

GAO

Report to Legislation and National  
Security Subcommittee, Committee on  
Government Operations

May 1987

# FLOOD INSURANCE

## Private Companies' Participation in the Write Your Own Program



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*Released*

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**Resources, Community, and  
Economic Development Division**

B-226596

May 29, 1987

The Honorable Jack Brooks  
Chairman, Legislation and  
National Security Subcommittee  
Committee on Government Operations  
House of Representatives

Dear Mr. Chairman:

As requested in your November 12, 1985, letter and subsequent discussions with your office, we reviewed the status of the Write Your Own (WYO) portion of the National Flood Insurance Program (NFIP) administered by the Federal Emergency Management Agency's (FEMA) Federal Insurance Administration (FIA). Through the WYO program, private insurance companies began marketing and servicing flood insurance policies in fiscal year 1984. Specifically, you asked us to provide information on the following:

- the status of the WYO program as of September 30, 1986,
- the benefits received by the federal government from the administrative expense allowance—32.7 percent in fiscal year 1986—the companies retain from WYO policy premiums, and
- how FIA is managing the WYO program and what its monitoring has shown on the WYO companies' administration of the program.

We are also providing information on companies' concerns with selected aspects of the WYO program that may be helpful in understanding and evaluating the WYO program.

In summary, we found that

- The total number of WYO policies rose to 1,016,000 by September 1986—about one half of all NFIP policies. Total NFIP policies in force increased from 1,925,000 when the WYO program began to 2,035,000 by September 30, 1986.
- The relationship between allowances retained from policy premiums for administrative costs and benefits to the federal government, such as increased policy sales, is uncertain. FIA bases those allowances generally on insurance industry averages. Companies' records do not identify the total actual administrative costs incurred in implementing the program. FIA does not require the companies to keep such records. Companies

indicated, however, that they incurred administrative expenses for various activities including marketing.

- FIA is still in the process of implementing a series of statistical reporting requirements, on-site reviews, and audits to help ensure that companies properly administer the program. If properly implemented, these efforts should provide the information needed to monitor the companies' performance and detect problems. FIA's monitoring to date indicates that most companies selling flood insurance have satisfactorily implemented the program.

Companies that we contacted expressed some concerns about the WYO program. Most notably they were concerned about competing with FIA's direct sales program, the timing of program changes, and their potential role in sharing the cost of flood claims.

## Background

Since early fiscal year 1984, FIA has used two mechanisms to sell and service flood insurance. Flood insurance is available from agents that sell through individual property and casualty insurance companies that participate in the WYO program. Flood insurance also continues to be available from agents that sell flood insurance through the direct sales program administered by FIA's current servicing contractor, Computer Sciences Corporation (CSC).

## Status of WYO Program

Although FIA established few short-term goals, sales through the WYO companies have grown faster than FIA and some of the companies anticipated. In September 1986 the WYO portion of the NFIP accounted for about 50 percent of the total policies. About 90 percent of the 1 million properties WYO companies insured were concentrated in 10 states. Although 10 companies had issued 90 percent of the WYO policies, 76 companies had insured properties in all states and some U.S. territories.

## Use of Administrative Expense Allowances and Their Effect on Policy Sales Is Uncertain

The administrative expense allowance for WYO companies will decrease from 32.7 percent in fiscal year 1986 to 30.4 percent in fiscal year 1988. The administrative costs for the WYO portion of the NFIP were expected to be higher than those for the direct sales portion during the WYO program's early years, in part, to pay for the companies' marketing efforts, according to FIA.

To help minimize program administrative costs, FIA does not require WYO companies to maintain records on how they use their administrative

allowances. Further, the writing companies that we contacted stated that they did not keep such information. Accordingly, we could not determine the effect the allowances had on policy sales. Those writing companies incurred various types of administrative expenses in implementing and maintaining the WYO program, such as marketing, training, and contracting with vendors that provide data processing and other services. For example, the companies generally paid insurance agents 15-percent commissions on flood insurance sales—an amount equal to about one half of the allowances the companies retain.

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## FIA's Management Controls

To ensure the program's financial integrity and that companies sell and service policies in accordance with program requirements, FIA established seven types of reporting and review requirements in the WYO Financial Control Plan for participating companies. When fully implemented, the plan should provide a basis to evaluate the adequacy of a company's implementation of and compliance with program requirements. WYO companies do some of the reports and reviews; FIA and its servicing contractor do others; and certified public accounting firms will do still others.

Although FIA officials were generally satisfied with most companies' operations, FIA was working with a few companies to improve their operations at the conclusion of our review (December 1986). FIA was also developing reports to facilitate its evaluation of the individual companies' performances based on transactions processed each month, and it was developing criteria for the termination of companies for unsatisfactory performance.

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## WYO Companies' Concerns About the WYO Program

When we discussed the program's operation with WYO companies' representatives, they expressed concerns on some aspects of the program. The topics include FIA's continuation of the direct sales program, the need for adequate notice from FIA on program changes, and companies' reservations about sharing the cost of claims.

Some companies' representatives said that the companies did not want to compete with the direct flood insurance sales program. FIA plans to retain the direct sales program through September 30, 1993, for reasons including the need to provide continuous service on policies reassigned from a company that withdraws from the WYO program.

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Some companies' representatives said that FIA had not provided enough advance notice on insurance premium rate changes. For example, one company that we contacted had issued policy renewal notices before FIA rescinded rate changes. FIA officials said that they recognize the validity of the companies' concerns and are trying to avoid such situations in the future.

Because a long-range program goal is to have the companies share part of the cost of claims, we discussed with companies' officials their views on how the flood insurance program would have to be structured for them to participate and share such costs. They said the insurance premium rates would need to be increased to assure the rates charged policyholders were commensurate with the risk assumed. They also indicated they would reconsider whether they could afford to participate. The availability of reinsurance<sup>1</sup> to cover their portion of the risk would be an important factor.

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## Scope and Methodology

We met with officials and reviewed documentation at FEMA headquarters and at CSC. We interviewed officials of 16 WYO companies to obtain their views on program operations and to obtain marketing, training, audit, or other materials that they developed in administering the program.

Our work took place between January and December 1986 and was performed in accordance with generally accepted government auditing standards except with respect to verifying the accuracy of computer programs and resulting reports. Information that we obtained may not be representative of all WYO companies. We discussed the information obtained with FIA and CSC officials and incorporated their comments as appropriate. As you requested, we did not obtain official agency comments.

Appendix I of this report discusses in detail the scope and methodology of our work and provides information on the goals of the WYO program and how it functions. Appendix II provides statistical data on the program. Appendix III discusses the administrative expense allowance the companies retain and the relationship of the allowance and other factors to companies' marketing strategies. Appendix IV summarizes FIA's management controls over WYO companies' activities and the results of its

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<sup>1</sup>Under reinsurance, insurance companies enter into contracts with other insurers to accept the risk of all or part of large claim losses.

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monitoring. Appendix V discusses companies' concerns about the WYO program.

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Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to the Director, Federal Emergency Management Agency; the Director, Office of Management and Budget; and other interested parties.

This report was prepared under the direction of John H. Luke, Associate Director. Appendix VI provides a listing of major contributors to this report.

Sincerely yours,



J. Dexter Peach  
Assistant Comptroller General

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**Abbreviations**

CPA	certified public accountant
CSC	Computer Sciences Corporation
FEMA	Federal Emergency Management Agency
FIA	Federal Insurance Administration
GAO	General Accounting Office
NFIP	National Flood Insurance Program
RCED	Resources, Community, and Economic Development Division
WYO	Write Your Own

# Objectives, Background, Scope, and Methodology

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## Objectives

The objectives of our review as requested by the Chairman of the Legislation and National Security Subcommittee, House Committee on Government Operations, were to provide information on

- the status of the WYO portion of the NFIP as of September 30, 1986,
- the benefits received by the federal government from the administrative expense allowance the companies retain from WYO policy premiums, and
- how FEMA's FIA is managing the WYO program and what FIA's monitoring has shown on the WYO companies' administration of the program.

