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Report to the Ranking Member, Committee on Financial Services, House of Representatives

December 2016

FLOOD INSURANCE

FEMA Needs to Address Data Quality and Consider Company Characteristics When Revising Its Compensation Methodology

Accessible Version

GAO-17-36

GAO Highlights

Highlights of GAO-17-36, a report to the Ranking Member, Committee on Financial Services, House of Representatives

Why GAO Did This Study

Private insurers (WYO companies) sell and service flood policies and adjust claims for NFIP under an arrangement with FEMA. In GAO-09-455, GAO made recommendations on FEMA's WYO compensation methodology and data quality. The Biggert-Waters Act built on these recommendations and required FEMA to develop a methodology for determining appropriate amounts WYO companies should be reimbursed. GAO was asked to review the status of FEMA efforts. This report examines, among other issues, (1) the extent to which FEMA revised compensation practices, and (2) trade-offs of potential alternatives to the WYO arrangement. GAO reviewed laws and regulations, analyzed FEMA data and data on expenses reported to NAIC for 2008–2014 (most recent available), and interviewed FEMA and NAIC officials, stakeholders (11 organizations with flood insurance expertise, three vendors), and 10 selected WYO companies with varying NFIP premium bases. To compare FEMA compensation with actual expenses, GAO examined information on accounting and reporting practices from a second selection of 10 WYO companies (in this case, insurers wiithin10 insurance groups) that received about 60 percent of compensation in 2008–2014.

What GAO Recommends

GAO maintains that its 2009 recommendations remain valid and will help FEMA meet Biggert-Waters Act requirements. In this report, GAO recommends that FEMA take into account company characteristics when developing the new WYO compensation methodology. FEMA agreed with the recommendation.

View GAO-17-36. For more information, contact Alicia Puente Cackley at (202) 512-8678 or cackleya@gao.gov

December 2016

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FEMA Needs to Address Data Quality and Consider Company Characteristics When Revising Its Compensation Methodology

What GAO Found

The Federal Emergency Management Agency (FEMA) has yet to revise its compensation practices for Write-Your-Own (WYO) companies to reflect actual expenses as required by the Biggert-Waters Flood Insurance Reform Act of 2012 (Biggert-Waters Act), and as GAO recommended in 2009. FEMA continues to rely on insurance industry expense information for other lines of property insurance to set compensation rates for WYO companies. Efforts by FEMA, the National Association of Insurance Commissioners (NAIC)—which collects data by line of insurance from insurance companies—and the WYO companies have resulted in some improvements to financial data on National Flood Insurance Program (NFIP) expenses that WYO companies report to NAIC. But GAO found inconsistencies among how 10 selected WYO companies (which received about 60 percent of the compensation FEMA paid in 2008–2014) reported federal flood data to NAIC that limit the usefulness of these data for determining expenses and setting compensation rates. For example, GAO analysis showed that adjusting for inconsistencies due to unreported expenses significantly reduced WYO company profits. Consequently, without quality data on actual expenses, FEMA continues to lack the information it needs to incorporate actual flood expense data into its compensation methodology as well as determine how much profit WYO companies make and whether its compensation payments are appropriate. FEMA has not clarified what other analyses it will undertake to address GAO 2009 recommendations concerning data quality. GAO also found the ways in which WYO companies operate, including how companies compensate agents and third-party vendors (with which some companies contract to conduct some or all of the management of their NFIP policies) can affect a company's expenses and profits. Considering company characteristics would allow FEMA to more effectively develop its compensation methodology and determine the appropriate amounts to reimburse WYO companies as required by the Biggert-Waters Act.

According to WYO companies and stakeholders, the current WYO arrangement and three potential alternatives GAO identified all involve trade-offs. Private insurers become WYO companies by signing a Financial Assistance/Subsidy Arrangement with FEMA and FEMA annually publishes terms for participation in the WYO program, including amounts companies will be paid for expenses. The current arrangement includes benefits for consumers from competition among approximately 75 WYO companies, but poses oversight challenges for FEMA due to the large number of companies. The three potential alternatives involve FEMA contracting with (1) one or more insurance companies to sell and service flood policies; (2) one vendor that would sell policies through agents and insurance companies would not be involved; or (3) multiple vendors to service policies while maintaining the WYO network to market and sell flood policies. All three potential alternatives would involve FEMA contracting with either WYO companies or vendors as federal contractors, a status that most WYO company representatives cited as creating more regulatory burden because of federal contract requirements. Representatives of most WYO companies and several stakeholders GAO interviewed preferred the current arrangement because of its predictability and noted that this characteristic would continue to encourage WYO company participation.

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Abbreviation

ALAE	allocated loss adjustment expenses
Biggert-Waters Act 2012	Biggert-Waters Flood Insurance Reform Act of
DHS	Department of Homeland Security
DSA	Direct Servicing Agent
FAR	Federal Acquisition Regulation
FEMA	Federal Emergency Management Agency
FIMA	Federal Insurance and Mitigation Administration
FIO	Federal Insurance Office
HFIAA 2014	Homeowner Flood Insurance Affordability Act of
IBNR	Incurred But Not Reported Losses
IPIA	Improper Payments Information Act
NAIC	National Association of Insurance Commissioners
NFIP	National Flood Insurance Program
OIG	Office of Inspector General
OMB	Office of Management and Budget
SALAE	special allocated loss adjustment expenses
SFFAS Standards	Statement of Federal Financial Accounting
ULAE	unallocated loss adjustment expenses
WYO	Write-Your-Own

U.S. GOVERNMENT ACCOUNTABILITY OFFICE
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December 8, 2016

The Honorable Maxine Waters Ranking Member Committee on Financial Services House of Representatives

Dear Ms. Waters:

Private insurers sell and service flood insurance policies and adjust claims for the National Flood Insurance Program (NFIP) under an arrangement with the Federal Emergency Management Agency (FEMA), an agency of the Department of Homeland Security (DHS). Under the Write-Your-Own (WYO) program, as of September 2016, NFIP had about 75 WYO companies. FEMA also sells and services flood insurance through a Direct Servicing Agent (DSA) that also provides an alternative when a WYO company is unable or unwilling to write a flood insurance policy. At the end of calendar year 2015, FEMA had 5.2 million NFIP policies, which equaled about $3.4 billion in earned premiums.

In 2009, we found that FEMA did not systematically consider actual flood insurance expense information when it determined payments to WYO companies for selling and servicing flood insurance policies and adjusting claims. As a result, we made recommendations aimed at improving the transparency and accountability of FEMA's payments to WYO companies.[1] In addition, section 224 of the Biggert-Waters Flood Insurance Reform Act of 2012 (Biggert-Waters Act) requires that FEMA develop a methodology for determining the appropriate amounts WYO companies should be reimbursed.[2] More specifically, the Biggert-Waters Act requires the methodology to be developed using actual expense data for the flood insurance line and can be derived from (1) flood insurance expense data produced by the property and casualty insurance companies; (2) flood insurance expense data collected by the National Association of Insurance Commissioners (NAIC); or (3) a combination of

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

[2]Pub. L. No. 112-141, Div. F, Tit. II, Subtit. A, § 100224, 126 Stat. 916, 936 (2012).

methodologies using expense data from the insurance companies and from NAIC.[3]

You asked us to look at FEMA's progress on revising its compensation practices and compare actual expenses with payments to WYO companies. This report discusses (1) FEMA's current compensation practices for WYO companies and the extent to which FEMA revised its practices in response to Biggert-Waters Act requirements; (2) information on over- and underpayments of NFIP policy claims; and (3) trade-offs of selected potential alternatives to FEMA's current arrangement with WYO companies for selling and servicing flood insurance policies.

To identify current compensation practices and changes since 2008, we reviewed the Biggert-Waters Act, other relevant laws and regulations, our previous reports, and FEMA documents.[4] We interviewed FEMA officials about implementation of the Biggert-Waters Act requirements and our 2009 recommendations, interviewed the National Association of Insurance Commissioners (NAIC) on WYO company federal flood data, and interviewed 10 WYO companies on how expenses were incurred and

[3]*Id*. Section 224 set deadlines for FEMA to complete its revisions, issue rules, and report to Congress. Specifically, the act required FEMA to (1) develop a methodology, described above, by January 2013, for determining the amount that WYOs should be reimbursed for selling, writing, and servicing flood insurance policies and adjusting claims; (2) issue a rule by July 2013 to formulate revised expense reimbursements to WYO companies participating in the program (such reimbursements must be structured to ensure they track the actual expenses, including standard business costs and operating expenses, of the WYO companies as closely as practicably possible); and (3) submit a report to Congress within 60 days of the rule's effective date including the specific rationale and purposes of the rule, the reasons for the adoption of the policies contained in the rule, and the degree to which the rule accurately represents true operating costs and expenses of WYO companies.

[4]See, for example, GAO, *Flood Insurance: Forgone Premiums Cannot Be Measured and FEMA Should Validate and Monitor Data System Changes*, GAO-15-111 (Washington, D.C.: Dec. 11, 2014); GAO-09-455; and *National Flood Insurance Program: FEMA's Management and Oversight of Payments for Insurance Company Services Should Be Improved*, GAO-07-1078 (Washington, D. C.: Sept. 5, 2007).

reported.[5] This is the first group of 10 WYO companies we selected. We later identified a second and third group of 10 WYO companies to address other aspects of our reporting objectives.

To compare FEMA compensation with actual expense data reported to NAIC, we obtained and analyzed premium, loss, and compensation data for all WYO companies for fiscal years 2008–2014 from FEMA and premium, loss, and expense data for all WYO companies from SNL Financial and NAIC for calendar years 2008–2014, the most current data available.[6] For purposes of our analysis, we retrieved federal flood line data reported to NAIC from SNL Financial. To better understand WYO companies' accounting and reporting of federal flood data and estimate the companies' profit on the flood insurance line, we selected another group of 10 WYO companies that accounted for about 60 percent of total compensation during calendar years 2008–2014.[7] We interviewed these WYO companies and requested and examined additional information and data they provided. We used this information and data to evaluate differences in premiums, losses, and expenses reported to NAIC and FEMA and corroborate statements the companies made to us about changes to their accounting and reporting practices and payments to their vendors and adjusters. Based on the additional information and data provided and our analyses, we made adjustments to the expenses

[5]For our interviews, we selected a nongeneralizable, purposive sample of 10 WYO companies, selected based on net premiums written in order to capture WYO companies with a large portion of the market share of premiums written, as well as obtain the opinions of WYO companies of different sizes, in terms of their involvement in NFIP. Of these 10 WYO companies, we selected 2 WYO companies that do not use subcontractors (vendors) to service policies to obtain a broader range of perspectives. Throughout the report, we discuss three different selections of 10 WYO companies. This was our first selection of WYO companies and we generally refer to it as WYO companies we interviewed.

[6]S&P Global Market Intelligence is a leading provider of financial data, news, and analytics. The data sourced in this report is from S&P Global Market Intelligence's SNL Financial database of publicly filed financial and insurance regulatory information, which includes information it purchases from NAIC. For this report, we refer to the source of the data for our analysis as SNL Financial.

[7]For purposes of our analysis of WYO company reporting, we selected a second nongeneralizable, purposive sample of 10 WYO companies, selected based on net premiums written during 2008–2014. We overselected WYO companies with a larger share of the market because of their relevance in the flood insurance market. The term "companies" for this selection includes all WYO insurers in a related insurance group. Several companies overlapped with the companies selected to interview. We generally refer to these WYO companies throughout the report as WYO companies we reviewed or analyzed.

reported to NAIC for unreported expenses, reclassifications of expenses, and the effects of different loss adjustment expense estimates and recalculated estimated profit (on a pre-tax basis) for these 10 WYO companies for calendar year 2014. Our analysis and ability to estimate expenses, make adjustments, and estimate profit were subject to certain limitations (for example, some information was not available to us to estimate the effect of unallocated overhead expenses).

We assessed the reliability of FEMA, NAIC, and SNL Financial data. For the FEMA data we (1) recalculated various types of compensation paid to WYO companies, and (2) reviewed various audit documentation, including documentation from prior GAO engagements and documentation from the DHS external auditor supporting its work on WYO program financial data included in the DHS fiscal year 2014 financial statements . We electronically and manually tested the data for missing elements, outliers, and other obvious errors and spoke with knowledgeable agency officials about the data. For the NAIC data, we reviewed related documentation and interviewed knowledgeable officials. We assessed the reliability of SNL Financial data by comparing it to NAIC data to ensure its accuracy and consistency. We requested additional information from the 10 selected companies to confirm the accuracy of the financial data they report to FEMA and NAIC. We determined these data were sufficiently reliable for the purposes of our reporting objective.

To collect information about NFIP policy claim over- and underpayments, we reviewed FEMA data on WYO company oversight processes and improper payment reviews.[8] We assessed the reliability of these data by obtaining relevant FEMA documentation and interviewing knowledgeable FEMA officials. We determined these data were sufficiently reliable for our reporting objective. We reviewed other documentation on FEMA's oversight of the claims process, a recent Senate Banking Committee investigation report, and a DHS Office of Inspector General (OIG) report that discussed issues associated with over- and underpayment of claims.[9]

[8]FEMA, as an executive branch agency, is required by the Improper Payments Information Act of 2002, as amended, to conduct improper payment reviews. Pub. L. No. 107-300, 116 Stat. 2350 (2002) (codified as amended at 31 U.S.C. § 3321 note).

