered by several modeling firms to estimate the financial consequences of various natural catastrophe scenarios and manage their financial exposures. To generate the loss estimates, the computer programs use large databases that catalog the past incidence and severity of natural catastrophes as well as proprietary insurance company data on policies written in particular states or areas. Using the estimates provided by these computer programs, insurers can attempt to manage their exposures in particular high-risk areas. GAO, *Catastrophe Risk: U.S. and European Approaches to Insure Natural Catastrophe and Insurance Risks*, [GAO-05-199](#) (Washington, D.C.: Feb. 28, 2005).

currently used in the NFIP to identify areas that are at risk of flooding and thus the areas where property owners would benefit from purchasing flood insurance. If FEMA determined that wind maps were necessary, it would then need to determine whether the agency could develop such maps on its own or whether contracting with wind-modeling experts would be required, and what the cost of these efforts might be.

FEMA Would Need to Promote Participation in a Combined Federal Flood and Wind Insurance Program and Coordinate Enforcement

Implementing the combined program would require FEMA to promote participation among communities and coordinate enforcement, a task that could be challenging for FEMA for two reasons. First, FEMA would need to manage community and state eligibility to participate in the program. The proposal calls for FEMA to work closely with and provide any necessary technical assistance to state, interstate, and local governmental agencies, to encourage the adoption of windstorm damage mitigation measures by local communities and ensure proper enforcement. While communities themselves are responsible for enforcing windstorm mitigation measures, FEMA officials told us they would have to coordinate with existing code groups to provide technical assistance training and guidance to local officials, and establish a wind mitigation code enforcement compliance program that would monitor, track, and verify community compliance with wind mitigation codes. According to an official at an organization representing flood hazard specialists, some communities are very good at ensuring compliance, while others are not. For example, in some larger communities, a city or county may have experts with vast experience in enforcing building codes and land use standards, but in other communities, a local clerk or city manager with little or no experience may be responsible for compliance. According to FEMA, the effectiveness of mitigation measures is entirely dependent on enforcement at the local level. Proper enforcement would require that resources were in place to pay for and train qualified inspectors and building department staff.

Second, FEMA would need to generate public awareness on the availability of wind insurance through the NFIP. Efforts to adopt new mitigation activities and strategies have been constrained by the general public's lack of awareness and understanding about the risk from natural hazards. To address this issue in NFIP, FEMA launched an integrated mass marketing campaign called FloodSmart to educate the public about the risks of flooding and to encourage the purchase of flood insurance. As we have noted in a previous report, according to FEMA officials, in a little more than 2 years since the contract began, in October 2003, net policy growth was a little more than 7 percent and policy retention improved

from 88 percent to 91 percent.¹⁸ Educating the public on a new combined federal flood and wind insurance program and promoting community participation could demand a similar level of effort by FEMA to encourage participation.

Expanding FEMA to Implement a Combined Federal Flood and Wind Insurance Program Could Add to Existing NFIP Management Challenges

Implementing a combined flood and wind insurance program and overseeing the requisite contractor-supported services could place additional strain on FEMA, which is already faced with NFIP management and oversight challenges and a \$17.3 billion deficit that it is unlikely to be able to repay. In March 2006, we placed the NFIP on our high-risk list because of its fiscal and management challenges.¹⁹ In addition to the agency's current debt owed to the Treasury, FEMA is challenged with providing effective oversight of contractors. For example, as previously reported, FEMA faces challenges in providing effective oversight of the insurance companies and thousands of insurance agents and claims adjusters that are primarily responsible for the day-to-day process of selling and servicing flood insurance policies through the WYO program.²⁰ In FEMA's claims adjustment oversight, the agency cannot be certain of the quality of NFIP claims adjustments that allocate damage to flooding in cases involving damage caused by a combination of wind and flooding.²¹ Expanding the WYO program to include combined flood and wind policies could increase the NFIP's oversight responsibilities as well as make resolving existing management challenges more difficult. In addition, FEMA faces ongoing challenges in working with contractors and state and local partners—all with varying technical capabilities and resources—in its map modernization efforts, which are designed to produce accurate digital flood maps.²² Ensuring that map standards are consistently applied across communities once the maps are created will also be a challenge. To the extent that FEMA uses wind speed maps under the combined program, the agency could face challenges similar to those currently faced by the NFIP's flood-mapping program.

¹⁸ GAO, *Federal Emergency Management Agency: Challenges for the National Flood Insurance Program*, [GAO-06-335T](#) (Washington, D.C.: Jan. 25, 2006).

¹⁹ GAO, *GAO's High-Risk Program*, [GAO-06-497T](#) (Washington, D.C.: Mar. 15, 2006).

²⁰ GAO, *Federal Emergency Management Agency: Ongoing Challenges Facing the National Flood Insurance Program*, [GAO-08-118T](#) (Washington, D.C.: Oct. 2, 2007).

²¹ [GAO-08-28](#).

²² [GAO-08-118T](#).

New management challenges created by implementing a combined federal flood and wind program could make addressing these existing challenges even more difficult. According to FEMA officials, implementing a new flood and wind program is a process that would likely take several years and would require a doubling of current staff levels. Determining appropriate wind mitigation measures, adapting existing WYO and Direct Service processes for wind coverage, establishing a new rate-setting process, promoting community participation, and overseeing the combined program would all require additional staff and contractor services with the appropriate wind expertise. While the total cost of adding staff and hiring contractors with wind expertise is not clear, FEMA's 2007 budget for NFIP salaries and expenses was about \$38.2 million.

FEMA Would Need to Set Premium Rates for the Flood and Wind Program Adequate to Cover All Future and Catastrophic Losses without Borrowing

Setting premium rates that would adequately reflect all expected costs without borrowing from the Treasury would require FEMA to make a number of sophisticated determinations. To begin with, FEMA would need to determine what those future costs are likely to be, a process that can be particularly difficult with respect to catastrophic losses. Once FEMA has determined the expected future costs of the program, it would need to determine premium rates adequate to cover those costs, a challenging process in itself for several reasons. First, the rate would need to be sufficient to pay claims in years with catastrophic losses without borrowing funds from the Treasury. This determination could be particularly difficult because it is unclear whether the program might be able to purchase reinsurance, and because attempting to build up a sufficient surplus to pay for catastrophic losses would require high premium rates compared to the size of expected claims and an unknown number of years without larger than average losses, over which FEMA has no control. Second, rate setting would have to account for two factors: adverse selection, or the likelihood that the program would insure only the highest-risk properties, and potentially limited participation because of comparatively low coverage limits. Both of these factors would necessitate higher premium rates, which could make rate setting very difficult. Finally, although no distinction between flood and wind damage would be necessary for property owners to receive payment on claims, such a distinction would still be necessary for rate-setting purposes.