We are also providing other information on program administration that may be helpful in understanding and evaluating the WYO program.

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## Background on the WYO Program

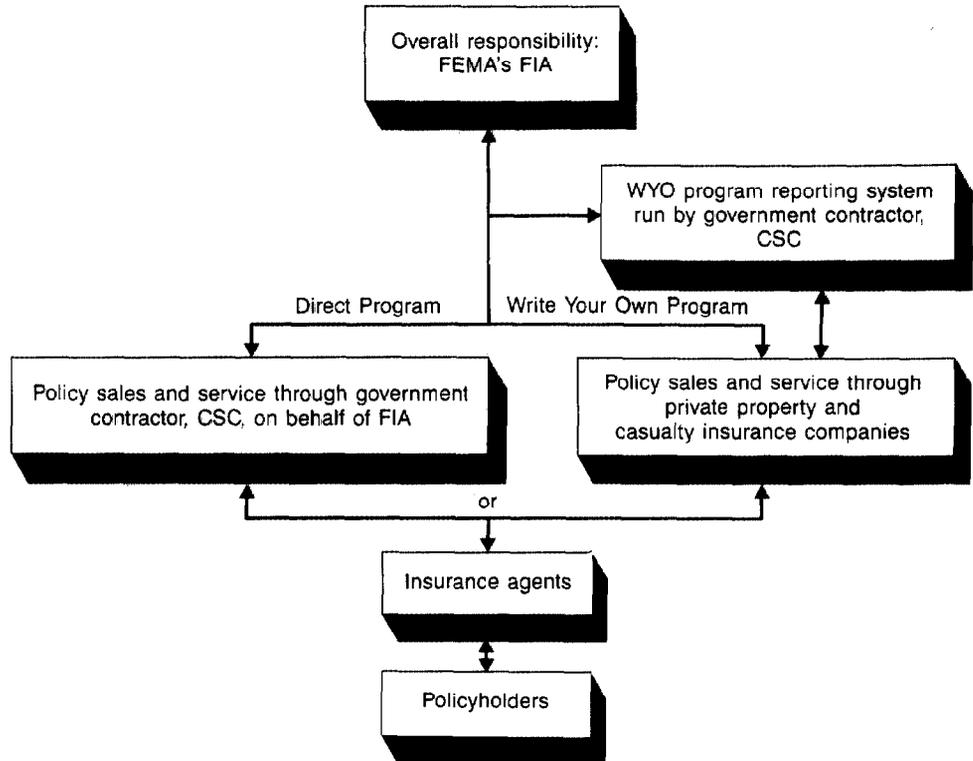
Authorized in 1968 at a time when flood insurance from private insurers generally did not exist, the NFIP currently makes flood insurance available to property owners in about 17,800 flood-prone communities. The law provides that the program can be operated by either private insurance companies under federal direction or can be managed by the government itself. Until 1978 the program was operated through pools of private insurance companies. FIA eliminated private insurance companies' involvement in 1978 because of numerous problems concerning budgeting and contracting and also FIA's regulatory authority over the program. From 1978 until November 1983, FIA exclusively sold and serviced flood insurance policies directly through a contractor.

In 1981 FIA started an effort to reinvolve the private insurance companies in the flood insurance program. Under this new effort, referred to as the WYO program, FIA established a policy sales and servicing mechanism under which insurance agents could sell flood insurance policies through individual property and casualty insurance companies.

The WYO program arrangement is somewhat parallel to the direct government sales program under which insurance agents had worked directly with the government contractor since 1978. Under the direct government sales program, hereinafter referred to as the "direct program," insurance agents sell policies under the NFIP name (rather than an individual company's name), service policies, and arrange for claims adjusters to visit and document reported losses. Agents receive from Computer Sciences Corporation (CSC), FIA's current servicing contractor, a 15-percent commission for their expenses based on premiums collected for policies under the direct program.

CSC handles the day-to-day operation of the direct sales/servicing portion of the NFIP and also provides summary accounting, statistical, and other services for the WYO portion of the program. Figure I.1 shows a graphic representation of the NFIP's organizational structure.

Figure I.1: Organizational Structure of the NFIP



Source: GAO.

The goals of the WYO program are to

- increase the number of NFIP policies and the geographic distribution of the insured properties,
- improve service to NFIP policyholders,
- allow the insurance industry to develop operating experience with flood insurance, and
- reduce or eliminate the federal government's role as the primary marketing agent of flood insurance to potential policyholders.

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A longer range goal is to revise the program's financial structure so the WYO companies would assume a portion of the financial risk on flood losses.

Under the WYO program, FIA retains responsibility for functions such as

- determining insurance rates, coverage limitations, and eligibility for all NFIP policies,
- providing the funds for claims payments, and
- maintaining a capability for agents to sell flood insurance through the NFIP's direct program.

Working with the private sector, FIA developed an arrangement that companies must sign each year to participate in the WYO program. According to the arrangement, companies sell insurance under their own names, collect the premiums, and retain a percentage of the premiums as an allowance for commissions and other administrative expenses. Companies service their own flood insurance policies, inspect and document losses, and pay the claims arising from flooding of their policyholders' properties. When companies pay claims exceeding net premium monies on hand, they are reimbursed by the federal government through a letter-of-credit. Thus, the companies bear no financial risk due to flood losses under the present arrangement.

When the WYO program became effective in fiscal year 1984, 48 companies had signed the arrangement. The first WYO policy was sold in November 1983. In 1984 FIA arranged for agents to transfer or "roll-over" policies from the direct program to designated WYO companies.

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## Scope and Methodology

We interviewed responsible program officials at FEMA's FIA and Office of Inspector General, and CSC to discuss program background, policies and procedures, and ongoing and proposed improvements to the WYO program.

We reviewed the legislative history, legal memoranda, regulations, operations manuals, statistical and audit reports, and other WYO program information available at FIA and CSC.

We reviewed program files and interviewed CSC account executives to verify the number of signed companies and/or to try to determine why companies had withdrawn from the program.

FIA and CSC officials told us that statistical data and, thus, reports prepared from transaction tapes the WYO companies submitted contain some errors. Officials attributed the errors to coding problems, companies improperly classifying policy transfers, and WYO transactions rejected by the CSC computer system. The FIA Deputy Administrator believes that the overall numbers and percentages are reasonably accurate as indicators of how the program is developing. We did not validate the underlying data CSC used to generate the statistical reports.

We interviewed officials representing 16 WYO companies to obtain information on their experience in administering the WYO program. These companies provide a mix of large, medium, and small companies (based on the number of flood insurance policies in force) and several companies that had signed the arrangement but had not started issuing flood insurance policies. We obtained available company operations manuals, marketing and training materials, and audit reports to determine how the selected companies were administering the program.

Although the sample of companies that we contacted gave us an overview of the options available for implementing the WYO program, our sample cannot be projected to the universe of WYO companies.

Seven of the 16 companies were writing flood insurance policies at the time we contacted them during our review. They had a variety of organizational structures. Some companies performed all WYO administrative operations in-house. Some used vendors for data processing and other services. Some sold flood insurance through exclusive agents that represent only one company or group of companies, some used independent agents who can sell insurance for several groups of companies, or any of several combinations. To settle flood claims, all seven used independent adjusters, supplemented in some cases by company staff.

The seven companies writing policies had issued about 76 percent of the total number of WYO policies in force based on November 1985 data—the most current data available at the time we selected the companies. Because other companies began issuing policies and/or increased their share of the market after that date, the selected companies' market share declined to about 71 percent of the WYO policies as of September 30, 1986.

We interviewed a vendor who contracted with several WYO companies and discussed the variety of management and other services such vendors can provide to WYO companies. About 120 of the 259 companies

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**Appendix I  
Objectives, Background, Scope,  
and Methodology**

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that had signed the 1986 WYO arrangement used or planned to use the services of one of seven such vendors.