[9]See Senate Committee on Banking, Housing, and Urban Affairs, Majority Staff Report, *Assessing and Improving Flood Insurance Management and Accountability in the Wake of Superstorm Sandy*, BIG/IR-2015-01 (Washington, D.C.: June 22, 2015), and Department of Homeland Security, Office of Inspector General, *FEMA Does Not Provide Adequate Oversight of Its National Flood Insurance Write Your Own Program,* OIG-16-47 (Washington, D.C.: Mar. 8, 2016).

We interviewed FEMA officials, representatives of 10 WYO companies (the first group selected, discussed above) and 14 stakeholders—11 organizations selected based on their knowledge of flood insurance and the WYO program and 3 vendors with a high level of participation in the WYO program. Our work focused on over- and underpayments, generally, and did not examine specific claims for any specific event.

To identify potential alternative approaches to FEMA's agreements with WYO companies and examine trade-offs, we reviewed prior GAO reports; conducted a literature review; and interviewed FEMA officials, 10 WYO companies, and 14 stakeholders (as discussed above). We also interviewed the Federal Insurance Office (FIO) in the Department of the Treasury. We analyzed FEMA NFIP policy data to understand the geographic concentration of market share for policies written by WYO companies and the role large and small companies and the DSA played in different states and counties under the current WYO arrangement.[10] We tested the reliability of NFIP policy data by reviewing related documentation, conducting electronic and manual data testing, and reviewing prior GAO assessments of the data. We determined these data were sufficiently reliable for our reporting objective. We also compared requirements of NFIP's WYO arrangement and the DSA with some federal contracting requirements and to general information on the Federal Crop Insurance Corporation.

We conducted this performance audit from April 2015 to December 2016 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.

[10]We included only residential NFIP policies in our analysis. We considered large companies as those among the insurance groups whose members collectively provided more than 80 percent of all premiums during 2014, the most recent year of available data at the time of our analysis. The 10 largest WYOs that we identified made up our third selection of WYOs but this group is generally more distinct in the report as the results pertain to our analysis on geographic market concentration.

Background

The National Flood Insurance Act of 1968 created NFIP.[11] According to FEMA, NFIP was designed to address a number of policy objectives, including offering affordable insurance premiums to encourage program participation and community-based floodplain management and reducing the reliance on federal disaster assistance. The act provided the federal government with the authority to work with the private insurance industry, and since its inception NFIP has largely relied on the private insurance industry to sell and service flood policies.

In 1983, FEMA established the WYO program with the goals of increasing the NFIP policy base and geographic distribution, improving service to policyholders, and providing the insurance industry with direct operating experience with flood insurance.[12] FEMA also sells and services flood insurance through the DSA, which a contractor operates. Private insurers become WYO companies by signing a Financial Assistance/Subsidy Arrangement with FEMA under which the insurers agree to issue flood policies in their own name, adjust flood claims, and settle and defend all claims arising from the flood policies.[13] Private insurers must meet FEMA's established criteria for becoming a WYO company. Requirements for a company to participate in the WYO program include, among others, 5 years of experience in property and casualty insurance lines, good standing with state insurance departments, and the ability to meet NFIP reporting requirements to adequately sell and service flood insurance policies.[14]

Each year, FEMA publishes in the *Federal Register* the terms for participation in the WYO program, including amounts WYO companies

[11]NFIP makes federally backed flood insurance available to homeowners in qualifying communities. National Flood Insurance Act of 1968. Pub. L. No. 90-448, Tit. XIII, 82 Stat. 476, 572 (1968).

[12]*See* 48 Fed. Reg. 46,789 (Oct. 14, 1983).

[13]The Financial Assistance/Subsidy Arrangement is codified at 44 C.F.R. pt. 62, app. A. According to the Subsidy Arrangement, the Department of the Treasury backs all flood policy claim payments made by the WYO company. Thus, the government, and not the WYO insurers, bear the risk of loss from claims arising from policies issued by the insurers.

[14]*See* 44 C.F.R. § 62.24.

will be paid to sell and service flood policies and adjust and pay claims. The compensation FEMA pays WYO companies is one factor it considers in setting premium rates for flood policies. This *Federal Register* notice also states that WYO companies are to comply with the provisions of NFIP's WYO Financial Control Plan Requirements and Procedures (Financial Control Plan). The Financial Control Plan outlines WYO companies' responsibilities for program operations, including underwriting, claim adjustments, cash management, and financial reporting, as well as FEMA's responsibilities for management and oversight.

Other Parties Involved in Day-to-Day Processing of Policies and Claims

WYO companies employ, contract, or work with other parties to sell and issue flood policies and receive, process, and pay claims. Insurance agents for one or more WYO companies are the main point of contact for most policyholders seeking to purchase an NFIP policy, find information on coverage, or file a claim. Based on information the insurance agents submit, the WYO companies issue policies, collect premiums from policyholders, deduct an allowance for expenses from the premium, and remit the balance to the National Flood Insurance Fund—into which premiums are deposited and from which claims and expenses are paid. WYO companies typically contract with flood insurance vendors to conduct some or all of the day-to-day processing and management of flood insurance policies.

WYO companies work with certified flood adjusters to settle NFIP claims. When flood losses occur, policyholders report them to their insurance agent, who notifies the WYO company. To assess damages, the WYO company assigns a flood adjuster, who may be independent or employed by an insurance or adjusting company. The adjuster is responsible for assessing damage; estimating losses; and submitting required reports, work sheets, and photographs to the WYO company, where the claim is reviewed and, if approved, processed for payment. FEMA reimburses the WYO company from the National Flood Insurance Fund for the amount of the claims and expenses paid. Claim amounts may be adjusted after the initial settlement is paid if claimants submit documentation that costs were different than estimated.

WYO Compensation

Current WYO compensation is structured primarily as allowances to pay for policy sales and servicing, claims adjusting and processing, and other services FEMA requires that participating companies provide.[15] This service-oriented compensation structure, with uniform rates generally based on insurance industry average expense ratios (proxies) and fee schedules, allows WYO companies to earn a profit to the degree that compensation exceeds their actual expenses. Most of FEMA's payments to WYO companies under the current compensation structure are not reimbursements of actual expenses incurred, but allowances on which the companies can either make a profit or incur a loss. Since the inception of the WYO program, FEMA has generally used proxies to determine the rates at which it pays WYO companies, and the payments FEMA makes are determined by applying these proxy rates to either premiums written or claim losses (see table 1).

Table 1: The Federal Emergency Management Agency's Write-Your-Own (WYO) Company Compensation Practices, Fiscal Year 2012–2016

		Percentage or dollar amounts for each year				
Type of payment	**Basis for determining payment**	**Fiscal year (FY) 2012 (percent)**	**FY 2013 (percent)**	**FY 2014 (percent)**	**FY 2015 (percent)**	**FY 2016 (percent)**
Commission expenses	Percentage of net written premiums (NWP).[a]	15	15	15	15	15
Operating expenses	Percentage of NWP based on average industry operating expenses for five lines of property insurance.	15.40	15.70	15.70	15.80	15.90
Claims adjustment expenses (Allocated Loss Adjustment Expenses)	Determined periodically based on information FEMA collects from independent adjusting firms on the cost of adjusting losses in other lines of insurance business.	Based on 2012 Adjuster Fee Schedule: From $90 to $1,640 in flat fees for claims up to $50,000; fees for claims over $50,000 are based on a percentage of the claim loss, beginning at 3.4 percent and declining to 2.1 percent for claim losses of more than $1,000,000.				

[15]Allowances are amounts the companies can withhold from written premiums (or requested from FEMA if premium income has been depleted) as reimbursement for the expenses they incur to fulfill their obligations under the arrangement.

Type of payment	Basis for determining payment	Percentage or dollar amounts for each year: Fiscal year (FY) 2012 (percent)	FY 2013 (percent)	FY 2014 (percent)	FY 2015 (percent)	FY 2016 (percent)
Claims processing expenses (Unallocated Loss Adjustment Expenses)	Based on a percentage of claim losses and a percentage of NWP.	1.5 of claim losses plus 1 of NWP	1.5 of claim losses plus 0.9 of NWP	1.5 of claim losses plus 0.9 of NWP	1.5 of claim losses plus 0.9 of NWP	1.5 of claim losses plus 0.9 of NWP
Additional adjustment and other expenses (Special Allocated Loss Adjustment Expenses)	Reimbursement of adjustment expenses exclusive of those paid according to the Adjuster Fee Schedule, plus other litigation, engineering, and appraisal expenses.	Actual expenses incurred	Actual expenses incurred	Actual expenses incurred	Actual expenses incurred	Actual expenses incurred
Incentive bonuses	Percentage of NWP for Write-Your-Own (WYO) companies that qualify.	0.25-2	0.25-2	0.25-2	0.25-2	0.25-2

Source: GAO analysis of Federal Emergency Management Agency (FEMA) information.| GAO-17-36

[a]Net written premium consists of total written premium (calculated values) on new and renewed policies net of subsequent changes (additions or refunds) from policy endorsements, corrections, and cancellations.

Commission and operating expenses are based on a proxy of a WYO company's net written premiums. FEMA established a commission expense allowance at 15 percent in 1983 after consulting with industry representatives. This percentage has not changed since and is written into the Financial Assistance/Subsidy Arrangement. The percentage used for calculating operating expenses is generally provided annually to WYO companies as part of the compensation package (see table 1).[16] The percentage is determined annually based on A.M. Best Company's aggregates and average industry operating expenses for five lines of

[16]FEMA's operating expense allowance is a 5-year average of the industry operating expense ratios for these five lines of property insurance plus an additional 1 percentage point. FEMA instituted this additional 1 percentage point increase in 2001 after some WYO companies told FEMA that their actual expenses to service flood insurance policies exceeded the industry average for the five lines of property insurance, other than federal flood, which are used as a proxy. We noted in our 2009 report that FEMA had not considered actual flood insurance expenses in deciding to increase the operating expense payments by the additional 1 percentage point of net written premiums. Importantly, we found that FEMA's payments to the WYO companies we reviewed would have exceeded the companies' actual operating expenses without these additional payments.

property insurance—fire, allied lines, farm owners multiple peril, homeowners multiple peril, and commercial multiple peril.[17]

Further, WYO companies receive payment for three types of claim adjustment expenses.

- Allocated loss adjustment expenses (ALAE). These are claim expenses to adjust specific claims. FEMA determines payment for ALAE based on information it periodically collects from independent adjusting firms on the cost of adjusting losses in other lines of insurance business, and presents the payment amount to WYO companies through a fee schedule.
- Unallocated loss adjustment expenses (ULAE). These are claim expenses that are incurred by the WYO company for routine operations not associated with a specific claim such as salaries, overhead, and maintenance. FEMA bases payment for ULAE on a percentage of net written premiums and a percentage of claim losses. Before May 2008, FEMA calculated the amount for ULAE as 3.3 percent of claim losses but changed its methodology to 1.5 percent of claim losses plus 1 percent of net written premium, which was further reduced to 0.9 percent in fiscal year 2013.[18] According to FEMA's statements in the *Federal Register*, the flat rate of 3.3 percent of claim losses resulted in payments far greater than expenses during catastrophic loss years and payments below actual expenses during low-loss years.[19]
- Special allocated loss adjustment expenses (SALAE). These are claim expenses related to litigation, engineering, appraisals, other experts, and additional claim adjustments. FEMA calculates SALAE based on actual expenses. In March 2015, FEMA eliminated the previous $2,500 approval threshold for SALAE expenses for experts

[17]*Best's Aggregates and Averages* provides current and historical statistics on the property and casualty industry. Among others, it provides company-specific information on lines of business, trends over time for various industry totals and ratios, and quantitative analysis reports looking at financial and performance measures.

[18]A FEMA official explained that the reason for lowering the percentage was that operating costs do not increase in direct proportion to increases in net written premiums collected or increases in the number of policies in force. In May 2008, FEMA also changed how it would communicate changes to ULAE compensation to WYOs. In the past, the 3.3 percent had been a fixed compensation rate in the Subsidy Arrangement, but would subsequently be provided to WYOs in a ULAE schedule annually.

[19]73 Fed.Reg.18,182, 18,184 (Apr. 3, 2008).

(Type 1) and required WYO companies to submit specific information to FEMA, including information on the claim, policy limits, and an explanation and justification for the reimbursement.[20] FEMA staff must review the information submitted and approve the expenditure before the WYO is allowed to incur any Type 1 expenses. In July 2016, FEMA removed the $5,000 threshold for Type 3 expenses (litigation-related) and required WYO companies to seek approval for reimbursement of such expenses and pre-approval if they wished to take more than three depositions in a case.[21]

In addition, FEMA pays WYO companies that meet certain policy growth goals a percentage of net written premiums as a marketing bonus. In 2009, we found that FEMA's marketing goals were not aligned with FEMA's NFIP goals. As a result, FEMA changed the formula for how WYO companies earn bonuses in the fiscal year 2013 compensation arrangement. A growth bonus is intended to provide an incentive for WYO companies to continue to grow the NFIP program by adding new policies. FEMA officials told us that the agency changed the program's growth bonus to better link it to new business—if a WYO company acquires another company's business, the number of transferred policies is added to the company's beginning number of policies and the total merged number of policies is used when calculating aggregate growth for the purposes of the bonus. Therefore, the WYO company is receiving a growth bonus based only on new business since the number of transferred policies is added to the existing policies in place before the percentage of growth is calculated. This allows FEMA to recognize WYO companies for actual growth and not for transferring policies from one company to another. With the new formula, WYO companies can receive a higher percentage of net written premiums as a growth bonus when the policy growth is tied to three supporting goals for selling policies: (1) in

[20]Federal Emergency Management Agency, "Amendment to W-10039 Special Allocated Loss Adjustment Expenses Eliminating the $2,500 Threshold for SALAE Type I Expenses for Experts—They Must Now Be Sent to FEMA for Approval from the First Dollar," WYO Bulletin, W-15010 (Washington, D.C.: Mar. 9, 2015). There are four types of SALAE: (1) Type 1, expert expense (e.g., engineer, surveyor, accountant); (2) Type 2, adjuster expense (in excess of applicable NFIP adjuster fee schedule); (3) Type 3, litigation expense (expense incurred to defend a suit, within the scope of the WYO arrangement, brought against a WYO company on a NFIP claim); and (4) Type 4, cost of appraisal (under the NFIP Standard Flood Insurance policy appraisal clause) or cost of examination under oath.