FEMA Would Need to Determine the Losses the Program Would Be Required to Pay, Including Losses from Catastrophic Events

The proposed flood and wind program would be required, by statute, to charge premium rates that were actuarially sound—that is, that were adequate to pay all future costs. As a result, in setting rates FEMA would need to determine how much the program would be required to pay, including in years with catastrophic losses, and use this amount in setting rates, as is done by private sector insurers. H.R. 3121 does not specify how a federal flood and wind program would pay for catastrophic losses beyond charging an adequate premium rate. According to insurers and industry consultants we spoke with, making such determinations can be difficult and involve balancing the ability to pay extreme losses with the ability to sell policies at prices people will pay. For example, insurers could charge rates that would allow them to pay claims on the type of event they would expect to occur only very rarely, but the resulting rates could be prohibitively expensive. On the other hand, charging premium rates that would enable an insurer to pay losses on events of limited severity could allow them to sell policies at a lower price, but could also result in insufficient funds to pay losses if a larger loss were to occur. Insurers can come to different conclusions over the appropriate level of catastrophic losses on which to base their premium rates. For example, one state regulator said that some private sector insurers in his state used an event he believes has about a 0.4 percent chance of occurring in a given year, but that the state wind insurance program based its rates on events he believes have about a 1 percent chance of occurring. For comparison, one consultant we spoke with believed that an event of the severity of Hurricane Katrina had about a 7 percent chance of occurring in a given year.

Determining the losses the program might be required to pay, especially in the event of a catastrophic event, could be especially important for FEMA. This is because if an event occurs that generates losses beyond an amount the program is prepared to pay, the program would be forced to borrow funds to pay those losses, triggering a borrowing restriction that would force it to stop renewing or selling new policies, effectively ending the program. On the other hand, premium rates high enough to pay losses resulting from the most severe catastrophic events might make the program prohibitively expensive for property owners.

Determining expected losses for the first year of the program would be complicated by the fact that FEMA would not know what type of properties would be insured. Private sector insurers set their premium rates using models that take into account several variables, including the number of properties to be insured, the risks associated with the properties' location, and the characteristics of the properties themselves.

This information is used in the wind-modeling process to create a variety of scenarios that result in losses of differing severity that can then be used to create possible premium rates. Existing insurers have established portfolios of policies and can use data from these portfolios in the modeling process. A new combined federal flood and wind insurance program, according to wind-modeling companies we spoke with, would need to develop a hypothetical portfolio, making assumptions about how many policies it might sell and where, as well as the characteristics of the properties that might be insured. Such assumptions can be challenging because the number and type of properties insured will, in turn, be affected by the price of coverage.

FEMA Would Need to Determine a Premium Rate That Is Adequate to Pay for Expected Losses without Borrowing

Once FEMA determines the severity of catastrophic losses a federal program would be required to pay, the agency would need to determine a premium rate that is adequate to pay such losses. This determination could be particularly difficult with regard to paying catastrophic losses—something that could occur in any year given the volatility of wind and flood losses—because of the borrowing restriction in H.R. 3121. Because it would be difficult, if not impossible, to repay any borrowed funds without the premium income from new or existing policies, this restriction, if invoked, could end the program. This would effectively require the program to charge premium rates sufficient to pay catastrophic losses without borrowing.

Private sector insurers generally ensure their ability to pay catastrophic losses by purchasing reinsurance, and include the cost of this coverage in the premium rate they charge. However, reinsurance may not be an option for FEMA. Some reinsurance industry officials we spoke with said that the potential for the program to insure a large number of only high-risk properties could create a risk of high losses that could make reinsurers reluctant to offer coverage. Another option would be to charge a premium rate high enough to build up a surplus adequate to pay for catastrophic losses. However, such a rate would likely be high, and it would require an unknown number of years of operations with lower than average losses to build up a sufficient surplus, over which FEMA has no control. For example, a loss that exceeds the program's surplus could occur in the early years, or even the first year, of the program's operations, potentially forcing the program to borrow funds to pay losses and effectively ending the program.

FEMA Would Need to Account for Likely Adverse Selection and Limited Participation