We attended the 1986 WYO conference held in Kansas City where WYO companies, vendors, claims adjusting and flood map reading companies, agent representatives, and others expressed their views on past operations, problems, and proposed changes in the WYO program.

# WYO Program Status

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wyo companies accounted for about 50 percent of the National Flood Insurance Program policies as of September 30, 1986. At that date, wyo companies accounted for

- 49.9 percent of the 2.035 million policies in force and
- 55.3 percent of the \$148.3 billion of insurance in force.<sup>1</sup>

The wyo companies collected about 47.6 percent of the \$484.9 million premiums paid in fiscal year 1986. The wyo companies accounted for about 22 percent of the claims payments made in fiscal year 1986.

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## Geographical Concentrations of WYO Policies

Our analysis of CSC's statistical reports shows that of the 1,016,000 wyo policies in force as of September 30, 1986, 89.5 percent were concentrated in 10 states. Florida had the largest number of wyo policies (46.0 percent of the total), followed by Louisiana (14.2 percent), and Texas (13.1 percent). These states were also the top three in terms of the number of policies in the direct (non-wyo portion) program. Table II.1 contains the number of NFIP policies in force for each state.

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<sup>1</sup>Insurance in force is the amount for which properties and/or contents are insured or the maximum amount for which the federal government could be liable from any single flood of each property.

**Appendix II  
WYO Program Status**

**Table II.1: NFIP Policies in Force by State—Ranked by WYO Policies in Force as of September 30, 1986**

State	Number of policies			State WYO as percentage of all WYO
	Direct	WYO	Total	
Florida	208,072	467,435	675,507	46.0
Louisiana	102,664	144,106	246,770	14.2
Texas	112,067	133,114	245,181	13.1
New Jersey	69,627	37,464	107,091	3.7
California	75,910	29,641	105,551	2.9
South Carolina	11,438	29,581	41,019	2.9
Mississippi	14,906	19,868	34,774	2.0
Pennsylvania	41,039	19,066	60,105	1.9
Virginia	17,889	15,478	33,367	1.5
North Carolina	20,342	13,713	34,055	1.3
<b>Total-top ten</b>	<b>673,954</b>	<b>909,466</b>	<b>1,583,420</b>	<b>89.5</b>
Maryland	10,923	9,684	20,607	1.0
Georgia	8,984	9,551	18,535	0.9
New York	53,721	8,551	62,272	0.8
Alabama	8,999	8,302	17,301	0.8
Michigan	11,824	6,150	17,974	0.6
Arizona	16,111	6,112	22,223	0.6
Illinois	17,147	4,905	22,052	0.5
Kentucky	10,750	4,719	15,469	0.5
West Virginia	10,280	4,554	14,834	0.4
Delaware	2,919	3,193	6,112	0.3
Connecticut	13,764	3,110	16,874	0.3
Missouri	11,668	3,066	14,734	0.3
Ohio	12,116	2,847	14,963	0.3
Indiana	9,673	2,569	12,242	0.3
Maine	2,771	2,011	4,782	0.2
Colorado	6,368	1,942	8,310	0.2
Hawaii	6,984	1,723	8,707	0.2
Tennessee	4,763	1,688	6,451	0.2
Oklahoma	8,924	1,608	10,532	0.2
Arkansas	5,054	1,595	6,649	0.2
Nevada	4,254	1,570	5,824	0.2
Nebraska	6,028	1,540	7,568	0.2
Minnesota	4,105	1,316	5,421	0.1
Massachusetts	23,648	1,279	24,927	0.1
Wisconsin	5,400	1,278	6,678	0.1
North Dakota	4,057	1,173	5,230	0.1

**Appendix II  
WYO Program Status**

State	Number of policies			State WYO as percentage of all WYO
	Direct	WYO	Total	
Washington	9,193	1,168	10,361	0.1
New Mexico	3,590	1,103	4,693	0.1
Kansas	6,000	933	6,933	0.1
Alaska	1,831	837	2,668	0.1
Oregon	5,083	804	5,887	0.1
Iowa	3,953	783	4,736	0.1
New Hampshire	2,002	728	2,730	0.1
Vermont	1,350	723	2,073	0.1
Rhode Island	6,675	646	7,321	0.1
Utah	1,619	395	2,014	0.0
Idaho	1,490	297	1,787	0.0
Wyoming	1,196	291	1,487	0.0
South Dakota	747	232	979	0.0
Montana	1,398	198	1,596	0.0
Puerto Rico	16,113	89	16,202	0.0
Virgin Islands	1,778	18	1,796	0.0
Washington, D.C.	38	4	42	0.0
Guam	24	0	24	0.0
Unknown <sup>a</sup>	0	1,421	1,421	0.1
<b>Total</b>	<b>1,019,269</b>	<b>1,016,172</b>	<b>2,035,441</b>	<b>100.0</b>

<sup>a</sup>CSC could not sort policies by state due to missing or erroneous data.

Source: GAO analysis of CSC reports.

WYO companies have reported policies in force in all states and some U.S. territories. In each of 15 states, WYO policies represented over one third of all flood policies as of September 30, 1986. In South Carolina and Florida, WYO policies accounted for over two thirds of all flood policies in these states at that date. Table II.2 shows the WYO market share of flood policies in each state as of September 30.

**Appendix II**  
**WYO Program Status**

**Table II.2: NFIP Policies in Force by State—Ranked by WYO Market Share as of September 30, 1986**

Market share in percentages

State	Number of policies			Market share	
	Direct	WYO	Total	Direct	WYO
South Carolina	11,438	29,581	41,019	27.9	72.1
Florida	208,072	467,435	675,507	30.8	69.2
Louisiana	102,664	144,106	246,770	41.6	58.4
Mississippi	14,906	19,868	34,774	42.9	57.1
Texas	112,067	133,114	245,181	45.7	54.3
Delaware	2,919	3,193	6,112	47.8	52.2
Georgia	8,984	9,551	18,535	48.5	51.5
Alabama	8,999	8,302	17,301	52.0	48.0
Maryland	10,923	9,684	20,607	53.0	47.0
Virginia	17,889	15,478	33,367	53.6	46.4
Maine	2,771	2,011	4,782	57.9	42.1
North Carolina	20,342	13,713	34,055	59.7	40.3
New Jersey	69,627	37,464	107,091	65.0	35.0
Vermont	1,350	723	2,073	65.1	34.9
Michigan	11,824	6,150	17,974	65.8	34.2
Pennsylvania	41,039	19,066	60,105	68.3	31.7
Alaska	1,831	837	2,668	68.6	31.4
West Virginia	10,280	4,554	14,834	69.3	30.7
Kentucky	10,750	4,719	15,469	69.5	30.5
California	75,910	29,641	105,551	71.9	28.1
Arizona	16,111	6,112	22,223	72.5	27.5
Nevada	4,254	1,570	5,824	73.0	27.0
New Hampshire	2,002	728	2,730	73.3	26.7
Tennessee	4,763	1,688	6,451	73.8	26.2
Minnesota	4,105	1,316	5,421	75.7	24.3
Arkansas	5,054	1,595	6,649	76.0	24.0
South Dakota	747	232	979	76.3	23.7
New Mexico	3,590	1,103	4,693	76.5	23.5
Colorado	6,368	1,942	8,310	76.6	23.4
North Dakota	4,057	1,173	5,230	77.6	22.4
Illinois	17,147	4,905	22,052	77.8	22.2
Indiana	9,673	2,569	12,242	79.0	21.0
Missouri	11,668	3,066	14,734	79.2	20.8
Nebraska	6,028	1,540	7,568	79.7	20.3
Hawaii	6,984	1,723	8,707	80.2	19.8
Utah	1,619	395	2,014	80.4	19.6
Wyoming	1,196	291	1,487	80.4	19.6
Wisconsin	5,400	1,278	6,678	80.9	19.1
Ohio	12,116	2,847	14,963	81.0	19.0