[21]Federal Emergency Management Agency, "WYO Litigation and Type 3 Special Allocated Loss Adjustment Expenses," *WYO Bulletin*, W-16045 (Washington, D.C.: July 19, 2016).

underserved areas, (2) for residential preferred risk policies, and (3) for nonresidential policies.[22]

FEMA Management and Oversight of WYO Companies

Within FEMA, the Federal Insurance and Mitigation Administration (FIMA) manages NFIP. According to FEMA staff, about 70 staff within FIMA are dedicated to managing and overseeing the WYO program and claim processes.[23] Their management responsibilities include establishing and updating NFIP regulations, analyzing data to actuarially determine flood insurance rates, and offering workshops and conferences to insurance agents and adjusters to explain NFIP requirements. In addition, FEMA is responsible for monitoring and overseeing the performance of the WYO companies to ensure that NFIP is administered properly.

FEMA has processes for monitoring and providing oversight of NFIP claims that are outlined in its Financial Control Plan. Under the current plan, the processes include triennial claims operation reviews, biennial financial statement audits, and underwriting reviews. The agency also is responsible for reinspecting claims and monitoring company performance as needed.

- **Claims operation reviews.** FEMA is to conduct these reviews at every WYO company on a 3-year rotating basis, according to the

[22]Beginning with the fiscal year 2013 WYO arrangement, the maximum growth incentive of 2 percent consisted of two parts—up to a 1 percent growth incentive based on the percentage of growth of a company's policies-in-force (existing and new) and the other 1 percent based on the company's success in meeting the targeted growth goals discussed above. Before 2013, the growth incentive bonus (also a maximum of 2 percent) was based solely on net growth of total policies. Under the new formula, if a company achieves two or more of the targeted growth goals, it can multiply its earned growth bonus percentage by a factor of 2.0. If it achieves one of the targeted growth goals, it can multiply its earned growth bonus percentage by a factor of 1.5.

[23]Throughout this report, we refer to FIMA as FEMA unless otherwise noted.

Financial Control Plan.[24] The stated purpose of these reviews is to evaluate a WYO company's processes for administering flood claims, NFIP data reporting, and the accuracy and service the company provides customers when handling claims. As part of the review process, FEMA officials are to review the entire claim file including coverage, policy compliance, and whether coverage limits are within NFIP statutory allowances. FEMA notes findings as critical and noncritical errors.

- **Improper payment reviews.** DHS is required to conduct annual reviews by the Improper Payments Information Act (IPIA), as amended.[25] Such reviews identify a statistically valid sample of payments done annually to estimate the percentage of improper payments.
- **Reinspection of claims.** While the claims operation review is meant to focus on transactions at WYO companies or groups of WYO companies selected by FEMA for review, the selection for reinspection of claims is to be based on specific events or large losses. Until 2015, all claim files were subject to FEMA's reinspection process outlined in the Financial Control Plan, which included routine reinspections as well as special assist reinspections, which are inspections of claims requested by Congress, a policyholder, a WYO

[24]According to FEMA's Financial Control Plan Monitoring document, the agency randomly selects 100 claim files for review based on the size of WYO companies. FEMA also reviews 100 randomly selected claims for the DSA each year. WYO companies with more than 100,000 policies in force receive a separate operations review every 3 years. For smaller WYO companies, FEMA randomly selects 100 claims from groupings of policies administered by a shared vendor. For example, FEMA would randomly select 100 claim files from one vendor servicing a group of WYO companies that each have from 50,000 to 99,999 policies, WYO companies that have from 25,000 to 49,999 policies, and WYO companies with fewer than 25,000 policies.

[25]IPIA, as amended, requires executive branch agencies to (1) review all programs and activities and identify those that may be susceptible to significant improper payments, (2) estimate the annual amount of improper payments for susceptible programs and activities, (3) implement actions to reduce improper payments and set reduction targets, and (4) report on the results of addressing the foregoing requirements. Pub. L. No. 107-300, 116 Stat. 2350 (2002) (IPIA) (codified as amended at 31 U.S.C. § 3321 note).

company, or the DSA.[26] Starting in 2015, FEMA discontinued routine reinspections but continued special assist reinspections.

- **Biennial audits.** According to the Financial Control Plan, the biennial audit is to provide an independent assessment of a WYO company's financial controls relating to its participation in NFIP and the integrity of the financial data it reports to FEMA. The audits provide an opinion on the fairness of a WYO company's financial statements, the adequacy of its internal controls, and the extent of its compliance with relevant laws and regulations, including reporting any discrepancies found in the claims process.
- **Audits for cause.** According to WYO Financial Control Plan Monitoring procedures, FEMA can conduct these audits as a last resort if other remedies in its oversight of WYO companies have been exhausted, or at the request of OIG. The monitoring procedures also state that there have been fewer than five such audits during the program's history.

NAIC and FEMA WYO Company Reporting

Insurance is primarily regulated by the states, unless federal law specifically relates to the business of insurance (as in the cases of flood and terrorism insurance).[27] Requirements and processes for regulating insurance may vary from state to state, but state regulators generally license insurance companies and agents, review insurance products and premium rates, and examine insurers' financial solvency and market conduct. According to NAIC, state regulators monitor an insurers' compliance with laws and regulations and a company's financial condition through solvency surveillance and examination mechanisms. Insurance regulators use insurance companies' financial statements and other

[26]For routine reinspections, FEMA would randomly select a percentage of files by flood event, size of loss, or class of business. According to the Financial Control Plan, every WYO company that reported 400 or more claims for a designated flood event would be considered for the reinspection program. Companies with fewer than 400 claims would be considered small volume, and FEMA would reinspect their claims as staffing and time allowed. Reinspections by request, also called special assist reinspections, could come about through a written request from a WYO claims coordinator or at FIMA's direction. For example, FIMA could require special assist reinspections for unusual situations, such as large or complicated losses.

[27]McCarran-Ferguson Act, 15 U.S.C §§ 1011-1015. Two federal insurance programs are the National Flood Insurance Program and the Terrorism Risk Insurance Program.

information as part of their continuous financial analysis, which is to be performed at least quarterly, to identify issues that could affect solvency.[28]

Through NAIC, the regulators also collect financial information from insurers for ongoing monitoring of financial solvency, including information on their federal flood line of insurance.[29] NAIC's statutory accounting principles prescribe standards for insurer accounting and reporting of financial information, which are intended to, among other things, ensure the consistent reporting of financial information.[30] NAIC also issues instructions for completing annual statements and related schedules and exhibits, including the Insurance Expense Exhibit, which provides premium, loss, expense, reserve, and profit data for each line of property and casualty business, including the federal flood line of insurance, and is presented both for the direct insurance written by insurers and net of reinsurance.[31] The exhibit provides a statutory allocation of income to lines of business and may be used to measure underlying profitability of insurance operations. Each WYO company

[28]State insurance regulators typically conduct on-site financial solvency examinations every 3–5 years, although they may do so more frequently for some insurers, and may perform additional examinations as needed.

[29]NAIC does not regulate insurers; according to NAIC officials, it provides services designed to make certain interactions between insurers and regulators more efficient. According to NAIC, these services include providing detailed insurance data to help regulators analyze insurance sales and practices; maintaining a range of databases useful to regulators; and coordinating regulatory efforts by providing guidance, model laws and regulations, and information-sharing tools.

[30]According to the preamble to NAIC's *Accounting Practices and Procedures Manual,* one of the concepts of statutory accounting principles is consistency, which serves "the regulators' need for meaningful, comparable financial information to determine an insurer's financial condition." However, the preamble notes that "codification [of statutory accounting principles] is not intended to preempt state legislative and regulatory authority" and "may be subject to modification by practices prescribed or permitted by a state's insurance commissioner." The preamble acknowledges that statutory requirements vary from state to state, and "while it is desirable to minimize these variations, to the extent that they exist it is the objective of NAIC statutory accounting principles to provide the standard against which the exceptions will be measured and disclosed if material."

[31]The Insurance Expense Exhibit allocates elements of total profit (or loss) to lines of business in two ways: direct business written and net of reinsurance. The direct basis of reporting reflects the financial results of an insurer when acting as a direct writer of insurance, whereas the net of reinsurance basis of reporting reflects the effects of an insurer's reinsurance activities. Through reinsurance, an insurer can either assume all or part of a risk undertaken originally by another insurer or cede a risk to another insurer. Reinsurance serves multiple purposes, including spreading an insurer's exposure to catastrophic losses.

determines its own method for allocating revenues and expenses, which may vary from company to company. WYO companies have been reporting this information to NAIC annually since 1997.[32]

FEMA's *National Flood Insurance Program Write-Your-Own Accounting Procedures Manual* prescribes the financial reporting requirements for all WYO companies.[33] This manual is part of the NFIP WYO Program Financial Control Plan, which also includes transaction record reporting and reconciliation procedures. These procedures describe, among other things, expectations for the timeliness of reporting and elements of the quality review that FEMA performs on submitted data.

FEMA Compensation and Oversight of the Direct Program

As previously discussed, FEMA's DSA serves as the insurer of last resort when a WYO company is unable or unwilling to write a flood insurance policy. Through the Direct Program, the DSA services both standard policies and other types of policies, including repetitive loss and group flood policies.[34] According to FEMA officials, as of August 2016, the DSA administers 15 percent of FEMA flood insurance policies.

[32]NAIC officials told us that they perform automated tests on the financial data they receive from insurance companies to ensure completeness but do not specifically review trends for the federal flood data and have not established ratio checks for flood data to look for outliers in flood data. The officials noted that the federal flood line is small in comparison to other lines of insurance a company holds. They said NAIC takes a more general approach, not specific to federal flood line data, and primarily reviews data for all insurance lines to identify any companies in financial decline—a part of its financial solvency monitoring system. Overall, NAIC officials told us that they rely on several quality checks for the data reported to them by insurance companies, including a review by an independent certified public accountant, quarterly and annual financial analyses conducted by state insurance regulators, and electronic validations run against the statutory financial statement filings.

[33]Federal Emergency Management Agency, *National Flood Insurance Program Write-Your-Own Accounting Procedures Manual*, (Mar. 10, 2015).

[34]A severe repetitive loss property is, for a single-family property, one that has incurred four or more claims payments exceeding $5,000 each, with a cumulative amount of such payments over $20,000; or at least two claims payments with a cumulative total exceeding the value of the property. 42 U.S.C. § 4014(h)(1). A group flood insurance policy is generally issued in response to a presidential disaster declaration and allows disaster assistance applicants to receive a group flood insurance policy certificate for a minimum amount of building and contents coverage for a 3-year period in exchange for a modest premium. *See* 44 C.F.R. § 61.17.

FEMA pays the DSA contractor for selling and servicing flood insurance and for adjusting and processing claims after a flood event through a competitively awarded predominantly fixed-price contract. The contractor has calculated its cost to sell and service policies as well as adjust claims following a noncatastrophic event based on its prior experience as a vendor for WYO companies. Based on this experience, the contractor charges a flat price per policy type that is not based on the premium amount. The DSA contractor also has the ability to withdraw funds on behalf of the agency from the Department of the Treasury to pay for certain actual costs, such as overhead costs for mailing and printing.

FEMA oversees the DSA contractor and conducts operation reviews on the DSA's underwriting and claims operations annually versus triennially for the WYO companies. According to FEMA officials, DSA financial-related information is subjected to the annual audit of the Department of Homeland Security's consolidated financial statements that an independent certified public accountant performs.

FEMA Still Relies on Insurance Industry Proxies for Setting Compensation and Has Not Yet Revised Its Practices in Response to the Biggert-Waters Act

FEMA continues to lack the information it needs to determine whether its compensation payments are appropriate and how much profit is included in what it pays WYO companies. Efforts by FEMA, NAIC, and WYO companies have resulted in some improvements to federal flood financial data reported to NAIC. But we found inconsistencies in how companies reported federal flood data to NAIC, which limits the usefulness of the data for setting compensation rates. Our analysis also shows that the manner in which WYO companies operate has an effect on their expenses and profits, which FEMA may find relevant when developing a WYO compensation methodology and rates. However, FEMA has made limited progress toward revising its WYO compensation methodology as required by the Biggert-Waters Act.