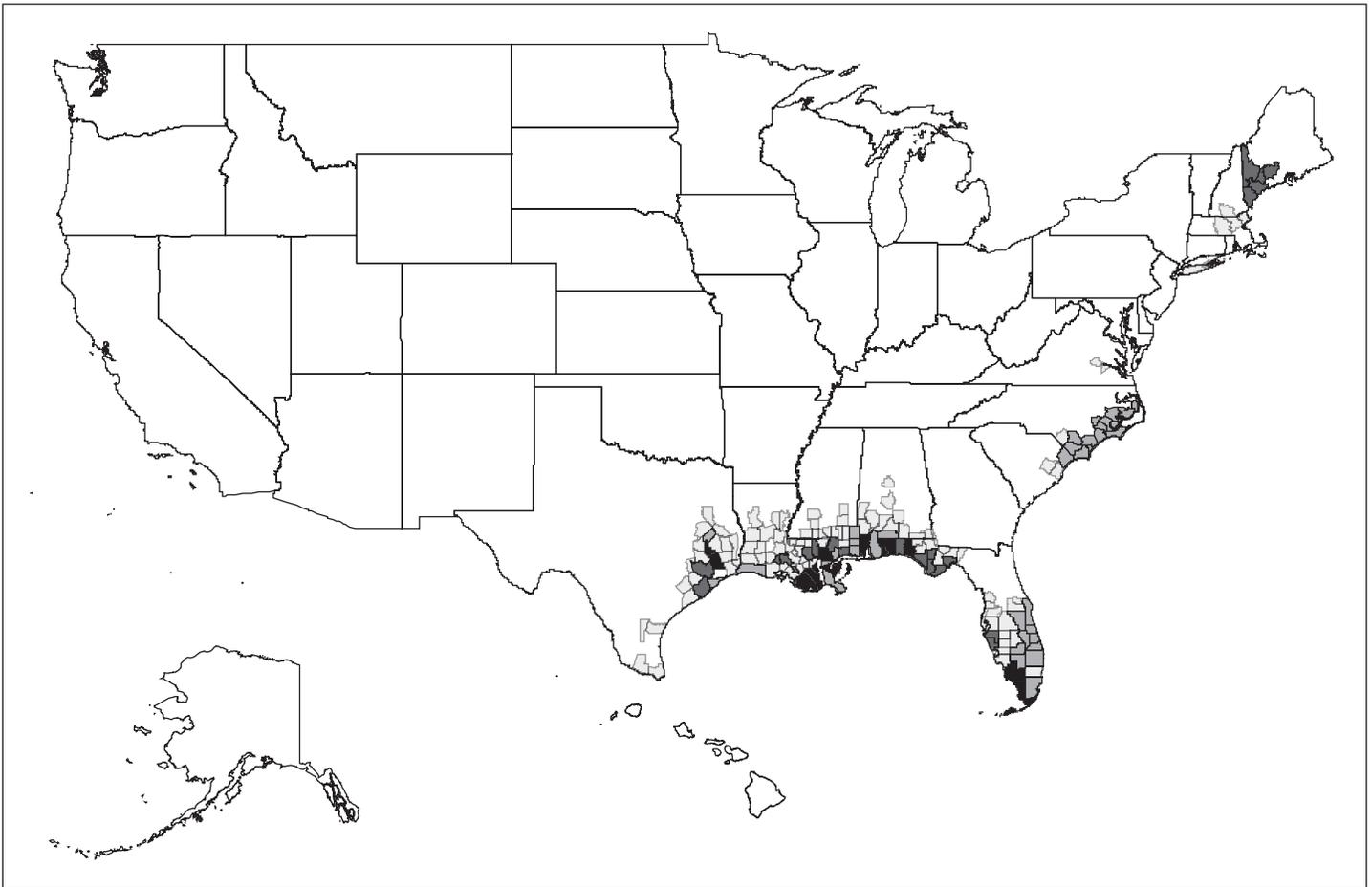
In determining a premium rate for a federal flood and wind program that was adequate to pay all future costs, FEMA would also need to take into account the adverse selection—the tendency to insure primarily the highest risks—and limited participation the program would likely experience. These factors can make rate setting difficult because they can both lead to increased premium rates, which can, in turn, lead to further adverse selection, limited participation, and the need for additional rate increases.

A Federal Flood and Wind Program Is Likely to Insure Primarily High-Risk Properties

For several reasons, a federal flood and wind program would probably insure mostly high-risk properties. First, a policy that combines flood and wind insurance would likely be of interest only to property owners who perceived themselves to be at significant risk of both flood and wind damage. Because consumers tend to underestimate their risk of catastrophic loss, those property owners who saw the need for a combined flood and wind policy would likely be those who knew they faced a high risk of loss. In addition, because the policy would include coverage for damage from flooding, those buying it would probably already have flood insurance, which is currently purchased almost exclusively in high-risk areas where lenders require it.²³ As shown in figure 1, areas where there have been multiple floods as well as hurricanes and where consumers are most likely to see a need for both flood and wind coverage are primarily limited to the eastern and Gulf coasts.

²³ In areas known as Special Flood Hazard Areas, federally insured or regulated lenders require borrowers to purchase flood insurance because of the risk of flood damage.

Figure 1: Geographic Areas That Experience Floods and Hurricanes, 1980-2005



-  6 to 10 floods and 2 to 4 hurricanes
-  6 to 10 floods and 5 or more hurricanes
-  More than 10 floods and 2 to 4 hurricanes
-  More than 10 floods and 5 or more hurricanes

Source: GAO analysis of FEMA data.

Second, a combined federal flood and wind insurance policy is likely to be of interest only in areas where state insurance regulators have allowed insurers to exclude coverage for wind damage from homeowners policies that they sell. According to several insurance industry officials we spoke with, in order to help protect consumers, state insurance regulators generally prohibit insurers from excluding wind damage from homeowners policies. According to insurers we spoke with, insurers can profitably write homeowners policies

that include wind coverage in most areas. Only in the coastal areas that are at the highest risk of hurricane damage have insurers asked for and received permission from state regulators to sell homeowners policies that exclude wind coverage. Property owners who already have wind coverage through their homeowners policies—generally those living in areas outside the highest-risk coastal areas—would generally not be interested in a combined federal flood and wind insurance policy because they would already have wind coverage. Once again then, only property owners in high-risk coastal areas would be the most interested in purchasing a federal policy. A federal flood and wind insurance program would find itself in the same situation as state wind insurance programs that generally sell wind coverage only in areas where insurers are allowed to exclude it from homeowners policies. According to officials from the state wind programs we spoke with, their programs generally insure only the highest-risk properties.

Participation in a Combined Federal Flood and Wind Program Is Likely to Be Limited

For several reasons, participation in a federal flood and wind program would probably be limited. First, a federal flood and wind insurance policy would likely cost more than purchasing a combination of flood insurance through the NFIP and wind insurance through a state wind insurance program, potentially limiting participation in the program. With respect to coverage for damages from flooding, while an estimated 24 percent of NFIP policyholders receive subsidized premium rates—with average subsidies of up to 60 percent—H.R. 3121 would require the new program to charge rates adequate to cover all future costs, potentially precluding any subsidies. As a result, the flood-related portion of a federal flood and wind policy would cost more than an NFIP flood policy for any property owners currently receiving subsidized NFIP flood rates. With respect to the wind portion of the coverage, a number of state wind insurance programs typically do not charge rates that are adequate to cover all costs, so a policy from a federal program that did charge adequate rates would likely cost more than a state wind program policy.²⁴ Property owners who are receiving subsidized NFIP rates and relatively low state wind insurance rates are unlikely to be willing to move to a new program that would be more expensive.