**Appendix II  
WYO Program Status**

State	Number of policies			Market share	
	Direct	WYO	Total	Direct	WYO
Connecticut	13,764	3,110	16,874	81.6	18.4
Idaho	1,490	297	1,787	83.4	16.6
Iowa	3,953	783	4,736	83.5	16.5
Oklahoma	8,924	1,608	10,532	84.7	15.3
New York	53,721	8,551	62,272	86.3	13.7
Oregon	5,083	804	5,887	86.3	13.7
Kansas	6,000	933	6,933	86.5	13.5
Montana	1,398	198	1,596	87.6	12.4
Washington	9,193	1,168	10,361	88.7	11.3
Washington, D.C.	38	4	42	90.5	9.5
Rhode Island	6,675	646	7,321	91.2	8.8
Massachusetts	23,648	1,279	24,927	94.9	5.1
Virgin Islands	1,778	18	1,796	99.0	1.0
Puerto Rico	16,113	89	16,202	99.5	0.5
Guam	24	0	24	100.0	0.0
Unknown <sup>a</sup>	0	1,421	1,421	0.0	100.0
<b>Total</b>	<b>1,019,269</b>	<b>1,016,172</b>	<b>2,035,441</b>	<b>50.1</b>	<b>49.9</b>

<sup>a</sup>CSC could not sort policies by state due to missing or erroneous data.

Source: GAO analysis of CSC reports.

## WYO Companies Report New Policy Sales

Increasing the number of NFIP policies in force through new sales is one of the WYO program's goals. WYO companies reported 282,000 new policies as of September 30, 1986, and 144,000 as of September 30, 1985, according to CSC statistics. In May 1986 a former FIA Administrator announced that because of the WYO program, the number of NFIP policies had increased to the highest number ever.

Of the approximately 1,016,000 WYO policies as of September 30, 1986, new policies represented 27.8 percent, policies transferred from the direct program to the WYO companies represented 37.7 percent, and renewals of prior new policies and prior policy transfers from the direct program represented 34.5 percent. An unknown portion of the renewals are attributable to renewal of new policies written by WYO companies during the first 2 years of the WYO arrangement. The remainder would be renewals of former direct program policies that had been transferred by agents now writing for the WYO companies.

While a 27.8-percent rate of new policies may be encouraging, it should be noted that some new policies are necessary to compensate for policies that lapse or are canceled. In the direct program, the rate of

nonrenewals averaged about 19 percent a year for the past 5 fiscal years. Therefore, if the WYO nonrenewal rate approximates the direct program's, the actual net gain would be only about 9 percent. FIA had begun developing a report on the nonrenewal rate for the WYO policies in February 1987 to enable it to determine whether the WYO program is improving the renewal rate of the NFIP.

## Companies' Participation

The total number of companies that had signed arrangements with FIA increased from 48 in the first year—fiscal year 1984—to 259 companies in fiscal year 1986. As of September 30, 1986, 76 companies had written flood policies, although 11 of those companies notified FIA that they intended to withdraw from the program. Table II.3 shows the status as of September 1986 of WYO companies that were writing flood policies (referred to as writing companies), and WYO companies that were not writing flood policies (referred to as nonwriting companies). FIA expects that companies that sign the arrangement will begin writing policies within 2 years. Companies need time to prepare for WYO implementation. For example, some of the companies that we contacted needed to redesign their accounting systems, contract with firms to provide data processing or other services, design and print forms and marketing materials, and/or train staff.

**Table II.3: Status of WYO Companies Signed for Fiscal Year 1986 as of September 30, 1986**

Companies	Total signed	Not licensed to write	Withdrawal notice given during year
Writing	76	0	11
Nonwriting	183	5 <sup>a</sup>	8
<b>Total</b>	<b>259</b>	<b>5</b>	<b>19</b>

<sup>a</sup>At time arrangement signed for fiscal year 1986.

Source: GAO.

From program inception until September 30, 1986, a total of 52 companies either did not renew their annual WYO arrangements or had given notice that they were withdrawing from the program. None canceled during fiscal year 1984—the first year. After reviewing documentation and interviewing CSC account executives, we categorized the reasons given for companies' decisions to discontinue program participation. We were able to determine the reason or reasons for 38 companies. As shown in table II.4, the most frequently cited reason was insufficient business. For example, each of the 11 writing companies that withdrew in fiscal year 1986 had 75 or fewer flood policies in force during the

year. The other eight companies had not begun to write flood policies. CSC account executives said that the eight nonwriting companies that either did not renew for or withdrew in fiscal year 1986 cited potentially insufficient business as a reason.

**Table II.4: Reasons WYO Arrangements Were Not Renewed or Were Canceled in Fiscal Years 1984-86<sup>a</sup>**

Reasons cited by companies <sup>b</sup>	Times cited
Insufficient business	19
High start-up costs	13
Lack of staff or financial resources	12
Incompatibility with other types of insurance	5
Problems in nonflood business	4
Insolvent	3
Sold and new owner did not renew	1
Unknown	14

<sup>a</sup>None of the companies canceled during fiscal year 1984.

<sup>b</sup>Some of the 52 companies cited more than one reason.

Source: GAO.

In addition to insufficient business, high start-up costs and lack of staff or financial resources were frequently cited reasons for discontinuing participation. Some of the 13 companies that cited high start-up costs specifically mentioned charges by their servicing vendor as an expense that caused them to end their participation. According to CSC account executives, many of the 12 companies that cited a lack of resources were small and did not have the staff to begin selling a new type of insurance. Some small companies were licensed to write policies in only one state. CSC officials told us that several small companies signed the arrangement during the first year and then dropped out after they became more aware of the reporting and other requirements of the WYO program.

CSC account executives said that, after signing the arrangement, five companies determined that flood insurance was incompatible with their nonflood insurance business. For example, three companies decided to focus their sales efforts on automobile insurance. Four companies reported that they had problems in their nonflood business that prevented them from selling flood policies. Three companies reportedly became insolvent and one other was sold to a party that did not choose to continue in the WYO program.

The FIA Deputy Administrator said that this turnover was not unexpected. He believed that it was the result of FIA's policy to allow all

property and casualty insurance companies to sign the arrangement. He stated that experience showed that for some small companies, such as those licensed to write insurance in only one state, participation was not cost-effective for them or the NFIP.

As of March 1987, 213 companies had signed the fiscal year 1987 arrangement. Fifteen of those companies had not signed an arrangement previously. Companies not renewing for fiscal year 1987 totaled 61, including the 19 that gave notice of withdrawal during fiscal year 1986. An official representing three companies that did not renew for 1987 told us that he had signed the 1986 arrangement before his companies were licensed in order to save licensing time, but the companies' current types of business were incompatible with flood insurance. An official representing three other nonrenewing companies said that they did not have enough agents in any state to sell enough policies to pay for costs those companies would incur if the companies started writing flood policies.

Companies that do not renew are responsible for servicing policies that they have sold until the policies expire or are transferred to the direct program or another WYO company.

## Claims Processed by WYO Companies

Reported WYO claims payments totaled about \$84 million for fiscal year 1986—or about 22 percent of the fiscal year 1986 NFIP claims payments. According to CSC data, as of September 30, 1986, companies had received about 13,000 claims cases since program inception. Table II.5 shows the number of cumulative claims cases at the end of the past 3 fiscal years.

**Table II.5: Cumulative Number of WYO Claims Cases**

	Cumulative cases as of		
	9-30-84	9-30-85	9-30-86
Claims paid	37	1,179	9,166
Cases closed without payment	28	625	3,320
Cases open at September 30	38	2,252	521
<b>Total number of cases</b>	<b>103</b>	<b>4,056</b>	<b>13,007</b>

Source: CSC.

To provide a perspective on how relatively small the above numbers are, CSC reported that the direct program paid over 28,500 claims and closed about 9,300 without payment in fiscal year 1986 alone. CSC reported about 1,900 cases open as of September 30, 1986, in the direct

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**Appendix II**  
**WYO Program Status**

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program. WYO companies had processed relatively fewer claims cases than the direct program because the severest floods occurred between August and November 1985 when WYO companies had only sold about 25 percent of all NFIP policies.