Efforts Have Resulted in Some Improvements to Federal Flood Financial Data Critical to Revising Compensation

Efforts by FEMA, NAIC, and WYO companies have resulted in some improvements to federal flood financial data reported to NAIC that are critical to a revised compensation methodology. FEMA officials told us that since our 2009 report they have worked with NAIC and WYO companies to help ensure that reasonable and accurate operating expenses for the federal flood insurance line are being reported to NAIC. In addition, FEMA officials told us that FEMA has analyzed WYO company financial data since 2009 to monitor improvements in the companies' federal flood data, but has found mixed results.

A FEMA official told us that after issuance of our 2009 report, the agency conducted site visits to four WYO companies to review the actual flood insurance data the companies submitted to NAIC. The official said that they found the visits helpful in understanding how the companies were reporting the financial results of their flood insurance lines. However, this official explained that it would require too many resources to meet with all the WYO companies individually and FEMA has not made any further company-specific inquiries or visits. As a result of these initial efforts, NAIC amended its guidance in 2011 on the reporting of WYO commission and fee allowances in response to FEMA's request.[35] According to FEMA, this change was intended to address one issue we found during our 2009 engagement–-specifically, that WYO companies were subtracting (netting) WYO compensation from expenses. Reporting expenses net of compensation instead of reporting expenses gross for the flood insurance they wrote resulted in higher calculated profits. We found that 2 of the 10 companies whose data we analyzed for this report changed from net to gross expense reporting in the first year in which the NAIC guidance was effective or at some point before 2014, and 7 WYO companies reported expenses gross, not net, during the 2008–2014 period.[36] Only one

[35]Statement of Statutory Accounting Principles No. 62R states that policies written by WYO companies under NFIP are considered insurance policies issued by the WYO with reinsurance ceded to FEMA, rather than uninsured plans; thus, commission and fee allowances received from FEMA should be reported consistent with reinsurance ceding commission.

[36]Two of the 10 companies selected as part of this engagement's analysis of WYO company reporting had also been selected as part our 2009 engagement.

company from those we selected to review continued to report a portion of its expenses net of compensation in 2014.

In addition, WYO companies have made other improvements to the federal flood insurance financial data they report to NAIC beyond reporting expenses. For example, our analysis confirmed that one WYO company revisited how certain expenses for servicing flood policies were allocated and reported to NAIC. Two other companies made changes in how they report losses—one changed its method for estimating losses reported to NAIC to be consistent with the method it used to report such losses to FEMA, while another said it changed its policy of reporting certain loss adjustment expense reimbursements as an offset to incurred losses reported to NAIC. These reporting changes collectively improved the quality of the NAIC financial data necessary to ensure comparability with financial data the WYO companies submit to FEMA, which is important to determining the amounts to be built into compensation rates for estimated expenses and profits.

To verify the accuracy of the NAIC data, FEMA officials told us that they request and analyze the federal flood insurance data that WYOs report to NAIC around April or May of each year. FEMA officials explained that the benefit of using NAIC data is that the data are reported on WYO companies' annual statements and it is more cost efficient to get all the data from one source than for FEMA to independently collect and verify the data from each WYO company.[37] WYO companies' financial statements are submitted to both NAIC and state regulators. A FEMA official told us that its analysis, which it has periodically performed since 2009, has included comparing each WYO company's premiums and losses reported to NAIC to the figures the companies report on the

[37]NAIC's Annual Financial Reporting Model Regulation (MDL-205) states that, among other things, an annual audit of insurers' financial statements prepared in accordance with statutory accounting practices prescribed, or otherwise permitted by, the Department of Insurance of the state in which an insurer is domiciled. The financial statements are required to be prepared in a form substantially consistent with the annual statement insurers file with the state insurance commissioners. While, according to NAIC, most states have not adopted the most recent version of this model regulation in a substantially similar manner, all have either adopted an older version of this model regulation or have undertaken other activity, such as passing legislation, governing insurers' submission of audited financial statements. While the WYO companies' financial statements are audited, the opinion expressed by an independent certified public accountant is on the financial statements as a whole and not on individual reported amounts or the financial data for each line of business presented on the Insurance Expense Exhibit, including the federal flood line.

financial statements they submit to FEMA. FEMA has also compared the aggregate homeowners' underwriting and loss adjustment expense ratios of the WYO companies to non-WYO companies. FEMA officials told us that for the largest 8 to 10 WYO companies, FEMA has also compared their underwriting and loss adjustment expense ratios (expenses expressed as a percentage of written premiums) for flood to the same ratios for their homeowners lines for a 5-year period to determine if a correlation exists between the companies' costs of operating these two lines of business. FEMA has prepared a report showing underwriting expenses and loss adjustment expenses grouped into various ranges, such as negative expense ratios, "0-5 percent", and "5-10 percent" to assess the trend in WYO company expenses over time.

In September 2016, FEMA officials estimated that WYO companies that make up about 80 percent of the net written premiums reported had adequately improved the quality of the underwriting expense data reported to NAIC. FEMA officials also said that these companies usually have underwriting expenses between 20 percent and 30 percent of their net written premium or an average expense ratio of 25 percent. By using that information as a model and excluding WYO companies with expenses that fall outside that range, FEMA officials stated that they may be able to use data from these companies to set future commission and operating expense allowances for all WYO companies. However, FEMA officials noted that the loss adjustment expense ratios varied much more significantly from company to company than did underwriting expense ratios. They also observed negative loss adjustment expense ratios for some WYO companies, although they added that such ratios can occur as a result of changes in loss reserve estimates. FEMA officials also said that they generally found great inconsistency in how WYOs were reporting expenses between two categories of loss adjustment expenses, which affected their ability to assess the reasonableness of the expense ratios of a single year, but had greater success in doing so when the ratios were calculated based on total loss adjustment expenses for a 5-year period.[38]

According to an August 2016 WYO Bulletin, beginning with the fiscal year 2017 arrangement year, FEMA intends to require that WYO companies provide to FEMA copies of all data submissions to NAIC related to their

[38]Loss adjustment expenses are classified for NAIC reporting purposes as either Defense and Cost Containment or Adjusting and Other.

flood insurance activities and to attest to the accuracy of those submissions.[39] FEMA stated in the bulletin that this requirement would be aligned with the arrangement's specification that, upon request, WYO companies supply FEMA with a true and correct copy of a WYO company's property and casualty annual financial statement filed with state insurance regulatory agencies and the arrangement's requirement that provides access to all records of WYO companies pertinent to the arrangement. FEMA also stated in the bulletin that this requirement will support FEMA's efforts to pay WYO companies based on actual expenses incurred by companies.

Inconsistencies in WYO Company Reporting Continue to Limit Its Usefulness in Setting Compensation Rates

Reporting Inconsistencies

We found that WYO companies were not consistently reporting their federal flood financial data to NAIC. The inconsistencies we found in the data WYO companies reported to NAIC resulted in unreported underwriting and loss adjustment expenses of varying amounts and significance by 8 of the 10 companies we reviewed. Further, we found that some WYO companies reported different loss and related reserves to NAIC and FEMA.[40]

More than half of the companies we reviewed did not report to NAIC all of their adjuster fees and other expenses incurred on the companies' flood losses and provided a variety of explanations for their accounting practices. Nearly all of the WYO companies we reviewed told us that they reported adjuster fees as a direct expense of the flood insurance line, but one WYO company told us that their interpretation of the NAIC rules was that adjuster fees should be reported as an expense ceded to FEMA and, thus, not reported as a direct expense to its flood line. Similarly, four WYO companies told us that they did not record reimbursable legal, engineering, appraisal, and other adjuster fees as direct expenses of their

[39]Federal Emergency Management Agency, "Revised Error Threshold for Claims Operation Reviews; Copies of NAIC Submissions Related to Flood Insurance," *WYO Bulletin*, W-16048 (Aug. 4, 2016).

[40]As discussed in appendix I, we took steps to assess the reliability of FEMA and NAIC data. However, we did not audit whether the FEMA and NAIC data were in accordance with financial reporting standards and requirements.

flood lines because, among other reasons, some viewed these as FEMA's expenses and not the company's, although this was not the practice for the remaining companies we reviewed. Still another WYO company told us that it reports policy or claim-specific expenses to the flood line, but does not report indirect expenses, such as claim handling fees paid to their vendor. Collectively, based on our analysis, these unreported loss adjustment expenses amounted to about $14 million. Also, some companies did not report certain related operating expenses for their federal flood line. These expenses included fees paid to flood vendors, premium taxes, and internal company overhead expenses that would normally be classified as a type of underwriting expense. However, due to the WYO companies' established practices at the time and their interpretation of NAIC's rules, these expenses were either not allocated to the federal flood line or were reported on the books of an affiliated company. Collectively, based on our analysis, these unreported operating expenses amounted to approximately $52 million. As discussed below, these unreported expenses had a significant effect on the combined profits of these companies.

The inconsistencies we found in how premiums are reported to FEMA and NAIC had little effect on individual company profit calculations. For nearly all companies we reviewed, differences in premiums WYO companies reported to FEMA and NAIC in 2014 were negligible (less than plus or minus 1 percent) and had a negligible effect on reported commission and underwriting expenses, and profit. Any differences that existed were generally attributable to timing differences—linked to a lag in WYO companies receiving financial data from vendors that, in turn, affected the companies' reporting to NAIC. Also, some of the differences we identified in incurred losses reported to FEMA and NAIC were also due to this reporting lag, but as the timing of floods and the payment of claim losses are less predictable than premium payments, the lag in reporting had a more significant effect on reported losses and loss adjustment expenses. For example, we determined the effect of the lag for one company was about 5 percent of incurred losses reported to FEMA, whereas for another company the effect was greater than 25 percent of incurred losses.

However, the inconsistency with the greatest effect on individual company-reported losses was related to how certain companies estimated incurred but not reported losses and related adjustment expenses.[41] Three of the WYO companies told us that the actuarial methodology they used to develop incurred but not reported loss estimates for NAIC reporting purposes was different than the methodology their vendor used to develop the estimates submitted to FEMA. Another company told us it accounted for its federal flood activity entirely on a cash basis and did not, therefore, report any unpaid loss and loss adjustment expense reserves to NAIC. In order to compare loss adjustment compensation with actual expenses, we adjusted these companies' reported expenses to remove the effect of these differences and substituted expense estimates we developed based on the loss and loss adjustment expense reserves the companies' vendors reported to FEMA. Collectively, the net effect of our adjusting for these differences in reported losses and loss reserves (some companies reported significantly higher losses and loss reserves to FEMA than to NAIC while others reported significantly lower estimates) was a net increase in reported loss adjustment expenses of more than $5 million. These adjustments are reflected below along with the unreported expenses noted above.

Effects of Inconsistent Reporting on Expenses and Profit for 10 WYO Companies

We performed additional analyses and comparisons for 10 selected WYO companies to adjust for inconsistencies (discussed previously) and determine the effect of the revised amounts on expenses and profits. The 10 companies we selected accounted for a majority of net written premiums, net paid losses, and total compensation paid for calendar year 2014 (see table 2). For more details about our methodology and the limitations of our analysis, see appendix I.

[41]Statement of Statutory Accounting Principles (SFFAS) No. 55, *Unpaid Claims, Losses and Loss Adjustment Expenses* defines Incurred but Not Reported Losses (IBNR) as "expected payments for losses relating to insured events that have occurred but have not been reported to the reporting entity as of the [financial] statement date." Statement No. 55 also notes that, "[a]s a practical matter, IBNR may include losses that have been reported to the reporting entity but have not yet been entered into the claims system" or bulk provisions, which are reserves to reflect deficiencies in known case reserves.

Table 2: Federal Emergency Management Agency (FEMA) Net Written Premiums, Net Paid Losses, and Total Compensation Paid for All and Selected Write-Your-Own (WYO) Companies, Calendar Year 2014

Population of companies	Net written premiums (dollars in millions)	Net paid losses (dollars in millions)	Total compensation paid (dollars in millions)	Total compensation paid as a percent of net written premiums
All WYO companies	3,035.9	572.4	1,080.9	35.6
10 selected WYO companies	2,279.5	366.4	799.4	35.1
Selected WYO companies as a percent of all WYO companies	75.1	64.0	74.0	—

Source: GAO analysis of FEMA data. | GAO-17-36

An initial comparison of selected WYO company compensation with the expenses the companies reported to NAIC appears to show that the companies collectively earned a profit of 25 percent in 2014 (as illustrated in table 3). However, after we adjusted the reported expenses for the effects of inconsistent reporting described previously, we estimated that the companies earned a profit of approximately 15 percent on the flood insurance line (see table 3).

Table 3: Type of Compensation and Expense, Amount of Compensation and Expenses (Unadjusted and Adjusted), and Amount and Percentage of Profit (Unadjusted and Adjusted) for 10 Selected Write-Your-Own (WYO) Companies, Calendar Year 2014 (dollars in millions)

Type of compensation and expense	Total Compensation Amount[b]	Expenses (dollars)		Profit (dollars)[a]		Profit (percent)[a]	
		Unadjusted	Adjusted[c]	Unadjusted	Adjusted	Unadjusted	Adjusted
Commission	332.0	403.9	403.9	(71.9)	(71.9)	(21.6)	(21.6)
Operating	403.0	167.0	218.1	236.0	184.9	58.6	45.9
Loss adjustment	62.4	34.2	56.7	28.2	5.7	45.1	9.0
Other	0.0	(5.9)	0.7	5.9	(0.7)	NA	NA
Total	**797.4**	**599.2**	**679.4**	**198.2**	**118.0**	**24.9**	**14.8**

Source: GAO analysis of Federal Emergency Management Agency and National Association of Insurance Commissioners data obtained from SNL Financial. | GAO-17-36

[a]Profit is presented on a pre-tax basis.