Second, a federal flood and wind policy would have lower coverage limits than the flood and wind coverage currently available in high-risk coastal

²⁴ Officials from several state wind insurance programs said that they have not been allowed by state insurance regulators to charge rates sufficient to pay expected future losses, as evidenced by denials of rate increases and assessments on private market insurers to help pay state wind program losses.

areas, further limiting participation. Currently, property owners in coastal areas subject to both flood and wind damage can purchase flood insurance through the NFIP and, in some areas, wind insurance through a state wind insurance program. Table 1 compares the policy limits for a federal flood and wind policy, as proposed in H.R. 3121, with a combination of policy limits from state wind insurance program and NFIP policies. While the federal flood and wind policy would cover a maximum of \$650,000 in damage for a residential property, a combination of NFIP and state wind program policies would provide on average, around \$1.7 million in coverage, or about 166 percent more coverage, depending on the state. For commercial properties, the federal flood and wind policy would offer up to \$1.75 million in coverage, but combined NFIP and state wind program policies would offer, on average, almost \$4 million or 126 percent more coverage.

Table 1. Comparison of Combination of State Wind Program and H.R. 3121 Flood Insurance Policy and State Wind Policy Limits with H.R. 3121 Flood and Wind Policy Limits

State	Residential			Commercial		
	(A) Combined NFIP flood and state wind program policy limits	(B) Federal flood and wind program coverage limit	(A-B) Difference	(C) Combined NFIP flood and state wind program policy limits	(D) Federal flood and wind program coverage limit	(C-D) Difference
Alabama	\$970,000	\$650,000	\$320,000	\$2,340,000	\$1,750,000	\$590,000
Florida	1,470,000	650,000	820,000	2,340,000	1,750,000	590,000
Georgia	2,470,000	650,000	1,820,000	3,340,000	1,750,000	1,590,000
Louisiana	1,220,000	650,000	570,000	8,340,000	1,750,000	6,590,000
Mississippi	1,720,000	650,000	1,070,000	2,340,000	1,750,000	590,000
North Carolina	1,970,000	650,000	1,320,000	4,640,000	1,750,000	2,890,000
South Carolina	1,770,000	650,000	1,120,000	3,840,000	1,750,000	2,090,000
Texas	2,240,000	650,000	1,590,000	4,456,000	1,750,000	2,706,000
Average	\$1,728,750	\$650,000	\$1,078,750	\$3,954,500	\$1,750,000	\$2,204,500

Source: GAO analysis of state wind program data and H.R. 3121.

Note: H.R. 3121 proposes increased coverage amounts for NFIP flood policies, which we use in this analysis. Residential coverage is for a single dwelling and includes coverage for property damage, damaged contents, and living expenses. Commercial coverage is for a single building and includes coverage for property damage and business interruption expenses.

Adverse Selection and Limited Participation Could Lead to Escalating Premium Rates, Making Rate Setting Difficult

Adverse selection and limited participation could, in turn, force FEMA to raise rates still higher for the projected program, leading to escalating premiums. This possibility further complicates the rate-setting process. In general, having only a small pool of very high-risk insureds requires insurers to charge premium rates at levels above what could be charged if the risk were spread among a larger pool of insureds of varying risk levels. As we have discussed, high premium rates can, in turn, further reduce the number of property owners who are able and willing to pay for coverage and force insurers to raise rates yet higher. This cycle, referred to as an adverse selection spiral, can make it very difficult for insurers to find a premium rate that is adequate to cover losses.

A Distinction between Flood and Wind Damage Would Still Be Necessary for Determining Premium Rates

Finally, although H.R. 3121 stipulates that a distinction between flood and wind damage would not be required for a policyholder's claim to be paid by a federal flood and wind program, a determination of the cause of damage would likely still be necessary for rate-setting purposes. According to several insurance industry officials we spoke with, separate determinations would be required because data on the losses associated with each type of damage are used to help determine future rates. For example, data on wind losses would be used to validate the losses predicted by wind models. While the officials said that such determinations would not need to be as accurate as when the distinction between flood and wind damage would determine under which policy a claim was covered, they would still need to be made. As a result, FEMA would need to determine whether and how such a determination might be made by FEMA staff, or if it would need to establish another process for doing so.

A Federal Flood and Wind Insurance Program Could Benefit Some but Would Involve Trade-offs

While a combined federal flood and wind program would entail costs, it could benefit some property owners and market participants. First, property owners could benefit from reduced delays in payments and assured coverage in high-risk areas. In addition, taxpayers in some states could benefit to the extent that the exposure to loss of state wind insurance programs is reduced. At the same time, these benefits could be limited by a borrowing restriction that could terminate the program after a catastrophic event, and comparatively low coverage limits could leave some property owners underinsured. Third, private sector insurers could also benefit if high-risk properties moved to a federal program, reducing the companies' risk of loss. But this shift would further limit private sector participation. Finally, while H.R. 3121 would require premium rates that were adequate to cover all future costs, actual losses can significantly

exceed even the most carefully calculated loss estimates, as we learned from the 2005 hurricanes, potentially leaving the federal government with exposure to new and significant losses.

A Combined Federal Flood and Wind Program Could Reduce Costs to Property Owners and Some State Taxpayers but Could Leave Some Owners Uninsured or Underinsured

The proposed federal wind and flood insurance program could help resolve claims more quickly and ensure continued coverage for property owners and could reduce costs to taxpayers in states with wind insurance programs. Specifically, a federal program that covered both wind and flood damage could limit the need to determine the extent of the damage caused by each peril when paying claims, effectively reducing potential delays in payment of wind claims to policyholders for rebuilding and other expenses. As we have seen, currently wind and flood coverage are generally available only under separate policies, with flood damage covered by the NFIP and wind damage generally covered under either a private market homeowners policy or a state wind insurance program policy. Because determining whether damages were caused by flood or wind also determines which entity is responsible for paying the claims, disputes can arise over the cause of the damage. As we saw after the hurricanes of 2005, such determinations can be a challenge because, for example, more adjusters were needed than were available, adjusters had difficulty reaching properties, and evidence at the damage scenes was often limited or compromised.²⁵ Some disputes over the cause of damages following the hurricanes of 2005 have taken several years to resolve, with consumers waiting months to receive payment on wind claims made shortly following those events.