# WYO Companies' Costs and Marketing Strategies Vary

Various factors impact on the ability to measure the benefits received by the federal government as a result of the administrative expense allowance retained by the companies from WYO policy premiums. Because of factors such as the lack of records at the WYO companies on how they use their allowances, we could not determine the benefits that could exclusively be credited to the WYO administrative allowance, which is higher than for sales through the direct program. We developed information relative to the administrative allowance, however, that should help the Subcommittee evaluate the WYO program. The WYO companies incur administrative costs for items such as marketing flood insurance, issuing policies, processing claims and changes to policies, training staff, and contracting with service vendors. The information available on company expenses attributable to flood insurance varied considerably for the seven writing companies that we contacted.

The percentage of premiums that FIA allows the companies for administrative expenses has decreased since fiscal year 1986. Generally on the basis of the insurance industry's average costs, FIA allowed all WYO companies to retain 32.7 percent of premiums collected during fiscal year 1986 for administrative expenses. The allowance will be 30.4 percent in fiscal year 1988. The allowance retained may fully cover administrative costs for some companies but may not be sufficient to cover such costs for all companies.

To help minimize program administrative costs, FIA does not require the companies to maintain records on how they use their WYO administrative expense allowance. Because such records are not required and kept by the WYO companies, we could not determine the specific effect of the allowance on policy sales. Companies' representatives cited several reasons why detailed cost information was not readily available on how their companies were using their allowances. These included

- The size of a company's flood insurance business relative to its other business influenced cost allocations such as the allocation of overhead costs. For example, the representative for two companies said that printing expenses related to the flood business had not been large enough to warrant allocation.
- The companies' accounting systems collected varying amounts of detail on in-house costs associated with the flood insurance program so that separation of WYO costs was not practicable.

We did obtain sufficient information from seven companies to determine that while those companies' strategies for marketing flood insurance

varied, their sales efforts were directed primarily toward agents to encourage them to sell policies.

One potential benefit of the WYO program is that additional staff trained in processing claims may result in faster payments to policyholders in the future. The writing companies that we contacted were training their staffs to provide claims service to their policyholders.

### Administrative Expense Allowance Is Decreasing

Under the WYO program, the administrative expense allowance for policies issued by the private companies is higher than the administrative costs for policies issued by the direct sales program operated by CSC, the NFIP servicing contractor. FIA has set lower allowances for fiscal years 1987 and 1988 because the published average industry costs, expressed as a percentage of premium income, have decreased. FIA uses those average industry costs in determining its WYO administrative allowance. Profit is not a component. FIA recognizes that companies that operate more efficiently than the industry average might spend less to administer the program than they receive to cover their expenses. Table III.1 lists the components FIA used in setting the total WYO administrative allowance for fiscal years 1986 to 1988. The allowance is expressed as a percentage of premiums collected.

Table III.1: Components FIA Used in Establishing the WYO Administrative Expense Allowance

Components	Fiscal years expressed as a percentage		
	1986	1987	1988
General expense	8.3	7.8	6.6
Marketing and other policy acquisition expense	6.3	6.3	5.7
State premium taxes	3.1	3.1	3.1
Agent commissions	15.0	15.0	15.0
<b>Total allowance</b>	<b>32.7</b>	<b>32.2</b>	<b>30.4</b>

Source: FIA.

Beginning with fiscal year 1985, FIA set the allowances for the first three components that contribute to the total allowance based on published industry averages. FIA set the WYO component for agent commissions at the same percentage it set for agents selling policies through the direct program.

With respect to the flood insurance program, the general expense component includes companies' costs for items such as underwriting,<sup>2</sup> accounting and statistical reporting to FIA, and overhead. The marketing and other policy acquisition expense component includes items such as advertising and agent bonuses. FIA includes the state premium tax component because states levy taxes of varying percentages on premiums collected by private companies to fund state oversight of companies' insurance operations. The federal government is not required to pay state premium taxes on policies sold under the direct program.

A few WYO companies sell insurance by mail or telephone with employee sales forces rather than selling insurance through insurance agencies. While those companies do not incur agent commissions, they do incur costs for salaries and related expenses, such as space, utilities, equipment, and advertising—expenses independent agents pay.

Under the WYO program, the administrative expense allowance for policies sold by the private companies is higher than the administrative costs for direct policy sales by the NFIP servicing contractor. FIA's Deputy Administrator said that they anticipated that for the first few years WYO administrative costs would be higher until companies sign the WYO arrangement and would then, hopefully, begin to increase the total number of NFIP policies in force.

## Types of Expenses Incurred

Although officials of the seven writing companies could not identify the total actual costs incurred in implementing the WYO program, they did identify the types of expenses they had incurred. The companies provided actual or estimated costs for several types of expenses. One or more of the companies incurred the following types of expenses in initiating and/or maintaining the program:

- creation and/or modification of computer and accounting systems, forms, and advertising;
- in-house costs or vendor charges for maintenance of data on flood policies and claims, and production of monthly reports for FIA;
- training and supervision of insurance agents, underwriters, administrative staff, and claims adjusters and examiners;

<sup>2</sup>Underwriting by FIA is the process of reviewing an application for insurance, determining and documenting the risk and applicable premium, and issuing a policy.

- state and municipal premium taxes, and state guaranty loss fund assessments;<sup>3</sup>
- agent commissions and licensing fees, and agent and manager bonuses; and
- other including travel, legal services, audits, flood map reading capability, and overhead.

The writing companies that we contacted generally paid insurance agents 15-percent commissions on flood premiums. The commissions ranged from zero for salaried sales agents at one company to up to 20 percent for those qualifying for another company's sales bonuses on new business. One other company offered lesser sales bonuses.

The following are examples of why companies' types of expenses varied. Some companies used FIA-provided forms, manuals, and workshops, while other companies developed their own materials and workshops to varying degrees. Some companies had developed more extensive marketing campaigns than others. Some companies used vendors to provide data processing and other services; other companies performed these functions themselves.

Companies' plans for the continued use of vendor data processing services varied. Three companies planned to continue using vendors for the foreseeable future. They wanted to lessen their costs associated with continuing changes in the statistical reporting requirements as FIA refines program reporting requirements and its computer edits of the data that companies submit. One company planned to continue using a vendor for flood insurance data processing because of dissatisfaction with its own data processing priority system. Another company may develop its own data processing system if the volume of flood insurance business would make it cost-effective. Representatives of two companies that had developed their own systems expressed satisfaction with those systems but were concerned about the potential impact of future program changes on those systems.

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## Staff Resources Increasing

Improved service to policyholders—such as faster processing of claims arising from flood damage—is one of the goals of the WYO program. One way to process claims faster, and thus one WYO program goal, is to increase the number of staff trained and available to handle flood

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<sup>3</sup>States assess insurance companies operating within their jurisdiction fees to cover claims filed on policies issued by insolvent companies.

claims. The processing of claims under the direct program has been hampered at times because of relatively fixed numbers of trained independent adjusters and servicing contractor staff. At the writing companies that we contacted during our review, the number of staff trained and available to process flood claims was increasing, which may result in faster claims processing.

Under the direct program, the servicing contractor hires independent adjusters to inspect and document flood damage. The contractor also uses staff claims examiners to review the files that adjusters submit and/or to reinspect flooded properties. The WYO companies and/or their vendors had trained or were in the process of training their claims examiners to review the files adjusters submitted on each flood claim. Some companies were training their own adjusters to handle flood claims as well. Some WYO companies' representatives said that, because of the volume of nonflood claims they have independent adjusting companies handle, the WYO companies have some leverage with those companies in requiring faster adjusting of flood claims.

Some companies have investigative units to supplement FEMA and CSC staff to check further on certain types of suspicious claims or the adjusting of those claims.