[b]Compensation is presented in this table on an accrual basis, whereas compensation in table 2 is presented on a cash basis. The difference reflects the effect of changes in loss adjustment expense reserves on reported but unpaid losses and incurred but not reported losses.

[c]We adjusted the companies' reported expenses to include the unreported expenses described above, adjustments for the unreported expenses due to netting of compensation and the effect of different incurred but not reported loss adjustment expense estimates, and reclassifications of expenses between underwriting and loss adjustment expenses.

While an aggregate measurement of profitability for all selected WYO companies can be calculated, this calculation is significantly influenced by a few WYO companies that dominate the flood insurance market and whose business model and cost structure may be different from that of the majority of insurers that participate in the WYO program. The 2014 flood insurance profits of the companies we reviewed, after our adjustments, ranged from approximately 2 percent to 38 percent. Removal of the two WYO companies that represent the outliers of this range would result in total profit of approximately 18 percent and a profit range that still varies significantly between 7 percent and 28 percent for the remaining eight companies. Importantly, our analysis and ability to estimate WYO company expenses and profit were subject to certain limitations (see app. I for details on these limitations and their potential effects), which included limiting our analysis to 1 year (2014). In addition, our 2014 estimates of company expenses and profit are an outcome of our effort to understand the issues surrounding the inconsistent financial reporting by the selected WYO companies and the various factors that can affect company expenses and profit. For these reasons, these estimates should not be taken to be a static or predictable indicator of WYO company profits.

WYO Company Operations Can Affect Flood Line Expenses and Profits and Are Relevant When Developing Compensation Methodology and Rates

Aside from the inconsistencies in reporting financial data, other factors specific to how WYO companies operate their flood line of business also can affect a company’s expenses and profits. These company-specific factors, coupled with the inherent uncertainty of the frequency and severity of loss events, the overall market for flood insurance, and changes to the flood insurance program’s design and requirements, can present challenges in developing the WYO compensation methodology. Further, these factors can also present challenges in setting rates that appropriately compensate WYO companies over time for providing services to policyholders.

Effects of WYO Company Operations on Flood Line Expenses and Profit

Based on our analysis of the costs of operating their flood lines of business in relation to expenses and profits, we found that companies’ operating characteristics could in part explain the significant variance in expenses and profits. One way to understand the amount of WYO company expenses and profits is in relation to the premiums paid by policyholders. As noted in table 2, total compensation paid to the WYO companies we reviewed represented approximately 35 percent of net written premiums. That is, 35 cents of every premium dollar paid by policyholders went toward compensation for the selected companies. As shown in table 4, by breaking down compensation into expense and profit components, slightly more than 5 percent of every dollar of premium written by the 10 WYO companies went to their profit.

Table 4: Expenses and Profit as a Percentage of Net Written Premium for Selected Write-Your-Own (WYO) Companies, as of Calendar Year 2014

	Percentage of net written premium		
Expense category and profit[a]	**Selected WYO companies (percent)**	**Minimum (percent)**	**Maximum (percent)**
Commission	17.7	15.2	20.7
Operating	9.6	6.1	18.2
Loss adjustment	2.5	1.1	3.9
Profit	5.2	0.8	13.5
Total[b]	**35.0**	**34.0**	**35.9**

Source: GAO analysis of Federal Emergency Management Agency and National Association of Insurance Commissioners data obtained from SNL Financial. | GAO-17-36

[a]Profit is presented on a pre-tax basis.

[b]Profit and total percentages of net written premium include other expenses net of other income.

As demonstrated previously, WYO company expenses and profit vary significantly and those variances can be explained in part by the companies' operating characteristics. For example, some WYO companies we interviewed told us that they used independent agents and generally paid these agents a commission higher than the 15 percent allowance FEMA provides. Further, the companies we selected for review had commission expenses of 17.7 percent of net written premiums on average (see table 4). Some WYO companies attributed the higher commission to stiff competition in writing new business or keeping current policies in place in certain markets. Agent commissions can vary not only from company to company, but also by volume of sales, across lines of property and casualty insurance, and between new business and renewal of existing policies. However, we did not determine whether agents' commissions for selling NFIP policies were affected by how insurers compensated agents for selling other lines of property and casualty business. Also, nearly all of the WYO companies we reviewed told us that they pay adjusters the same amount that FEMA provides as an adjuster fee allowance and, thus, do not earn a profit on this category of compensation.[42]

The operating expense allowance, including policy growth incentive bonuses, and the ULAE allowance are the remaining categories of compensation on which WYO companies can earn a profit and, thus, offset losses on agent compensation. The operating and ULAE allowances compensate WYO companies for the expenses incurred to operate and administer their flood lines and fulfill the companies' obligations under their agreements with FEMA, but are not directly associated with selling specific policies or adjusting specific claims. It is in these areas that the companies' operating characteristics and their compensation of vendors can more directly affect the expenses they incur and the profits they earn on the federal flood line. In addition to premium taxes and fees, these allowances cover such insurer expenses as salaries and benefits of company personnel, printing and postage, advertising, equipment, training and travel, audit and legal services, and other expenses. The expenses are incurred to fulfill company obligations, such as to underwrite and issue policies; collect, remit, and account for funds; submit financial and statistical reports; conduct audits and reviews; and manage all aspects of the claims process.

All of the WYO companies we reviewed use vendors to some extent to operate their flood lines. Most of the WYO companies used third-party vendors, while the others used an affiliated company to provide various services. Many of the companies that used third-party vendors told us that they generally outsource policy, claims, reporting, and other functions to their vendor, although some use a vendor's systems software and retain responsibility for underwriting policies and adjusting claims. Vendors we interviewed said that they offer a variety of service levels that WYO companies can choose from depending on the degree of control they want over the underwriting and claims processes and, thus, the customer service experience of their policyholders and agents.

WYO companies and vendors told us vendors are paid a percentage of gross or net written premiums and ULAE allowances and may be paid for additional expenses incurred in providing services above what is provided for in the base contract. Third-party vendors with whom we spoke said

[42]FEMA also reimburses WYO companies for certain loss adjustment expenses, such as those for engineering and legal services, and, thus, do not earn a profit on this category of compensation.

that the amount WYO companies pay depends on the nature and extent of the services provided and the volume of premiums and losses. We were not able to obtain information from all WYO companies about how much they pay their vendor, but from the information we were able to obtain from some WYO companies we were able to estimate the amount paid. We noted that the difference between what the WYO companies paid third-party vendors varied by 2 percent or more of net written premium. In addition, we observed that some companies paid up to twice the amount of incurred loss ULAE compensation to their vendors as others. Such differences in vendor compensation can affect WYO company flood line profits. And because vendor compensation is based in large part on FEMA's allowances or the written premiums and losses on which those allowances are based, changes in those allowances will, absent changes to the vendor contracts, carry through to the vendors.

We identified expenses of approximately $80 million in aggregate that three WYO companies paid to their affiliated vendors in 2014; this amount represents approximately 12 percent of total adjusted expenses (see table 3 above). Company representatives told us that the affiliated vendors provided policy administration, claims processing, cash management, reporting, and other services that third-party vendors typically offer and may include additional management, financial, and legal and regulatory services commonly performed by an insurer's employees. Some companies told us that the fee charged was either intended to cover only the affiliate's expenses or was equivalent to what they would expect to pay a third-party vendor for the same services. We did not determine the amount of intercompany profits or losses reflected in the expenses these WYO companies reported and one company told us that this information is not made public. Without more specific information on the affiliated vendors' activities and intercompany profits and losses, it would not be possible to determine how the fees charged by these affiliated vendors compare to what a third-party vendor otherwise would charge in an arms-length transaction. Excluding intercompany profits and losses (or a portion thereof) from expenses would increase or decrease, respectively, the profit shown in tables 3 and 4.

In addition to vendor fees, some of the WYO companies whose data we analyzed allocate internal company overhead expenses for corporate-wide support functions to their flood lines. Companies told us that they allocate overhead expenses in accordance with the methods prescribed by NAIC. In some cases companies told us that expenses were allocated based on the results of cost studies for those functions that support the federal flood line or were allocated to each line of property and casualty business in proportion to factors such as head count, salaries, and premiums written or earned. In the cases in which we were able to obtain sufficient information to determine how much of the WYO companies' expenses were allocated to overhead, we observed that overhead as a percentage of net written premium ranged from less than 1 percent to almost 3 percent. The amount of overhead allocated to the flood line can affect the company's profit on this line and the variances we observed may reflect the relative significance of the federal flood line to the WYO companies' total property business and the extent that certain activities are performed by internal WYO company personnel versus their vendors.

WYO Company Perspectives on Factors That Can Affect Their Expenses and Profit

Aggregate industry average expense ratios and WYO company flood line expenses and profit are both historical in nature and, as such, may not fully account for current conditions and the effects that changes to the flood program's design and requirements may have on WYO companies' expenses and profits in the future. The 10 WYO companies whose reporting we reviewed cited a number of factors that they consider when evaluating the WYO arrangement in relation to their financial and strategic goals. Some WYO companies told us that their goals can be met as long as they are able to offer flood insurance as part of a full menu of products that help meet the financial needs of their customers without undue financial and reputational risks being placed on the company. Some companies specifically cited as a concern the mandates imposed by Congress and FEMA as part of recently enacted legislation (Biggert-Waters Act and the Homeowners Flood Insurance Affordability Act of 2014) that the companies said imposed significant unreimbursed costs on them.[43] Some WYO companies also stated that additional fees, assessments, and surcharges imposed by this legislation added to customers' out-of-pocket costs. According to the WYO companies, these additional costs to consumers resulted in some property owners dropping their flood coverage and leaving the WYO companies with a smaller policy base.

[43]Homeowner Flood Insurance Affordability Act of 2014, Pub. L. No. 113-89 (2014); Biggert-Waters Flood Insurance Reform Act of 2012, Pub. L. No. 112-141, Div. F, Tit. II, Subtit. A, 126 Stat. 916 (2012).

FEMA Has Not Yet Revised Its Compensation Methodology

FEMA has not yet revised its compensation methodology in response to section 224 of the Biggert-Waters Act or our prior recommendations and continues to rely on insurance industry proxies for other lines of insurance for setting compensation rates (see table 1 for FEMA's compensation practices). The Biggert-Waters Act built on our 2009 recommendations and required that FEMA take into account actual expenses and determine in advance the amount of profit built into its compensation rates when determining compensation.[44] FEMA officials told us that the agency began the rulemaking process in late 2014 in response to the Biggert-Waters Act requirements, but that its progress had slowed as litigation over Hurricane Sandy claims escalated and more resources were assigned to that issue. As of September 2016, FEMA was unable to provide a timeline for completing its rulemaking required under section 224. One FEMA official explained that it is difficult to determine a timeline for rulemaking since some elements of the process, such as economic analysis and the concurrence process through FEMA and DHS, are beyond the agency's control. In September 2016, FEMA officials told us that an upcoming regulatory action in response to section 224 of the Biggert-Waters Act would address FEMA's new methodology for compensating WYO companies, as well as fully address our open recommendation from the 2009 report related to compensation and data quality.[45]

However, FEMA has not made clear whether its expense ratio analysis, planned data requests, and WYO company attestations of the accuracy of their financial data (as discussed previously) represent the entirety of the agency's plan to ensure the accuracy of the data WYOs submit to NAIC. FEMA also has not made clear whether—in light of its own observations on unusual expense ratios and our findings of inconsistent WYO company reporting—it intends to make other inquiries and perform other

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[44] *See* Pub. L. No. 112-141, Div. F, Tit. II, Subtit. A, § 100224, 126 Stat. 916, 936 (2012) for Biggert-Waters Act requirements. Our recommendations included that FEMA determine in advance the amounts built into the payment rates for estimated expenses and profit (to enable FEMA to determine how much of its payment covers expenses and how much goes toward profit) and consider the results of the analysis of payments, actual expenses, and profit in evaluating the methods for paying WYO companies. See GAO-09-455.

[45] GAO-09-455.

analyses that will fully address our recommendations. Among the 10 recommendations in the report, we made the following five relating to compensation methodology and data quality that have not been fully addressed:[46]

- We recommended that FEMA (1) determine in advance the amounts built into the payment rates for estimated expenses and profit; (2) annually analyze actual expenses and profit in relation to the estimated amounts used in setting payment rates; and (3) consider the results of the analysis of payments, actual expenses, and profit in evaluating methods for paying WYO companies.
- We also recommended that FEMA increase the usefulness of the data WYO companies report to NAIC by (1) taking actions to obtain reasonable assurance that expense data can be considered in setting payment rates and (2) developing data analysis strategies to annually test the quality of flood insurance data the companies report to NAIC.

Federal managerial cost accounting standards state that reliable cost information is critical to the proper allocation and stewardship of federal resources and that actual cost information is an important element agency management should consider when setting payment rates.[47]

Our 2009 recommendations to FEMA remain relevant as FEMA seeks to develop a compensation methodology as required by the Biggert-Waters Act. They included that the agency should determine whether data reported to NAIC could be used to set WYO compensation rates and that FEMA develop comprehensive analysis strategies to annually test the quality of the data. Although FEMA has reported improvements to data that WYO companies submit, FEMA stated that although it has compared underwriting expense ratios to the related allowances it pays insurers, it has not yet compared WYO companies' reported expenses to the payments it makes to the WYO companies and determined the companies' profits due to resource limitations. As a result, and as we noted in 2009, FEMA does not have the information it needs to determine whether its payments are appropriate and how much profit is included in its compensation of the WYO companies. In addition to being helpful in

[46] Of the remaining five recommendations, FEMA implemented four of them that were related to the WYO program's control plan and incentive bonus structure and we closed one related to the program's compensation methodology as not being implemented.