A combined federal flood and wind insurance program could also help ensure the availability of wind coverage for property owners in high-risk coastal areas where some insurers have sought to reduce their exposure. According to several state insurance regulators and wind insurance program officials we spoke with, insurers in their states have been seeking to reduce their exposure in high-risk coastal areas by writing fewer policies there, and their state wind programs have generally picked up the policies no longer written by the private market. We obtained data about eight state wind insurance programs and found that these programs have grown substantially since 2004 (table 2). For example, between 2004 and 2007 the number of policies written by the Florida Citizens Property Insurance Corporation (Florida Citizens) grew about 47 percent to around

²⁵ [GAO-08-28](#).

1.3 million, and the program’s total exposure increased approximately 110 percent to around \$434 billion. Over approximately the same period, the number of policies written by the Texas Windstorm Insurance Association increased by about 92 percent to almost 200,000 and the program’s total exposure grew around 158 percent to around \$54 billion. While state insurance programs appear to be providing wind coverage for those who cannot or do not obtain such coverage in the private market, a combined federal flood and wind insurance program could help further ensure the continued availability of wind coverage in areas that private sector insurers are leaving.

Table 2. Comparison of Selected State Wind Insurance Program Policies in Force and Exposure from 2004 to Most Recent Available

(Dollars in billions)

State plan	2004		Most Recent Publicly Available		Change (percentage increase)	
	Policies in force	Exposure	Policies in force	Exposure	Policies in force	Exposure
Alabama Insurance Underwriting Association	2,909	\$0.3	8,649	\$1.5	5,740 (197%)	\$1.2 (347%)
Florida Citizens Property Insurance Corporation	873,996	206.7	1,288,522	434.3	414,526 (47)	227.6 (110)
Georgia Underwriting Association	28,501	2.8	26,445	4.4	-2,056 (-7.2)	1.6 (59)
Louisiana Citizens Property Insurance Corporation	135,457	14.3	129,203	21.1	-6,254 (-4.6)	6.9 (48)
Mississippi Windstorm Underwriting Association	14,796	1.6	30,962	5.4	16,166 (109)	3.7 (229)
North Carolina Insurance Underwriting Association	94,612	31.6	148,411	60.8	53,799 (57)	29.2 (92)
South Carolina Wind and Hail Underwriting Association	20,519	6.0	35,403	14.5	14,884 (73)	8.5 (141)
Texas Windstorm Insurance Association	103,503	20.8	199,085	53.7	95,582 (92)	32.9 (158)
Total	1,274,293	\$284.1	1,866,680	\$595.7	592,387 (46%)	\$311.6 (109%)

Source: GAO analysis of state wind insurance program public financial statements.

Note: Some states offer coverage for perils other than wind, including hail, fire, and broader homeowners coverage. However, policy limits are not based on the type of damage, so the exposure from wind damage is equal to the policy limit, regardless of whether the policy includes other types of coverage. Date of latest information publicly available as of February 2008: Alabama—September 2007, Florida—April 2007, Georgia—September 2007, Louisiana—March 2007, Mississippi—December 2006, North Carolina—June 2007, South Carolina—July 2007, Texas—August 2007.

Further, to the extent that the federal program insures properties that were previously insured through state wind programs, it could also reduce costs that some state residents pay to support the state wind programs. Some state wind insurance programs provide that if premiums are inadequate to cover the programs losses, the program can assess insurers operating within the state to make up the difference. For example, in 2005 the state of Florida assessed insurers a total of \$163 million to fund the deficit in its state wind insurance program (Florida Citizens), while the state of Mississippi assessed insurers \$525 million to cover losses incurred by its wind program. Some states also use other methods to pay wind insurance program deficits, but ultimately taxpayers also cover those costs. For example, Florida Citizens also issued bonds totaling almost \$5 billion and arranged for a \$1 billion line of credit to cover losses following the 2005 hurricane season, and the state of Louisiana issued bonds for approximately \$978 billion. States generally allow insurers to pass along the costs of these assessments to their policyholders, so the costs of such assessments and financing arrangements are primarily born by insurers and insureds within those states. To the extent that a federal program could reduce losses to state wind insurance programs, it could reduce the costs to insurers and policyholders.

These benefits could, however, be limited by the provision within H.R. 3121 that prevents FEMA from selling new or renewing existing policies if it borrows funds to pay claims. As noted earlier in this report, FEMA could find it difficult to determine premium rates adequate to cover expected losses, especially catastrophic losses. If the program is unable to pay losses in any year, it could trigger the program's borrowing restriction and effectively end the program. Ending the program, especially following a catastrophic event, could leave property owners without insurance coverage, which in many cases is required by mortgage lenders, and with no means of buying such coverage quickly. Several insurance industry and state regulatory officials said that if a federal flood and wind insurance program were implemented, it could displace state wind insurance programs and private sector coverage in high-risk coastal areas. If it did, and then was effectively terminated because of the borrowing restriction, property owners might find themselves unable to quickly purchase new coverage because state wind programs and private markets would not be prepared to quickly offer such coverage, if at all. The situation would be particularly difficult for property owners whose homes or buildings had been destroyed. In this scenario, property owners could find themselves without the appropriate insurance coverage, in violation of their agreements with lenders.

Further, the relatively low coverage limits under a federal flood and wind policy could leave some property owners without adequate insurance. As we have seen, property owners in coastal areas subject to both flood and wind damage can purchase flood insurance through the NFIP and, in some areas, wind insurance through a state wind insurance program. In table 1, we compared the policy limits for a federal flood and wind policy, as proposed in H.R. 3121, with a combination of policy limits from state wind insurance programs and the increased NFIP policy limits proposed in H.R. 3121. As shown, the federal flood and wind policy would provide less coverage than that provided by a combination of NFIP and state wind program policies for both residential and commercial properties. As a result, the comparatively lower policy limits proposed for the federal flood and wind policy could leave some property owners with significant exposure to losses.