## Companies' Marketing Strategies and Efforts Vary

FIA established a goal of having 2.5 million policies in force by September 1988. That goal has been communicated to the WYO companies, but FIA has not established specific marketing goals for the WYO program such as what share of the total program the private companies should write. FIA expects, but has not required, WYO companies to spend funds to market flood insurance. FIA officials said they anticipated that the companies would first establish themselves in the traditional flood-prone states that had relatively large numbers of flood policies, and then spread into other areas. Program statistics and the comments of WYO companies' representatives support this pattern.

In the absence of specific FIA marketing goals, the marketing strategies of the WYO companies that we contacted varied depending on factors such as company goals, the length of time the company had been writing flood insurance policies, and the company-agent relationship.

WYO companies have been primarily marketing flood insurance to insurance agents, rather than advertising directly to potential policyholders. Program statistics indicate that this approach may be successful. As of

September 30, 1986, the WYO companies reported that about 28 percent of the policies covered newly insured property.

WYO companies' officials mentioned several key points that influenced their marketing strategies. These included:

- Flood insurance was a secondary line of insurance after the property owner purchases basic property loss and liability insurance.
- Companies were sensitive to the fact that slow or poor service on flood insurance claims could adversely impact on policyholder retention of other types of insurance, so they did not want to expand flood policy sales beyond their ability to process related claims.
- Four of the seven writing companies limited the marketing of their flood and/or nonflood types of insurance in certain states because of state regulation and/or charges. State regulation includes action by insurance commissions, legislatures, and/or state courts, particularly with respect to coverage.
- Some companies developed marketing materials for two audiences—the agents, to encourage them to write flood policies with a particular company, and the potential policyholders. The companies had not sent flood marketing materials to their nonflood policyholders without the agents' permission. Companies' representatives said that their agents "own" or control the policies. Also, some companies required the agents to share or pay all of the cost of advertising directed toward customers. Six of the seven companies could not require agents to use company-provided marketing materials.

## Possible Changes Under Consideration by FIA

FIA is considering several options for revising the way it calculates the administrative expense allowance, according to FIA's Deputy Administrator. Options under study include variances in allowances for renewals and new business and bonuses for higher volume policy sales. FIA is also studying whether it should revise the administrative expense allowance to reflect that some companies pay their sales forces or agents percentage commissions only, some companies pay salaries only, and other companies use both types of compensation. FIA also plans to review whether the companies' marketing of flood insurance is increasing the number of policies in force sufficiently to justify the full marketing and other policy acquisition expense allowance.

Because the federal government guarantees payment of valid claims arising from flood insurance policies, FIA is working with the National Association of Insurance Commissioners to request that states exempt WYO policies from state guaranty loss fund assessments as the states revise their procedures.

# FLA's Management and Companies' Administration of the WYO Program

FIA manages the WYO program (1) through a series of statistical and accounting requirements companies and/or their vendors must incorporate into their systems for reporting on flood insurance transactions and (2) by monitoring WYO companies' administration. At the conclusion of our review (December 1986), FIA was continuing to improve several portions of its monitoring system and was developing plans for specific periodic financial audits by certified public accounting (CPA) firms of WYO companies' flood insurance operations. To carry out its monitoring activities, FIA has supplemented its resources with a committee made up of FEMA and industry officials with contractor assistance from CSC and a CPA firm.

Although FIA officials were generally satisfied with the majority of the writing companies' operations, FIA was working with a few companies to improve their operations at the conclusion of our review. FIA was also developing reports to facilitate its evaluation of companies' performances based on transactions processed and was developing criteria for the termination of companies for unsatisfactory performance. We believe that the system FIA is developing should, when fully implemented, provide FIA with the information needed to monitor the companies' performances and detect problems promptly so corrective action can be initiated.

FIA's WYO management system is designed to help assure that a policyholder pays the same premium rate for the same coverage regardless of which company issues a policy, and receives the claims settlement to which he is entitled; and that all funds connected with the program are properly accounted for. FIA has established statistical and accounting requirements the companies and/or their vendors must incorporate into their systems for processing flood insurance transactions. Those requirements facilitate FIA's computer-aided analyses of companies' monthly reports on transactions to identify problems companies experience. FIA also relies on a series of on-site reviews of companies' internal controls and operations. As long as companies operate in accordance with FIA's requirements, they may and do administer the program as they choose.

Table IV.1 provides a listing of the major management controls provided for in the WYO Financial Control Plan. The Plan explains the procedures under which the WYO companies and FIA are to maintain financial control of policies sold under the WYO program. To supplement the Financial Control Plan, FIA has also developed a Statistical Plan and an Accounting Procedures Manual for WYO companies.

**Appendix IV  
FIA's Management and Companies'  
Administration of the WYO Program**

**Table IV.1: Management Controls  
Required by WYO Financial Control  
Plan**

<b>Plan reference</b>	<b>Type of control</b>	<b>Scheduled frequency</b>	<b>Performed by</b>
Preamble	On-site evaluations of company audit plans	Triennial	FIA
Part 1	Company audit reports	Yearly	Company
Part 2	Statistical edits of WYO computer tapes	Monthly	CSC
Part 3	Underwriting operation reviews	Triennial	FIA
Part 4	Claims operation reviews	Triennial	FIA
Part 5	Claims reinspections	As claims are adjusted	Company and FIA/CSC
Part 6	Independent financial audits	Triennial	CPA firm

Source: GAO.

The following discussion presents the controls in the sequence that FIA and the companies generally implement them. We discussed with representatives from seven writing companies selected aspects of their companies' administration of the program, including internal controls they apply, particularly in the payment of claims; and reviews of their flood insurance operations and actions being taken as a result of those reviews. We have included companies' comments in the sections below along with FIA's comments on the results of their monitoring of WYO companies.

### Monthly Statistical Reports

The monthly computer tapes submitted by companies provide FIA with financial and other data on WYO policy underwriting and claims activities. Part 2 of the WYO arrangement's Financial Control Plan requires the companies to submit monthly reports to FIA's servicing contractor—CSC—on all transactions affecting policies they have issued. CSC edits the transaction tapes and produces a series of reports on each reporting company and total WYO program operations. During our review, FIA and CSC were working to improve the quality of the data submitted and to develop additional reports to facilitate FIA's monitoring of companies' program administration.

### Data Errors Being Reduced

CSC provides FIA with reports on the number of transactions identified as containing errors by type of error, and on companies required to report but did not. FIA officials have used the reports on errors and missing transaction tapes as an early alert to companies' problems in operating the WYO program. Inconsistencies in computer programs used by the

companies and CSC, however, have limited the value of the data for monitoring purposes. Reports on the number of policy files with errors indicated as much as 54 percent of the policies had errors at one point. The overall error rate had declined to 24 percent as of September 30, 1986. FIA, CSC, and companies' representatives told us that the number of errors had been inflated due to data entered incorrectly on computer tapes and software inconsistencies between companies and CSC.

FIA and CSC began a special high-priority project about November 1985 to identify the causes of errors and reduce the number of computer-related errors, so attention could be directed to errors arising from the underwriting process. FIA issued revised statistical system edits<sup>4</sup> to the companies in August 1986 designed to reduce future computer errors. FIA officials said that while they had nearly completed this project by February 1987, they would not know the results of the changes until about April 1987 due to the 60-day lag in reporting.

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### Claims Analyses Reports Not Available Until 1987

FIA and CSC have developed periodic management reports that provide limited information on all WYO companies' claims activities. FIA did not have management reports available in fiscal year 1986 that would permit it to routinely review all WYO companies' claims service performance between on-site visits. FIA officials stated that development of such reports is a priority project in fiscal year 1987. FIA and CSC had begun to develop the reports by the conclusion of our review.

Although FIA provided processing time guidelines to the companies, FIA and CSC had not developed, from the monthly data companies submitted, reports on each company's claims payments and timeliness in processing individual claims. When we discussed with FIA officials the limited information on claims service, an FIA official stated that they are including the development of such reports in their priority projects for fiscal year 1987. As of February 1987, CSC had developed samples of several additional reports that will better enable FIA to monitor WYO companies' claims service. The new reports would include comparisons of the timeliness of claims settlements and of the consistency in claims payments of losses under similar circumstances for the direct and WYO portions of the NFIP.