[47] Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government.*

identifying potential inconsistencies in expense reporting, such a comparison of compensation payments and actual expenses would help FEMA to identify differences in how individual companies operate and the related effects on company expenses and profit. As discussed previously, we found that the manner in which a WYO company operates has an effect on its expenses and profits and is thereby relevant for FEMA to take into consideration as it develops its new compensation methodology. FEMA's completion of additional actions to improve data quality and transparency and accountability over compensation will help it meet Biggert-Waters Act requirements.

Data and Views on Over- and Underpayment of NFIP Claims

Data on over- and underpayment of claims in fiscal years 2008–2015 varied in over- and underpayments identified, depending on the type of review conducted as part of FEMA's NFIP claims oversight. FEMA officials, some WYO company representatives, and some stakeholders agreed that over- and underpayment of NFIP claims were not widespread and cited several factors that contributed to over- and underpayment issues. A recent DHS OIG report found that, among other things, FEMA was unable to ensure that WYO companies were properly implementing NFIP and unable to identify systemic problems in the program. Currently, a FEMA working group is developing a new WYO oversight plan to address financial oversight, claims, underwriting, appeals, and litigation.

FEMA Data on Over- and Underpayment of Claims

To obtain information about over- and underpayments of NFIP claims, we reviewed available data from FEMA documenting triennial claims operation reviews, improper payment reviews, claims reinspections, biennial audits, and audits for cause for fiscal years 2008–2015. We found that the extent of over- and underpayments varied, depending on the type of review conducted.

Claims Operation Reviews

The vast majority of WYO companies received satisfactory ratings in FEMA's recent claims operation reviews and overpayments by companies and the DSA ranged from 2.7 percent to 6.7 percent of claim amounts reviewed. Between fiscal years 2008 and 2015, the number of

WYO companies that received unsatisfactory ratings on their claims operation reviews ranged from zero to three each year. Under the current Financial Control Plan, FEMA reviews samples of WYO claim files during claims operation reviews.[48] FEMA reviewers note findings as critical and noncritical errors and allow a 19 percent error rate under the current Financial Control Plan; an overall error percentage of 20 percent or higher is a basis for an unsatisfactory rating.[49] According to an August 2016 WYO bulletin, FEMA planned to reduce the acceptable error percentage for claims operation reviews to 10 percent starting in fiscal year 2017 to better encourage WYO companies to adopt policies and practices designed to more accurately handle flood insurance claims and ensure that WYO companies pay all claims authorized by the Standard Flood Insurance Policy.[50] Examples of critical errors in files include claim payments that exceed the policy terms, incorrect payments, and significant payment delays.[51] FEMA's review steps provide an opportunity for WYO companies to respond to and resolve errors before the agency issues a final report.

In fiscal year 2015, FEMA's claims operation review of 866 claims found 23 overpayments totaling $80,202 and 15 underpayments totaling $93,256. The percentage of overpayments in 2015 was lower than in previous years, while the number and percentage of underpayments was higher than in previous years (see table 5). FEMA officials said that for 2013, the particular companies selected for review or lower losses overall might have contributed to fewer overpayments compared to other years. FEMA officials noted that although claims operation reviews required identifying a selection of claim files for review, results were not generalizable to the larger population of claim files for a WYO company or across NFIP.

[48]FEMA aims to review 100 randomly selected claim files for each company. According to agency officials, around 10 FEMA employees typically conduct the reviews, mostly from January through June (before hurricane season), although they have completed some reviews in August. Since 2014, FEMA developed the Underwriting and Claims Operation Review Tool, a database used to capture and monitor FEMA's underwriting and claims operation reviews.

[49]The 20 percent threshold was established when FEMA updated the Financial Control Plan in 1999.

[50]See W-16048.

[51]One or more critical errors or three or more noncritical errors in a single file would be counted as one error in determining a company's overall error percentage.

Table 5: Federal Emergency Management Agency (FEMA) Triennial Claims Operation Review Findings, Fiscal Year 2011–2015

Fiscal year (FY)	Claims reviewed[a]	Overpayments			Underpayments		
		Number	Percent	Total dollars	Number	Percent	Total dollars
2015	866	23	2.7	**80,202**	15	1.7	**93,256**
2014	893	60	6.7	**218,908**	1	0.1	**246**
2013	708	21	3.0	**30,445**	2	0.3	**538**
2012	705	45	6.4	**381,779**	2	0.3	**5,560**
2011	790	43	5.4	**110,863**	2	0.3	**1,340**

Source: GAO analysis of FEMA data. | GAO-17-36

[a]These data include National Flood Insurance Program policies written by Write-Your-Own companies and the Direct Servicing Agent.

Under the current Financial Control Plan, FEMA can refer WYO companies with unacceptable performance to the Standards Committee, which can recommend appropriate remedial actions for companies with performance issues.[52] For example, the committee can require WYO company managers to address performance issues at a committee meeting, require a WYO company to develop and satisfy a plan to remedy its performance issues, monitor performance until the WYO company achieves acceptable levels of performance, and recommend that FEMA not renew a company's WYO arrangement. In 2002, the Standards Committee recommended that FEMA not renew one company's WYO arrangement. According to FEMA officials, the company's inability to resolve underwriting errors contributed to its departure from the WYO program. Since 2008, five WYO companies have appeared before the Standards Committee to address performance issues.

- One WYO company appeared in 2011 to address unsatisfactory underwriting and claims operation reviews.
- Three other WYO companies appeared between 2008 and 2010 to address unsatisfactory underwriting operation reviews; one of these companies was among the largest group of writers of flood insurance from 2008 to 2014.
- The other company, also among the largest group writers of flood insurance from 2008 to 2014, appeared before the Standards

[52]The current Financial Control Plan, from 1999, established the Standards Committee, comprising 12 members appointed by FEMA that include 5 FEMA staff members, 1 representative of FEMA's Office of Financial Management, and 6 industry representatives from WYO companies or other entities.

Committee in 2014 to address its administrative processes for debt collection.

Improper Payment Reviews

According to FEMA officials, DHS's Office of the Chief Financial Officer conducts improper payment reviews annually. These reviews examine NFIP policies written by WYO companies as well as those written by the DSA. Under IPIA, an improper payment is any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements.[53] According to FEMA officials, improper payment reviews identify a statistically valid sample and the results are generalizable to the entire population, whereas FEMA's claims operation review results, as discussed previously, are not generalizable.[54] They said another difference is that the claims operation reviews select entire claim files for review, while the improper payment review tests individual payments; a claim file can include multiple payments.

FEMA's most recent improper payment reviews found that improper payments in NFIP claims for fiscal years 2012–2014 occurred less than 0.2 percent of the time, well below FEMA's threshold of 1.5 percent (see table 6).[55] For example, the fiscal year 2014 review of 338 payments found two improper payments (one overpayment and one underpayment), for an error rate of approximately 0.16 percent. According to a recent IPIA audit report, errors can be typographical such as inconsistencies in recording payment amounts across building estimates, final reports, claims summaries, or checks issued. Errors can also derive from the estimation of recoverable depreciation. For example, an adjuster might

[53]An improper payment also includes any payment to an ineligible recipient or for an ineligible good or service, any duplicate payment, any payment for a good or service not received (except for such payments where authorized by law), and any payment that does not account for credit for applicable discounts. 31 U.S.C. § 3321 note.

[54]DHS's Office of the Chief Financial Officer follows guidance by the Office of Management and Budget (OMB) in selecting a sample of files to review. See Office of Management and Budget, *Issuance of Revised Parts I and II to Appendix C of OMB Circular A-123,* Memorandum M-11-16 (Washington, D.C.: Apr. 14, 2011). The goal of the review is to obtain an overall estimate of the percentage of improper payment amounts within plus or minus 2.5 percent precision at the 90 percent confidence level.

[55]We reviewed results from the improper payment reviews for fiscal years 2008–2014, the most recent data available.

not have included replacement cost value in the final claims payment calculations.

Table 6: Federal Emergency Management Agency (FEMA) Improper Payments Review Results, Fiscal Year 2008–2014

Fiscal year (FY) of payment	Samples tested	Percent of improper payments	Threshold percent of improper payments	Total improper payments	Number and dollar amount	Overpayments	Number and dollar amount	Underpayments	Number and dollar amount
2014[a]	338	0.16	1.5	2	**64,597**	1	61,439	1	3,158
2013	348	0.05	1.5	7	**6,593**	0	0	7	6,593
2012	323	0.02	1.5	6	**2,307**	3	2,002	3	305
2011	328	0.75	2.5	15	**472,428**	15	472,428	0	0
2010	320	1.21	2.5	16	**205,832**	15	204,739	1	1,092
2009	301	2.22	2.5	16	**1,558,946**	16	1,558,946	0	0
2008	369	6.38	2.5	43	**4,341,876**	41	4,164,537	2	177,339

Source: FEMA. | GAO-17-36

[a]These were the most recent data available and include National Flood Insurance Program policies written by Write-Your-Own companies and the Direct Servicing Agent.

Reinspections of Claims

As previously discussed, until 2015, FEMA conducted routine reinspections of claims files, randomly selected by flood event, size of loss, or class of business. In addition, FEMA selected claims for reinspection in response to requests from within the agency, WYO companies, appeals from policyholders, and requests from Congress (special assist reinspections).[56]

Starting in 2015, FEMA discontinued the routine reinspections. According to agency officials, they discontinued this type of review because the annual IPIA review provided comparable information. In August 2016, FEMA officials confirmed that the agency planned to continue conducting

[56]According to the current Financial Control Plan, FEMA would review around 40–100 claims per WYO company for its routine reinspections, depending on the number of claims that a company had reported for each designated flood event in a given year. The agency allowed a 3 percent error rate for companies that reported 400 or more claims. If such a company's error rate exceeded 3 percent, FEMA would reinspect additional claims and the company's claim adjusters would have to undergo additional training. If a company's error rate exceeded 3 percent twice in a 6-month period or exceeded 10 percent in any month, FEMA could require more training and take additional action.

special assist reinspections, and also was piloting a random claims quality check to review and analyze NFIP claims early in the claims process to identify any systemic claims processing issues associated with particular flood events. From 2010 to 2015, the agency reviewed from around 50 to more than 2,400 claim files each year through a combination of routine reinspections and special assist reinspections.[57] In this period, FEMA's reinspections identified underpayments totaling more than $5.95 million and overpayments of about $2.34 million (see table 7). According to FEMA officials, heightened interest in claim underpayments following Hurricane Sandy might have led to an increased interest in reviewing for possible underpayments in recent years.

Table 7: Federal Emergency Management Agency (FEMA) Reinspections of National Flood Insurance Program Claims Results, 2010–2015 (amounts in dollars)

Year[a]	Potential overpayments[b]	Potential underpayments[b]
2015	34,007	1,375,697
2014	606,788	475,236
2013	800,580	1,456,129
2012	642,508	2,434,797
2011	52,782	59,000
2010	205,353	149,950
Total	**2,342,018**	**5,950,809**

Source: FEMA. | GAO-17-36

[a]These data include National Flood Insurance Program policies written by Write-Your-Own companies and the Direct Servicing Agent. Claims reinspections in 2010–2014 included routine reinspections and special assist reinspections, in response to requests from within FEMA, WYO companies, policyholders, and Congress. Claims reinspections in 2015 included only special assist reinspections.

[b]FEMA officials refer to these data as potential overpayments and potential underpayments as these amounts were calculated at the time of the reinspection.

The total number of claims reinspected increased in 2013, after Tropical Storm Isaac and Hurricane Sandy in 2012, which as of July 31, 2016, caused more than $555 million and $8.3 billion in NFIP losses, respectively. The number of claims FEMA reinspected generally declined between 2013–2015. A FEMA official noted that the decline was due to the fact that FEMA bases the number of reinspections it conducts on the number of claims received as a result of flooding events and that there

[57]FEMA conducted its last routine reinspections of claims in fiscal year 2014. The 55 claims reinspected in fiscal year 2015 were selected in response to requests from within the agency (34 claims or 62 percent), WYO companies (12 claims or 22 percent), policyholders (5 claims or 9 percent), and Congress (4 claims or 7 percent).

were no significant flooding events during this time period. Table 8 shows the numbers and types of claims reinspections initiated from fiscal years 2010 through 2015.

Table 8: Federal Emergency Management Agency (FEMA) Reinspections of National Flood Insurance Program Claims Initiated, Fiscal Year 2010–2015

Reason for reinspection	Subtype	Number and percent of reinspections conducted in each fiscal year					
		2015	**2014**	**2013**	**2012**	**2011**	**2010**
Routine reinspection	Routine reinspection	0 (0)	56 (20)	2,316 (96)	1,504 (86)	357 (81)	851 (87)
Special assist reinspections	FEMA request	34 (62)	181 (63)	15 (1)	18 (1)	26 (6)	9 (1)
	Write-Your-Own company request	12 (22)	21 (7)	61 (3)	81 (5)	39 (9)	80 (8)
	Policyholder appeal	5 (9)	23 (8)	18 (1)	13 (1)	15 (3)	34 (3)
	Congressional request	4 (7)	6 (2)	1 (0)	30 (2)	3 (1)	3 (0)
	Enhanced[a]	NA	NA	NA	102 (6)	Na	NA
	Total	**55**	**287**	**2,411**	**1,748**	**440**	**977**

Source: GAO analysis of FEMA data. | GAO-17-36

[a]In 2012, FEMA conducted special support reinspections in North Carolina after Hurricane Irene in 2011, to assist Write-Your-Own companies with the resolution of their claims.