In addition, the proposed federal flood and wind policy would cover fewer perils than the combination of an NFIP flood policy and a state wind insurance program policy, possibly creating gaps in coverage for some property owners. For example, while flood and wind damages would be covered under the proposed federal policy, all of the state wind insurance programs we reviewed also covered hail damage, and several insured against additional perils, such as fire. As a result, property owners who purchased a combined federal policy as a replacement for NFIP and state wind program coverage might no longer be insured for certain perils or might have to purchase additional coverage in the private market to eliminate any coverage gaps. The prospect of reduced coverage or purchasing additional policies could make a federal flood and wind policy less appealing to property owners.

Finally, the comparatively lower coverage limits and limited number of perils covered could result in some property owners purchasing a federal flood and wind policy as well as other coverage. In instances where a property owner purchased additional wind coverage through a private sector or state wind program policy, allocating damages between a federal flood and wind policy and the additional policy would require a determination of total wind damage. This determination would, in turn, require a distinction between flood and wind damage, potentially undercutting one of the primary goals of a federal flood and wind program. And to avoid confusion or disputes over how losses would be allocated among several policies, FEMA would need to reach agreement with other insurers, in advance, as to how losses would be apportioned across the separate insurance policies. For example, they would need to agree on

whether one policy would pay before another, or whether losses would be divided up among policies and in what proportion.

Some Insurers Could Benefit from Reduced Exposure in High-Risk Areas

Some insurers could benefit from a federal flood and wind program if the program insured properties in high-risk areas that were previously covered by private sector insurers. Several state insurance officials told us that insurers in their states had been seeking to reduce their exposure in high-risk coastal areas by writing fewer policies there. To the extent that a federal program insured properties currently insured by private sector insurers, those insurers would be less exposed to losses from those high-risk properties. However, the extent to which the federal program might insure properties currently insured by private sector insurers would in large part be determined by the premium rate for a federal program. If the federal policy were less expensive than private coverage, property owners would be more likely to move to the new program.

While a federal flood and wind program would not need to include several costs that private insurers must generally include when determining a premium rate adequate to cover all future costs—such as the cost of capital or taxes—it is not clear that premium rates for a federal program would be lower than those charged by insurers.²⁶ We have noted that federal flood and wind insurance is most likely to be appealing to property owners in only the high-risk coastal areas where private sector insurers are trying to reduce their exposure. According to several insurance industry officials we spoke with, insurers are willing to write wind coverage in these areas if they can charge premiums that cover their expected costs. While NAIC takes issue with the claim, some insurance industry officials said that state insurance regulators had denied premium rate increases necessary to cover expected losses. To the extent that private sector insurers are not charging premium rates for wind insurance that are adequate to cover future costs in high-risk coastal areas, the rates for a federal program that is charging such rates could be higher.

Further, while a federal flood and wind program would likely insure primarily high-risk properties, private sector insurers currently sell policies that include wind coverage in all geographic areas, including medium- and low-risk areas. Such diversification allows insurers to spread

²⁶ The cost of capital is the return required by investors to compensate them for putting their money at risk by investing in a company.

out the risks associated with catastrophic losses on high-risk properties over a larger group of policyholders, possibly allowing private sector insurers to charge lower premium rates on the highest-risk properties as compared to rates for a federal flood and wind program that does not experience such diversification. Further, private sector insurers can generally supplement premium income with investment income on funds that they hold, but a federal flood and wind program would probably not have such an opportunity. Finally, competition among private sector insurers can encourage insurers to operate more efficiently and hence more profitably. A combined federal flood and wind program would not be subject to such competition, and thus might not operate as efficiently as private sector insurers.

While reducing private insurers' exposure to loss in high-risk areas would benefit these insurers, it is not clear that the public in general would benefit. In a previous report, we identified several public policy goals that could be used to examine the advantages and disadvantages of a federal role in the provision of catastrophe insurance.²⁷ One of these goals was to encourage private markets to provide natural catastrophe reinsurance, thus reducing the potential costs to taxpayers. A federal wind and flood program that insured property owners who had previously had private insurance would not further that goal. To the extent that the federal program displaced coverage currently provided by the private market, it could actually shift more of the risk of loss to taxpayers.

Program Could Expose the Federal Government to an Increased Risk of Loss

Although a combined flood and wind program could provide benefits to some property owners, states, and insurers, it could expose the federal government to an increased exposure to loss. While the actual exposure that a federal flood and wind program might create is unclear, the likelihood for the program to insure primarily high-risk properties could create a large exposure to loss. As of 2007, wind programs in eight coastal states—programs that insure primarily high-risk coastal properties—had a total loss exposure of nearly \$600 billion . While it is unclear how much of this exposure would be assumed by the federal program, a risk management consulting firm developed another estimate of potential wind-related losses that took into account the federal program's likely

²⁷ [GAO-08-7](#).

adverse selection.²⁸ Assuming that the program experienced just a moderate amount of adverse selection, and that the program would write coverage for around 20 percent of the current market for wind coverage, the firm used wind modeling technology to estimate the potential wind-related losses. The estimates ranged from around \$6.5 billion in losses for the type of catastrophe that has a 10 percent chance of occurring each year, \$11.4 billion for one that has a 5 percent chance of occurring each year, to around \$32.7 billion for the type that has a 1 percent chance of occurring each year. The same firm that did the modeling for this estimate considered Hurricane Katrina to be the type of event that has a 6.6 percent chance of occurring in any year. For purposes of comparison, NFIP flood losses from Hurricane Katrina alone totaled around \$16 billion, and according to the Insurance Services Office, losses paid by private sector insurers—most of which were wind-related—totaled around \$41 billion.²⁹

The potential exposure to the federal government, however, could be reduced by several factors. First, the program could encourage mitigation efforts that would reduce damage from wind. As noted earlier in this report, H.R. 3121 would require communities to adopt mitigation standards approved by the Director of FEMA and consistent with International Code Council building codes related to wind mitigation. In addition, H.R. 3121 would require the Director of FEMA to carry out studies and investigations to determine appropriate wind hazard prevention measures. Further, according to FEMA, the CRS structure could be applied to a federal flood and wind program, reducing premium rates for communities and property owners that implemented wind mitigation measures. Such measures could reduce losses due to wind damage and thus the federal government's exposure to loss. Second, the federal government's exposure is potentially limited to the amount FEMA is authorized to borrow from the Treasury, which was raised to \$20.8 billion in March of 2006. However, if losses were to exceed this limit, Congress would be faced with raising the amount FEMA could borrow, thereby increasing the government's exposure or failing to pay policyholders up to the full amounts specified in their policies.