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<sup>4</sup>The statistical system edits are designed to check whether policy data entered into the computer system are correct, and whether the correct premium has been calculated and collected. For example, one edit checks whether coverage under each policy exceeds the amount authorized under the program.

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## Claims Reinspections

FIA's monitoring of selected WYO companies indicates that those companies generally provided satisfactory claims service, although the companies made some errors due to insufficient experience.

On behalf of FIA, CSC conducted 299 joint reinspections with nine companies' designated representatives in fiscal year 1986—the first year joint reinspections were done—to review the quality of the claims adjusters' work. The reinspections involved a review of companies' claims files and visits to flooded properties in four states. Program savings occur when errors are detected before a company completes claims payments and the amount a company plans to pay is reduced. For example, at one company, the joint reinspections resulted in savings of about \$50,000. The joint reinspections have also been used to train company staff in the specific kinds of evidence needed to document flood losses.

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## Staff Inexperienced

FIA officials told us that the companies' examiners had not always recognized errors in the files submitted by the claims adjusters. For example, some allowed too much for cleanup costs, or allowed for certain kinds of water damage not covered by flood insurance, or did not recognize that the adjusters had applied depreciation incorrectly. FIA officials attributed this problem to insufficient experience with flood claims. FIA officials based their statements on the joint CSC/WYO company reinspections done under Part 5 of the Financial Control Plan and FIA operational reviews of WYO claims—a desk audit of claims files done under Part 4 of the Plan, which is described in the section of this appendix that discusses on-site monitoring by FIA.

Also, some WYO companies' representatives told us that, because their staffs were still being trained and had relatively little experience in flood claims processing, they were not certain that their companies were prepared yet to deal promptly with an influx of flood claims after a large disaster.

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## Problems in Identifying Claims for Reinspections

To identify opportunities for joint reinspections before companies pay flood claims, CSC started preparing reports in January 1987 that identify, by community, clusters of 25 or more notices of claims received in a short period of time. FIA's goal is to do joint reinspections on about 10 percent of the claims. The WYO arrangement suggests that claims should be adjusted and processed for payment in about 10-1/2 weeks on the average from the date the policyholder notifies the insurance agent of the loss. FIA officials said that in their limited monitoring of selected WYO

companies, those companies processed claims in less time than the arrangement suggests.

During our review, FIA had difficulty identifying opportunities for conducting joint reinspections with WYO companies before they pay claims. The regular monthly statistical reports that include data on claims filed are not available to FIA until about 60 days after the close of the month when the WYO companies recorded the data. Sometimes, the WYO companies do not immediately learn of localized floods affecting their policyholders. For example, one WYO company that we contacted instructed its agents to directly contact designated claims adjusting companies on flood claims to speed the adjusting process, rather than notifying the WYO company and it notifying the adjusting company. By the time a WYO company learns that it has several claims in a given location, insufficient time may remain to arrange a joint reinspection before the company would normally pay the policyholder's claim.

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## Company Audit Reports

Under Part 1 of the WYO Financial Control Plan, each company is required to conduct an evaluation of its operating procedures and submit an audit report 30 days after its first 12 months of operation. The report is to cover underwriting, claims, accounting and statistical/data processing, and financial management. FIA permits the company to designate who will perform the audit. These audits have been done by the companies' program managers, internal auditors, and/or vendors. As of December 1, 1986, FIA had received 79 audit reports (including 28 second reports) covering 51 companies.

Companies' representatives said that they found these audits helpful to their own monitoring efforts. They said that the audits, combined with FIA's feedback from its monitoring efforts, were helpful in identifying errors being made by agents, claims adjusters, their own administrative staff, and/or vendors. Two companies, which did not have an internal audit function prior to writing flood insurance policies, have established and staffed such a function.

Although FIA reported that all companies submitted their audit reports as scheduled, FIA officials said that they have not found those reports as useful as they anticipated because of variations in content. FIA officials cited as examples: some reports were two pages in length with no detail on what was found; some contained details on each policy and claim file reviewed during the company audit, but contained no summaries; and some did not include corrective actions planned and/or implemented.

FIA intends to develop standard reporting requirements. FIA's Deputy Administrator told us in December 1986 that FIA's target date for implementing a standard reporting format for company audit reports is October 1, 1988, because of other higher priority projects. That date also reflects FIA's cycle of proposing regulatory changes each spring for implementation the following October. He said that in the meantime FIA will continue dealing with the company audit reports on a case-by-case basis.

## On-Site Monitoring by FIA

FIA maintains program oversight, in part, by using two types of on-site monitoring—operational reviews and evaluations of companies' audit plans. FIA procedures call for operational reviews of policy and claims files under Parts 3 and 4 of the Financial Control Plan to be performed at least once every 3 years. FIA did not wait until companies had been writing policies for 3 years before conducting these reviews. FIA officials said that the reviews are being conducted earlier in order to distribute FIA's workload, to detect errors as soon as practicable after a company begins operations, or respond to problems when FIA learns of them.

During operational reviews, FIA conducts on-site examinations of WYO companies' underwriting and policy administration and claims operations. As of September 30, 1986, FIA had conducted 14 underwriting and policy administration reviews and 10 claims reviews. In all but one case, FIA reviewers gave the companies satisfactory ratings while noting needed improvements as appropriate. At the conclusion of our review, one company had received an unsatisfactory preliminary rating for claims operations because FIA staff identified excessive claims payments attributed to inaccurate damage estimates and other problems.

At the conclusion of the reviews, the reviewers meet with company officials and advise them of the problems found. FIA provides copies of its draft reports on the reviews to the companies for formal response and corrective action. An FIA official told us that potentially serious or unresolved problems would be referred to the WYO Standards Committee.

The Standards Committee, which meets at least four times a year, consists of five insurance industry representatives and five government representatives appointed by the FIA Administrator, and one ex officio member—the FEMA Inspector General. The Committee's duties and responsibilities include

- evaluating companies' performance against the standards contained in the WYO arrangement,
- monitoring companies' compliance with the Financial Control Plan, and
- recommending changes needed in the Financial Control Plan or the company performance standards.

The Standards Committee receives technical assistance from the Flood Insurance Committee of the National Committee on Property Insurance—an insurance industry advisory organization.

FIA also conducts triennial on-site evaluations of WYO companies' operations to review the companies' audit plans. A former Administrator set a goal of reviewing the plans of one third of all writing companies annually. By December 1, 1986, FIA had conducted evaluations of 33 companies' audit plans and had designated four companies for special monitoring because of financial difficulties. FIA was continuing to monitor the condition of three companies at the conclusion of our review.

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## Independent Audits

To implement Part 6 of the Financial Control Plan and meet audit requirements for the NFIP as a whole, FIA is developing plans for an independent CPA audit of each writing company's flood business at least once every 3 years. A CPA firm under FIA contract is formalizing the criteria for an "audit for cause" also.

Of the seven writing companies, one told us that its CPA firm had audited its WYO business. Representatives of one other company said that their WYO business was not specifically audited but their flood policies were in the universe of policies from which the CPA firm drew its sample for a company-wide audit. The representative for two companies told us that their CPA firm had requested the monthly bank reconciliations on the flood business. Other companies' officials said that they had not discussed with their independent auditors the reasons why the auditors had not included the flood business in the audits. State regulators had not specifically audited the flood business of any of the seven companies.

At the audit workshops at the 1986 WYO conference, panel members told participants that the companies will probably either have to have their independent accounting firms audit their WYO business in enough detail to render an opinion, or let FIA do financial audits of the companies on a staggered basis.