Biennial Audits

No WYO companies received unsatisfactory biennial financial audit ratings during fiscal years 2010–2015; prior to that, two WYO companies received unsatisfactory ratings in 2009. Most recently, in fiscal year 2015, FEMA conducted 37 biennial audits, which resulted in 36 satisfactory ratings and 1 nonrating for which FEMA planned to follow up in its 2016 review. According to FEMA officials, a WYO company receives a satisfactory rating from FEMA when it receives an unqualified opinion from the auditor. Normally, every company receives a rating but might receive a nonrating if a company was exempt from the biennial audit in the reporting year.

According to the current Financial Control Plan, FEMA's biennial audits of WYO companies include claims, underwriting, and financial reviews. For the claims portion of the audits, FEMA identifies a random sample of a WYO company's claim files for an independent auditor to verify, among other things, that adjuster reports contain adequate evidence to substantiate the payment or denial of claims, including the amount of losses and that building and contents allocations are correct. DSA financial-related information is handled differently. It is subject to the annual audit of DHS's consolidated financial statements performed by an independent certified public accountant. FEMA officials told us that, as of December 2015, the contract officer responsible for managing the DSA contract met with the DSA contractor biweekly to discuss any issues with the company's data submissions to the agency.

Audits for Cause

In addition to the oversight processes described above, according to the current Financial Control Plan, FEMA can conduct audits for cause on its own initiative or upon the recommendation of the Standards Committee or OIG when certain criteria are met. According to FEMA's Financial Control Plan Monitoring procedures, an audit for cause is a last resort if other remedies available to the Standards Committee are exhausted, OIG requests one, or agency officials believe immediate action is necessary. For example, FEMA could determine an audit for cause was necessary based on claims reinspection results showing consistent overpayments or biennial audits showing significant problems.

According to agency officials, FEMA has not conducted any audits for cause as a result of biennial audits since 2007. The officials also were unaware of any audits for cause having been conducted as a result of claims reinspections.

FEMA, WYO Company, and Stakeholder Views on Over- and Underpayment of Claims

FEMA officials, some WYO company representatives, and some stakeholders agreed that over- and underpayment of NFIP claims were not widespread.[58] We asked stakeholders about their perspectives on any over- or underpayment of NFIP claims and none who responded on this issue described NFIP over- or underpayments as widespread. Some WYO company representatives said companies do not typically consider claim over- and underpayments a significant issue because companies or their vendors have procedural safeguards to help ensure they pay claims appropriately. Some WYO company representatives said over- and

[58]In its review of flood insurance claims following Hurricane Sandy, a staff report of a Senate committee found that available audit data suggested that payment errors did not occur at a significant rate. To the extent they exhibited any pattern of error, overpayments seemed more common than underpayments. The report made various recommendations related to improving NFIP claims handling. See *Assessing and Improving Flood Insurance Management and Accountability in the Wake of Superstorm Sandy*, BIG/IR-2015-01.

underpayments of NFIP claims were caused by similar factors as over- and underpayments in other property and casualty lines.

According to FEMA officials, lack of documentation was the main cause of overpayments. For example, they said overpayments could happen when the contents of a policyholder’s home were not adequately documented or an adjuster did not correctly calculate losses (use of actual cash value and incorrect depreciation figures). According to FEMA officials, WYO companies generally have reimbursed FEMA for any overpayments they identified, and the companies would request reimbursement from the insured in cases of large or potentially fraudulent overpayments. For example, FEMA recovered the $61,439 overpayment from fiscal year 2014 identified in the IPIA review. The officials said that when the DSA has identified overpayments, it also has sought to recoup the money from the recipient insureds.

Representatives of several WYO companies and two stakeholders said that companies lacked incentives for underpayments and FEMA officials said underpayments were generally small and typically resulted from mathematical errors.[59] Representatives from most WYO companies with whom we spoke said that companies typically did not track underpayments. According to FEMA officials, representatives of two WYO companies, and two stakeholders including a vendor, some policyholders lack an understanding of the terms of NFIP coverage. They said policyholders sometimes expect to be made whole after a flood event, but the NFIP standard flood insurance policy coverage is limited to direct physical losses by or from flood, depending on the type of insured

[59]In addition, FEMA officials noted that underpayments could result from overlooking the payment of recoverable depreciation to the policyholder, when owed.

property and the amount of coverage obtained.[60] In a 2014 report, we found that homeowners may not understand their insurance coverage well enough to know what is covered, what is excluded, and what loss events and circumstances might result in paid, partially paid, or denied claims, and disaster events could highlight differences between consumers' expectations for insurance and their actual coverage, resulting in added frustrations.[61]

Representatives of some WYO companies and a few stakeholders said factors related to the nature of the claims process and large loss events contributed to over- and underpayment issues, including the following:

- **Nature of the claims adjustment process.** The claims adjustment process can lead to differences across claims. Representatives of one WYO company said that claim adjusters must make judgment calls with respect to calculating depreciation. For example, three experienced adjusters might calculate three slightly different estimates for the same claim, according to representatives of another WYO company.
- **Large claims volume.** According to two stakeholders, processing a large volume of claims can contribute to claims processing errors and lead to increased perceptions that over- and underpayments are an issue.
- **Inexperienced adjusters.** Lack of qualified adjusters after large storms can lead to claims processing errors. Representatives of a

[60]The maximum coverage for residential properties is $250,000 for building coverage and $100,000 for contents coverage. Separate deductibles apply to each type of policy obtained (building and contents) and the policy provides replacement cost, actual cash value, or a special loss settlement, depending on the type of property. For single-family primary residences, the replacement cost is limited to not more than the least of: (1) the necessary amount actually spent to repair or replace the damaged part of the dwelling for like use; (2) the building limit of liability shown on the declarations page of the policy; and (3) the replacement cost of the part of the dwelling damaged using materials of like kind and quality and for like use. For mobile homes and similar residential dwellings used as a principal residence, losses are paid according to a special loss settlement determination: if such a dwelling is totally destroyed or damaged to such an extent that it is not economically feasible to repair it to its pre-damage condition, the lesser of (1) the replacement cost or 1.5 times the actual cash value (whichever is less) or (2) the building limit of liability shown on the declarations page of the policy applies. If the structure is partially damaged and it is economically feasible to repair it to its pre-damage condition, NFIP will settle the loss according to replacement cost conditions.

[61]GAO, *Homeowners Insurance: Multiple Challenges Make Expanding Private Coverage Difficult*, GAO-14-179 (Washington, D.C.: Jan. 30, 2014).

WYO company said public adjusters often lacked NFIP experience. To meet immediate needs for assessing damage caused by recent large storm events, FEMA provided a limited waiver of claim adjuster certification.[62] According to a stakeholder, this practice led to hiring claim adjusters who otherwise would not have met FEMA's qualifications. Representatives of the WYO company said inexperienced adjusters might give claimants false hope for the amount of claims they might receive, leading to perceptions of underpayments. A representative from another WYO company said adjusters learn on the job, and having a few errors was not unusual for a complex line of business like NFIP. In addition, representatives of the WYO company said streamlining adjusting software could help address this issue. The WYO company representatives and a stakeholder said training and additional oversight of adjusters was needed.

- **Changes by FEMA to the Standard Flood Insurance Policy claims process.** In the 4 years following Hurricane Sandy, FEMA issued several bulletins outlining processing changes for claims associated with the loss event, which may have further complicated what some described as already a complex process. Among these changes, FEMA allowed WYO companies to pay claims after receiving an adjuster's estimate but before a policyholder provided all necessary paperwork, with the expectation that additional payouts would be required once the losses were fully documented. FEMA issued three extensions to the 60-day filing window for policyholders to submit proof of loss information to their WYO insurer, extending the filing window to 1 year, then 18 months, and finally, 24 months after the event.
- **Market fluctuations.** Replacement cost calculations in the data might change between the time an adjuster develops an estimate and a contractor begins repairs.

Recent OIG Report Identified NFIP Oversight Deficiencies

In March 2016, a DHS OIG report found that although FEMA performed the required oversight reviews of WYO companies in accordance with the

[62]Specifically, in November 2012, following Hurricane Sandy, FEMA provided a limited waiver of adjuster certification that allowed adjusters who had received certification on or after June 1, 2010, to return to active status until June 1, 2013. See Federal Emergency Management Agency, "Hurricane Sandy – Emergency NFIP Flood Certification," *WYO Bulletin,* W-12083 (Washington, D.C.: Nov. 1, 2012).

agency's Financial Control Plan, it could improve its processes.[63] For example, the OIG report stated that FEMA was not using the results from its Financial Control Plan reviews—including claims operation reviews, biennial audits, and claims reinspections—to make WYO program improvements because the agency lacked adequate guidance, resources, or internal controls. Among other findings, OIG found that FEMA was unable to ensure that WYO companies were properly implementing NFIP and unable to identify systemic problems in the program. FEMA management acknowledged that NFIP lacked a consistent or reliable method to identify systemic problems or recognize patterns or warning signs. The OIG report recommended that FEMA develop and implement procedures to evaluate the results of the oversight under the Financial Control Plan and determine the overall effectiveness of established NFIP internal controls. In response, the agency planned to evaluate the Financial Control Plan review process and make recommendations to improve its oversight of WYO companies, which are expected by December 30, 2016.

As of August 2016, a FEMA working group was developing a new WYO oversight plan to address financial oversight, claims, underwriting, appeals, and litigation, to be completed by January 2017. According to FEMA officials, the working group would update the Financial Control Plan after developing the WYO oversight plan.[64] They said FEMA planned to monitor WYO company error rates on claims and underwriting operation reviews as part of its WYO company oversight, and its oversight would include performance measures.

Prior to the issuance of the OIG report, FEMA had begun evaluating the customer experience to further identify ways to align NFIP and FEMA's processes around the policyholder. For example, according to agency officials, in 2015 FEMA surveyed approximately 2,000 policyholders to

[63]OIG-16-47.

[64]In May 2016, FEMA proposed to remove the WYO arrangement and a summary of the Financial Control Plan from the Code of Federal Regulations. 81 Fed. Reg. 32,261 (May 23, 2016). According to the agency, removing the arrangement from federal regulations would provide more flexibility to FEMA and industry partners to negotiate operational adjustments, and more quickly and efficiently meet the needs of industry partners and NFIP operations. A copy of the Financial Control Plan was included in the Code of Federal Regulations from 1985 until 1999, when the plan was removed from the Code of Federal Regulations and replaced with a summary. In May 2016, FEMA proposed removing the summary because it found having the information in both the Financial Control Plan and the regulation was duplicative and unnecessary.

understand customers' priorities and found, among other things, that customers would prefer a simplified program and more coverage choices.[65]

Furthermore, FEMA has begun reorganizing FIMA, including separating the department into two branches—one to oversee the WYO program and the other to oversee the DSA—and establishing separate claims and claims appeals processes. To improve claims processing, FEMA planned to gather more real-time claim data from WYO companies and the DSA to enhance the customer experience and detect problems or errors as they occur. To improve the claims appeals process, the agency established a new appeals branch within FIMA's Policyholder Services Division devoted to redesigning and overseeing the appeals process and planned to implement changes by December 30, 2016. According to FEMA officials, these changes would help address a March 2016 OIG recommendation that the agency properly document and update existing procedures for the claims appeal process.[66] In addition, in an effort to understand how policyholders move through the claims process after flood events and possible issues with that process, FEMA began obtaining detailed claims information from WYO companies on a weekly basis. According to agency officials, the data, while unverified and unedited, provided insights into the claims process not previously available to FEMA following large loss events.

Current WYO Arrangement and Potential Alternatives Involve Trade-offs

According to our analysis and interviews, the current WYO arrangement provides advantages to consumers and insurers but disadvantages to FEMA in overseeing a large number of companies. While potential alternatives involving fewer participating WYO companies could ease oversight for FEMA, these alternatives could lead to reduced market penetration, among other trade-offs. Most WYO companies we

[65]According to FEMA officials, the survey results were not statistically significant but provided insights on how to improve NFIP and the customer experience. Other findings included that customers do not understand their risk of flooding, which affects the perceived value of flood insurance, and that FIMA should work more collaboratively with external partners in improving the NFIP customer experience.

[66]OIG-16-47.

interviewed preferred the current WYO arrangement over any of the three potential alternatives we identified. All the potential alternatives involve FEMA contracting with participating companies, a status that most WYO company representatives cited as creating more regulatory burden because of federal contract requirements.

Trade-offs of Current Arrangement Include Advantages for Consumers and Insurers from WYO Company Competition but Disadvantages for FEMA Oversight

Based on our analysis and interviews with FEMA, WYO companies, and stakeholders (relevant organizations and vendors), the current WYO arrangement has trade-offs (see table 9). For example, while competition among the approximately 75 companies under the current arrangement may lead to improvements in customer service, the large number of companies increases the amount of oversight FEMA must provide. Representatives of most WYO companies and several stakeholders with whom we spoke preferred the current arrangement over adopting an alternative structure for the program. Representatives of some WYO companies said the current approach is predictable. This stability could continue to encourage WYO participation.