²⁸ Tillinghast, Towers, Perrin, "Analysis of H.R. 920, 'Multiple Peril Insurance Act of 2007'" (Washington, D.C.: July 2007). H.R. 920 proposed a federal multiperil insurance program and was essentially incorporated into H.R. 3121. We did not verify the methodology or results of this analysis.

²⁹ The Insurance Services Office is a provider of data and analytics for the risk management industry.

While H.R. 3121 would require a federal flood and wind program to charge premium rates that were adequate to pay all future losses in order not to create additional liability for the federal government, as we have seen, estimating future losses is difficult, and losses can exceed expectations. For example, losses from Hurricane Katrina and other hurricanes were beyond what NFIP could pay with the premiums it had collected. NFIP reported unexpended cash of approximately \$1 billion following fiscal year 2004, but as of May 2007 the program had suffered almost \$16 billion in losses from Hurricane Katrina. In addition, officials from several wind-modeling companies told us that the severity of Hurricane Katrina was well beyond their previous expectations, and rates that they had believed were actuarially sound turned out to be inadequate. As a result, they have had to revise their models accordingly. If losses for a combined flood and wind program did exceed the premiums collected by the program, FEMA could be forced to borrow from the Treasury to pay those losses. As of December 2007, FEMA still owed approximately \$17.3 billion to the Treasury, an amount it is unlikely able to repay. In addition, the requirement in H.R. 3121 to stop renewing or selling new policies until such losses are repaid could actually increase the cost to the federal government. This is because the program's source of revenue, which it could use to pay back the borrowed funds, would be limited to premiums paid by those whose policies had not yet come up for renewal. And once those policies expired, the program would receive no premium income. It is not clear how any debt remaining outstanding at that time would be paid, and the costs could fall to the federal government and, ultimately, taxpayers.

Agency Comments and Our Evaluation

We requested comments on a draft from FEMA and NAIC. FEMA provided written comments that are reprinted in appendix II. NAIC orally commented that they generally agreed with our report findings. FEMA also generally agreed with our findings and emphasized the challenges it would face in addressing several key issues. Finally, FEMA provided technical comments, which we incorporated as appropriate.

In their comments, FEMA officials stressed their concerns over the effect that the program's proposed borrowing restriction would have on their ability to set adequate premium rates. Specifically, they said that

- It would be nearly impossible to set premium rates high enough to eliminate the possibility of borrowing to pay catastrophic losses.

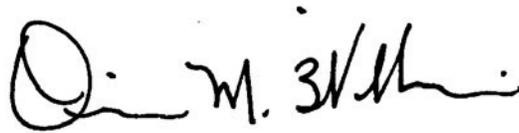
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- Purchasing enough reinsurance to pay all catastrophic losses without borrowing, even if it were possible, would require premium rates so high as to be unaffordable.
 - The high variability of combined flood and wind coverage means that there is always the possibility of catastrophic losses in any given year regardless of how premiums are designed.

In addition, FEMA officials said that the termination of the program due to the borrowing restriction would create other difficulties. They said that not only could it leave property owners without coverage, but it could also prevent the program from repaying any borrowed funds.

As stated in our report, the proposed borrowing restrictions would make rate setting a difficult and challenging process, and could result in high premium rates. In addition, we stated that termination of the program due to the borrowing restriction could potentially leave some property owners uninsured following a catastrophic event and limit FEMA's ability to repay any borrowed funds. Finally, we acknowledged that the high variability of flood and wind losses would make setting rates adequate to pay losses without borrowing even more challenging, and we clarified language in the report that the risk of catastrophic losses could occur in any year regardless of how premiums are designed.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the Ranking Member of the Committee on Financial Services, House of Representatives; the Chairman and Ranking Member of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate; the Chairman and Ranking Member of the Committee on Homeland Security and Governmental Affairs, U.S. Senate; the Chairman and Ranking Member of the Committee on Homeland Security, House of Representatives; the Secretary of Homeland Security; the Executive Vice-President of NAIC; and other interested committees and parties. We will also make copies available to others on request. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or williamso@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix III.

A handwritten signature in black ink, appearing to read "Orice M. Williams". The signature is stylized and cursive.

Orice M. Williams
Director
Financial Markets and
Community Investment

Appendix I: Objectives, Scope, and Methodology

Our objective was to examine the proposed federal flood and wind insurance program put forth in H.R. 3121, the Flood Insurance Reform and Modernization Act of 2007, in terms of (1) the program's potential effects on policyholders, insurance market participants, and the federal government; (2) what would be required for Federal Emergency Management Agency (FEMA) to determine and charge actuarially sound premium rates; and (3) the steps FEMA would have to take to implement the program.

To evaluate the program's potential effects on policyholders, insurance market participants, and the federal government, we interviewed officials from the FEMA, the National Flood Insurance Program (NFIP), state insurance regulators, the National Association of Insurance Commissioners (NAIC), state wind insurance program operators, primary insurers, reinsurers,

insurance and reinsurance associations, insurance agent associations, risk-modeling organizations, actuarial consultants, the American Academy of Actuaries (AAA), the Association of State Flood Plain Managers (ASFPM), the National Flood Determination Association (NFDA), and others. We also obtained information on state-sponsored wind insurance programs in three coastal states and one inland state, and discussed them with program officials as well as the insurance regulators within those states. We compared selected wind insurance program policies in force and exposure data from 2004 to the most recent available in eight states: Alabama, Florida, Georgia, Louisiana, Mississippi, North Carolina, South Carolina, and Texas. We also collected and analyzed state wind program data from these eight states and provisions of H.R. 3121 to compare the combination of state wind program and H.R. 3121's flood insurance policy limits with H.R. 3121's flood and wind policy limits. To develop our natural hazard risk maps, we used data from FEMA and the National Oceanic and Atmospheric Administration (NOAA). We used historical hazard data from 1980 to 2005 as a representation of current hazard risk for flood, hurricanes, and tornadoes. Finally, to evaluate the federal government's exposure, we reviewed an estimate of potential wind-related losses for a federal program from an actuarial consulting firm.