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**Appendix IV  
FIA's Management and Companies'  
Administration of the WYO Program**

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FEMA is finalizing a plan to include the WYO portion of the NFIP in the audit of the NFIP's fiscal year 1986 transactions. The NFIP must be audited by an outside auditor at least once every 3 years. The results of those audits are subject to GAO review. For fiscal years 1984 and 1985, FIA had not opted to include the WYO portion in the CPA audit of the NFIP.

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The FIA Deputy Administrator told us that two companies, which were not among those we contacted, had not satisfactorily implemented the requirements in the Financial Control Plan. FIA and CSC staff have been working with those companies to correct the problems noted. To deal with problem companies in the future, FIA has contracted with a CPA firm to formalize criteria for an audit for cause. Such an audit with adverse findings could result in a company being barred from WYO program participation.

We believe that FIA's efforts to improve the reinspection program combined with its efforts to develop routine reports on WYO companies' claims processing will better enable FIA to monitor the claims service under the WYO program.

# Companies' Concerns About the WYO Program

During our discussions with WYO company officials and at the Kansas City WYO conference, they expressed concern and/or opinions on several aspects of program administration. Below are discussions of three program matters we believe may be helpful in understanding and evaluating the WYO program. The three are

- continuation of the direct sales program,
- need for adequate advance notice from FIA on program changes, and
- willingness of companies to share the cost of claims.

## Continuation of the Direct Sales Program

One concern that company representatives discussed at the WYO conference and with us is the potential for competition between the direct and WYO portions of the NFIP and whether the direct program is still needed. FIA has decided to retain the direct program for the next few years. FEMA is preparing the request for proposals for a new contract in order to continue operation of the direct program through September 30, 1993.

FIA and company officials cited the following information indicating the need to continue the direct program for the next few years.

1. Currently, if a company withdraws from the WYO program, its WYO policies are reassigned to the direct program to assure continued service to the policyholder, unless another company agrees to accept those policies. FIA needs a servicing agent for policies if it terminates its arrangement with a WYO company suddenly. For example, a company may be terminated due to inadequate management. Most companies have not operated the WYO program long enough to prove that they can manage it as required. Also, some insurance companies may go out of business due to financial losses incurred on their nonflood types of insurance.
2. The direct program provides a neutral location for companies and/or agents to send flood policies including those cases when a company limits its own operations in a state, or is not licensed to do business in a state. The actual availability of flood insurance from WYO companies is more limited than a list of writing companies would indicate.
3. Some companies may not be willing to provide service to the agent who only writes two or so flood insurance policies a year. For example, one representative told us that his company would not license an agent in one particular state unless the agent could expect to write at least 10 flood policies a year because of the state's high agent licensing fees. Some companies question the cost-effectiveness of the direct program

dealing with agents who write few policies, but FIA's policy on competition is that such agents will not be excluded from writing flood policies.

4. Some companies may not want the business of a particular flood insurance applicant. One company said that it does not accept applicants for its nonflood policies if it learns that the applicant has a bad credit record because such policyholders have filed higher than average claims. That company permits its agents to write policies for such applicants through the direct program. Another company expected its agents to refer undesirable applicants to a nonaffiliated agent—partly to avoid inheriting such policyholders later in the process of agents transferring policies from the direct program to that company.

## Need for Adequate Notice From FIA on Program Changes

Companies' representatives expressed concern to FIA at the May 1986 conference and to us about the way FIA implements NFIP changes. Companies' representatives were concerned about FIA actions that change premiums after the companies have prepared renewal notices. After the conference FIA postponed indefinitely part of the proposed changes in rates and coverage scheduled for implementation October 1, 1986, because of adverse congressional reaction to the proposed rate increases. When we discussed the matter with FIA officials at the conclusion of our review, they said that they recognize the validity of the WYO companies' complaints and are trying to avoid such situations in the future.

Companies' representatives said that they need adequate notice from the FIA on the amount of and effective date for rate changes. They said that FIA had announced changes affecting premiums and then rescinded or delayed the changes too close to when the companies or vendors should have been changing the systems that generate renewal notices. For example, one company we contacted had already issued the notices before FIA rescinded rate changes. Policyholders paid incorrect renewal premiums and the company had to make refunds. The company also had to rescind notices it had sent to agents.

Because of such comments, during our review, we asked the writing companies and the vendor we contacted about the amount of lead time they needed to implement changes. For a simple change such as a premium rate revision, the companies said they need as much as 120 days notice prior to the effective date, even though the change itself basically

involves changing a number in a formula. Their lead times take into consideration that renewal notices are automatically generated by computers 60 to 90 days before a policy expires, and subsequent corrections are costly to process. They said that they may need more than 120 days for changes requiring reprogramming and testing of computer software.

WYO companies' representatives also said that companies and agents have difficulty learning the flood insurance program, especially when it is changing frequently. Representatives commented on insurance agents receiving frequent notices of changes on flood insurance when the agents may have as many as 40 other types of insurance on which to stay current. They suggested that changes be grouped into larger, less frequent changes.

FIA's Administrator said that FIA is very much aware of the companies' concerns and FIA is trying to provide enough advance notice of changes to avoid the issuance of incorrect premium notices to policyholders or otherwise complicate program administration. For example, in 1986 FIA delayed for 3 months the requirement that WYO companies print new policy forms for fiscal year 1987 to allow the companies more time for printing.

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## Companies Expressed Reservations on Sharing Cost of Claims

Because companies' sharing the risk of losses from claims exceeding premium income is a long-term goal of the WYO program, we discussed the companies' willingness to share in such losses with representatives of writing companies. Some said their companies would not be willing to share flood claim losses unless the insurance premium rates are increased to cover such potential losses. They also said other factors that would influence decisions on sharing flood losses were the availability of reinsurance and the potential for spreading the risk of losses geographically.

The WYO companies must have some control over the rates so that they are commensurate with the risk that companies would be expected to bear, according to some companies' representatives. The present system in which FIA proposes rates that can be denied or revised by the Congress is not attractive to the private sector. Some representatives said that if the program were "privatized" as presently constituted, they were not certain that their companies would continue to participate. If the companies did continue to participate, they may not be willing to sell unlimited amounts of flood insurance in all areas of the nation. For

example, six of the seven writing companies that we contacted were limiting sales of their nonflood property insurance in coastal areas.

Another concern and a current problem is obtaining sufficient reinsurance, according to some companies' representatives. Companies obtain reinsurance to cover potential liabilities in their nonflood types of insurance to satisfy state insurance commissions that they are financially reliable. The representatives believed that finding reinsurance for flood risks from a nonfederal source would increase that problem.

Some representatives also expressed reservations about their companies' abilities to insure properties in enough geographical areas to spread the cost of catastrophic losses among policyholders. If property owners perceive insurance premiums to be more costly than a potential flood loss, they may not buy or renew flood insurance policies, unless required to do so—by their lender, for example.

FIA's Deputy Administrator said that FIA recognizes that the NFIP would need to be actuarially sound before the WYO companies would be willing to share the risk on losses. He noted that legislation would be needed to authorize a catastrophic reserve with a funding mechanism to cover major events.

One company proposed to FIA that the federal government establish a reinsurance fund to cover floods, earthquakes, volcanic eruptions, nuclear accidents, catastrophic earth movements, and major hurricanes. Multihazard coverage would be provided through regular property insurance policies, and covered losses would be paid from a fund created by an annual assessment on premiums collected from all companies selling multihazard insurance. This is based on the following:

- People generally buy insurance only for a risk that they perceive as probable.
- The types of hazards listed tend to occur only in certain parts of the country and with varying likelihood of catastrophic damage.

Every state is at risk from one or more of the hazards listed, so a combined risk fund would permit spreading the risk from any one type of disaster and geographical area to all property owners at reasonable rates.

FIA's Deputy Administrator said that the need for a multihazard catastrophic federal reinsurance fund has not been demonstrated by the

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**Appendix V  
Companies' Concerns About the  
WYO Program**

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state insurance commissions or the insurance companies. He said that establishing such a fund could result in the federal government reinsuring losses that are currently the financial responsibility of insurance companies.

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