To examine the challenges FEMA would likely face in determining and charging a premium rate that would cover all expected costs, we spoke with FEMA/NFIP officials, state insurance regulators, NAIC, state wind insurance program operators, primary insurers, reinsurers, insurance and reinsurance associations, insurance agent associations, risk-modeling organizations, actuarial consultants, AAA, ASFPM, NFDA, and others. We

also reviewed our previous reports and testimonies, Congressional Budget Office (CBO) reviews, and academic and other studies of coastal wind insurance issues. In addition, we reviewed information provided by professional associations, such as the American Insurance Association, and congressional testimony by knowledgeable individuals from the insurance industry, ASFPM, and NFDA.

To examine the challenges FEMA would face in developing and implementing a federal flood and wind insurance program, we discussed the issue with FEMA/NFIP officials, state insurance regulators, NAIC, state wind insurance program operators, primary insurers, reinsurers, insurance and reinsurance associations, insurance agent associations, risk-modeling organizations, actuarial consultants, AAA, ASFPM, NFDA, and others. We also reviewed our previous reports on FEMA's management and oversight of NFIP. In addition, we reviewed congressional testimony by knowledgeable individuals from the insurance industry, ASFPM, and NFDA.

We conducted our work in Washington, D.C., and via telephone from October 2006 to April 2007 in accordance with generally accepted government auditing standards. Those standards 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 obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Comments from the Federal Emergency Management Agency

U.S. Department of Homeland Security
500 C Street, SW
Washington, DC 20472



FEMA

April 15, 2008

Orice M. Williams
Director
Financial Markets and Community Investments
United States Government Accountability Office
441 G Street, NW
Washington, DC 20548

RE: GAO Draft Report, *Natural Catastrophe Insurance: Analysis of a Proposed Combined Flood and Wind Insurance Program* (GAO-08-504)

Dear Ms Williams:

Thank you for providing the Department of Homeland Security, Federal Emergency Management Agency (FEMA), the opportunity to review and comment on the GAO draft report, *Natural Catastrophe Insurance: Analysis of a Proposed Combined Flood and Wind Insurance Program*.

FEMA has completed its review and commends the GAO for writing an excellent and well researched report that clearly lays out the issues and challenges in designing and implementing the combined federal flood and wind insurance program contemplated in H.R.3121. However, we would like to make the following comments which primarily concern the emphasis placed on several key issues:

- The draft report states in numerous places the conundrum regarding the H.R.3121 requirement that the Federal Multi-peril Program would essentially have to terminate if it ever had to borrow from the Department of Treasury. As noted in the report there are serious problems with that requirement, as follows:
 - (1) setting rates would be next to impossible if the premiums had to be set high enough to eliminate the possibility of borrowing;
 - (2) terminating the program abruptly would leave policyholders in the lurch without coverage; and
 - (3) when the program was forced to terminate, the loan could never be paid back because the premium revenues would stop.

FEMA recommends that these points be stated comprehensively in the beginning of the report and be given more emphasis. For example, item #3 listed above, is a key point but it is not referenced until at the end of the report.

- The draft report states in numerous places that setting the premium rates would be "difficult." It also states numerous reasons why setting the rates is difficult. However, the statements do not adequately convey the magnitude of the problem. As noted above, the H.R.3121 requirement to terminate the program, if and when borrowing would be required, makes the setting of adequate premium rates nearly impossible. There are only three ways that to preclude the possibility of borrowing, none of which would be practical:

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Appendix II: Comments from the Federal
Emergency Management Agency

Orice M. Williams
April 15, 2008
Page 2

- (1) Purchase comprehensive reinsurance so that the catastrophic risks are assumed by the reinsurers. The draft report documents the problems with a reinsurance approach. Even if the Program could purchase such comprehensive reinsurance, the size of the premiums required to support it would make the Program unaffordable to homeowners;
- (2) Establish such high premium rates that all conceivable catastrophic risks would be covered even if large loss events occurred early in the Program. Again, the magnitude of those rates would mean that few could afford to purchase the insurance; or
- (3) Incorporate sufficient restrictions and exclusions in the coverage to protect the Program against catastrophic losses. However, that approach would negate one of the goals of the Program which is to provide security to homeowners located in high risk areas.

- The report contains a statement that could easily be misinterpreted. On Page 4/42, it states:

"Under the proposed legislation, if FEMA set premium rates too low and needed to borrow to pay claims, the program would have to stop renewing or selling new policies, and thus would effectively terminate."

Comment: As written, this statement implies there is some level of premium rates that would assure borrowing would never be needed. However, that implication is erroneous because there is almost no level of premiums that could give this type of assurance. For example, if in the first year of its existence the Program is impacted by a catastrophic event, borrowing would be unavoidable. Therefore, the report should clearly indicate that the combination of wind and flood coverage is a highly volatile and risky line of insurance and that there is always the probability of catastrophic losses occurring in any given year regardless of how the premiums are designed. FEMA recommends that the following sentences replace the text above:

"Under the proposed legislation, if FEMA needed to borrow to pay insurance claims, the Program would have to stop both renewing in force policies and selling new policies, and thus would effectively terminate. Realistically, because possible losses under the combination of wind & flood coverage are so highly variable from year to year, there is little chance of designing a program with premiums adequate enough to preclude the chance of borrowing."

If you need additional information, please contact me by telephone at 202-646-2780.

Sincerely,



David I. Maurstad
Assistant Administrator
Mitigation Directorate

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

Orice M. Williams, (202) 512-8678 or williamso@gao.gov.

Staff Acknowledgments

In addition to the person named above, Lawrence D. Cluff, Assistant Director; Farah B. Angersola; Joseph A. Applebaum; Tania L. Calhoun; Emily R. Chalmers; William R. Chatlos; Thomas J. McCool; Marc W. Molino; and Patrick A. Ward made key contributions to this report.

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