Table 9: Trade-offs of the Current Write-Your-Own (WYO) Program Arrangement

	Potential costs to insurers	Federal Emergency Management Agency (FEMA) oversight	Market penetration[a]	WYO company participation
Advantages	WYO companies have general expectations about the costs of participating, based on their past involvement Competition among WYO companies may lead to some efficiencies and lower some costs for them	FEMA has established oversight and data collection requirements for WYO companies	The large number of WYO companies may better facilitate NFIP market penetration Competition among WYO companies may lead to improvements in customer service	Known costs and past involvement contribute to continued participation

	Potential costs to insurers	Federal Emergency Management Agency (FEMA) oversight	Market penetration[a]	WYO company participation
Disadvantages	Costs to WYO companies include actual costs and reputational risks associated with large-loss events WYO companies stated that there is not a mechanism to request additional compensation for additional unforeseen work (for example, implementing recent regulatory changes), which could limit economies of scale	Requires oversight of a large number of companies, approximately 75 as of September 2016 Vendors administer policies on behalf of most WYO companies, but FEMA lacks vendor oversight processes, including visibility over compensation and expenses between WYO companies and vendors	Competition among WYO companies has led to higher agent commission costs in certain parts of the United States	Reputational risk and regulatory uncertainty could potentially lead to lower participation rates

Source: GAO analysis. | GAO-17-36

Note: To summarize the advantages and disadvantages, we compiled information from several sources, including our prior work and interviews with WYO companies and stakeholders. More specifically, we selected a nongeneralizeable sample of 10 WYO companies and 14 stakeholders with flood insurance expertise, based on their knowledge of flood insurance and the WYO program. These stakeholders included several vendors with whom WYO companies contract, officials from industry groups representing insurance companies and agents, and academics, among others.

[a]Market penetration refers to the proportion of property owners that purchase flood insurance.

However, a few stakeholders and representatives of a few WYO companies said costs for WYO companies had increased with recent legislation, which could discourage WYO participation in the future. Under the DSA contract, FEMA may direct changes within the general scope of the contract regarding the description of services to be performed, time of performance, and the place of performance of the services, but it must compensate the contractor for these changes. For example, if there is a change in law or regulation after the execution date of the contract that affects the contractor’s performance of the services, FEMA must compensate the contractor, through an equitable adjustment, for the changes. We discuss federal contract requirements and differences between the DSA contract and the WYO arrangement in more detail in appendix II. While FEMA uses proxies to compensate WYO companies, it compensates the DSA based on a predominantly fixed-price contract (tied to a fixed-price per policy, based on policy type). Our review of contract modifications showed an example in which the DSA sought equitable adjustments from FEMA for changed work caused by implementation of the Biggert-Waters Act and the Homeowner Flood Insurance Affordability Act of 2014 (HFIAA). In the modifications we reviewed, the DSA generally was compensated for its estimated additional costs imposed by the change if it could prove the changes affected the work under the terms of the original contract. For example, in December 2014 FEMA equitably adjusted the DSA contract to pay an additional $830,070 to implement the

Biggert-Waters Act and $125,531 to implement HFIAA, which repealed and modified certain provisions of the Biggert-Waters Act. WYO companies also were affected by these changes but representatives of two WYO companies and a stakeholder said WYO companies were not able to request additional compensation to recoup additional costs.

In other comments about the current arrangement, FEMA officials and representatives of one WYO company said FEMA oversight of vendors that administer policies was needed. FEMA's current oversight processes do not include direct oversight of vendors. According to FEMA officials, nine vendors serviced about 85 percent of NFIP policies as of May 2015. One stakeholder—a vendor—noted that FEMA auditors frequently visited the vendor to conduct triennial claims operation reviews and biennial financial audits of the WYO companies that the vendor serviced. FEMA officials noted that the agency's relationship is with the WYO company and, therefore, its oversight was specific to WYO companies and did not include any requirements for vendors.

Potential Alternatives to the Current WYO Arrangement Each Involve Trade-offs

Three potential alternatives to the current structure for the WYO program each involve trade-offs, although WYO company representatives and stakeholders generally preferred the third alternative that would maintain a WYO network. All three potential alternatives involve FEMA contracting with participating companies (WYO companies or vendors), a status that most WYO company representatives cited as creating more regulatory burden because of federal contract requirements.[67] (We discuss federal contract requirements and the views of WYO companies about the program being premised on contracting in more detail in app. II.)

More specifically, we identified the following three potential alternatives (see fig. 1):

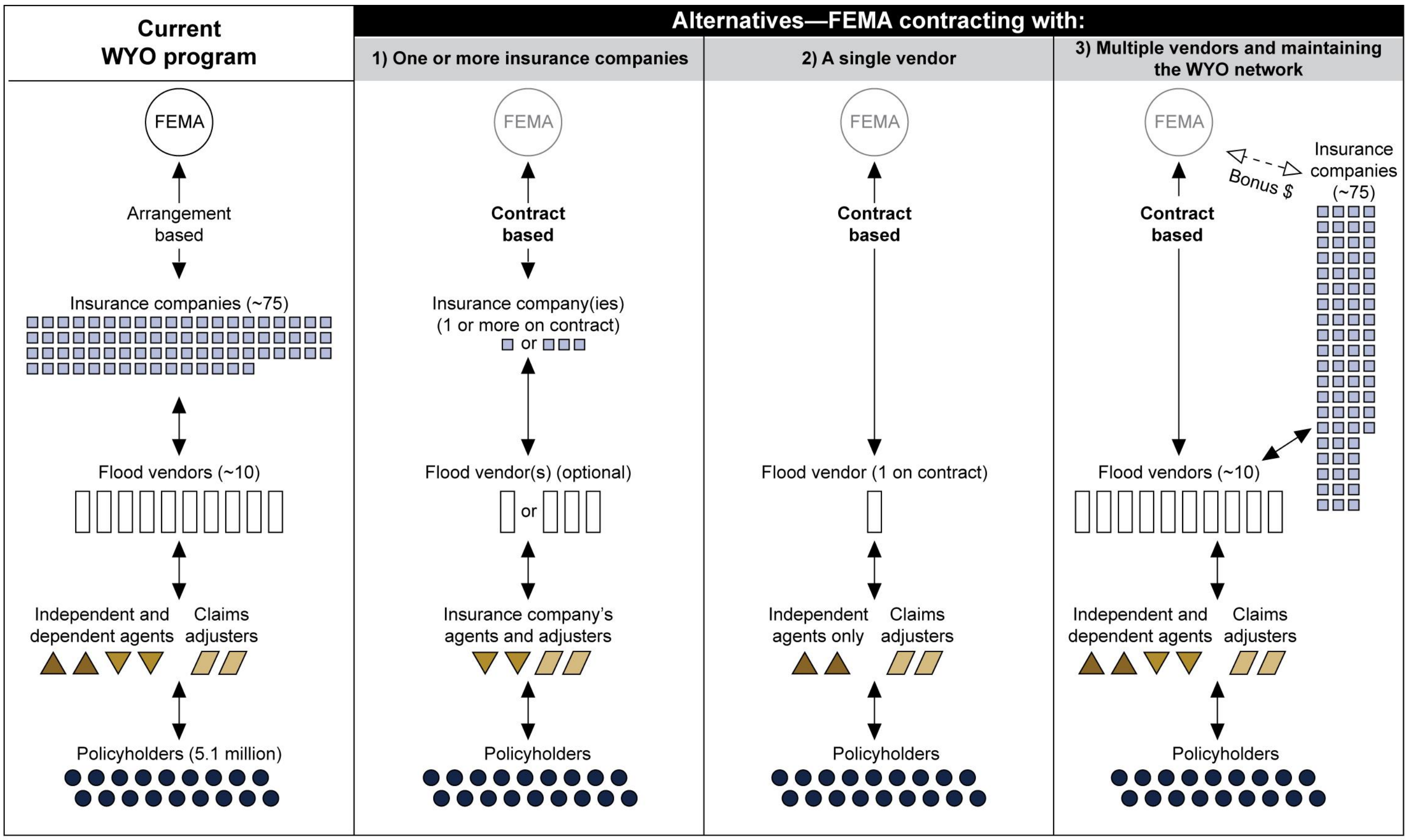
- **Alternative 1: FEMA contracts with one or more insurance companies.** FEMA would solicit offers for a contract with one or more

[67]We solicited input from WYO companies and stakeholders to understand their views on three potential alternatives to the WYO arrangement, which we first identified in a prior report, GAO-09-455. We did not conduct market research or prepare an acquisition strategy in accordance with the Federal Acquisition Regulation and applicable agency supplements, as FEMA would be required to do.

insurance companies to sell and service flood policies and adjust claims.

- **Alternative 2: FEMA contracts with one vendor.** FEMA would solicit offers for a contract with a flood insurance vendor to service flood policies. The arrangement would be similar to the NFIP Direct program. The vendor would sell flood insurance policies through independent insurance agents, and insurance companies would not be involved.
- **Alternative 3: FEMA contracts with multiple vendors and maintains the WYO network.** The WYO companies would sell flood policies, while one or more vendors would service the policies. FEMA would solicit offers for contracts from multiple flood insurance vendors to service flood policies. Insurance companies that wanted to sell flood insurance would contract with one or more of the vendors to service flood policies sold by insurance company agents. Because FEMA would pay vendors to administer the flood policies, participating insurance companies would not incur any operational expenses for their flood line; rather, FEMA would pay the insurance companies a sales bonus for performance.

Figure 1: Federal Emergency Management Agency (FEMA) National Flood Insurance Program Write-Your-Own (WYO) Arrangement and Three Potential Alternatives



FEMA: Oversees NFIP, including the performance of insurance companies. Also responsible for establishing and updating NFIP regulations and analyzing data to actuarially determine flood insurance rates.

Insurance companies: Private insurers sell and service flood insurance policies and adjust NFIP claims under an arrangement with FEMA. These companies employ, contract, or work with other parties to market and sell NFIP policies and receive, process, and pay claims on behalf of the federal government. Approximately 75 insurance companies participated in the WYO program as of September 2016.

Flood vendors: Companies that work under contract with insurance companies to conduct some or all of the day-to-day processing and management of NFIP policies. Approximately 10 flood vendors participate in the current WYO program.

Agents: Individuals that work under contract with insurance companies and serve as the main point of contact for most policyholders seeking to purchase an NFIP policy find information on coverage, or file a claim. Dependent agents work on behalf of a single insurance company and independent agents contract with multiple insurance companies.

Claims adjusters: NFIP-certified adjusters settle NFIP claims and may be independent, employed by an insurance company, or employed by an adjusting company. The adjuster is responsible for assessing flood damage, estimating losses, and submitting required documentation to the participating insurance company.

Policyholders: Consumers in participating communities that have purchased or renewed a NFIP policy, which carries a 1-year term and can include building or contents coverage for residential or commercial structures. There were 5.1 million policies in force as of July 2015.

Source: GAO. | GAO-17-36

We previously reported that the three alternatives had advantages and disadvantages in terms of the potential impact on the basic operations of administering flood insurance policies and adjusting claims, as well as on

FEMA's oversight of the program and its contractors.[68] In the following analysis, we discuss the trade-offs of each alternative based on four factors that we identified: the cost to WYO companies, oversight by FEMA, market penetration, and WYO company participation.[69]

Alternative 1, in which FEMA would contract with one or more insurance companies to sell and service flood policies and adjust claims, would maintain the WYO company network to some extent but likely would involve fewer participating WYO companies (see table 10).

- Some stakeholders said that many current WYO companies would elect not to participate in a bid process because they opposed becoming federal contractors. However, representatives of one WYO company said that by not participating, these companies would lose a competitive advantage. That is, offering flood insurance in addition to home, life, and automobile insurance allows participating multiline insurers to address multiple insurance needs of their customers. Representatives of another WYO company said that WYO companies with in-house servicing capabilities would have a competitive advantage over other companies that use third-party vendors.
- Fewer WYO companies could or could not represent an advantage for FEMA. Oversight might be easier than that required for the approximately 75 WYO companies in the current arrangement as of September 2016. Representatives of one WYO company said FEMA could collaborate more closely with WYO companies if fewer were involved in the program. However, one stakeholder said overseeing federal contracts could require expanded oversight processes and additional resources from the agency.
- Responding to large loss events could be more challenging with fewer WYO companies. Furthermore, a change in the composition of WYO companies could affect market penetration. (We discuss geographic concentration of market share for WYO companies later in this report.)

[68]See GAO-09-455.

[69]As noted previously, for purposes of this report, market penetration refers to the proportion of property owners who purchase flood insurance. We identified the four factors based on our prior work evaluating these arrangements and initial interviews with industry participants.

Table 10: Trade-offs of Write-your-own (WYO) Arrangement Alternative 1: Federal Emergency Management Agency (FEMA) Contracting with One or More Insurance Companies

	Potential costs to insurers	FEMA oversight	Market penetration[a]	WYO company participation
Advantages	With fewer WYO companies, participating companies would potentially deliver more coverage and could yield efficiencies through economies of scale	Overseeing fewer than 75 WYO companies could ease FEMA oversight FEMA could collaborate more closely with fewer participating WYO companies	Having more than one WYO company would maintain competition and could help sustain customer service quality for policyholders	Federal contract requirements might make participating WYO companies more invested in NFIP than some that participate in the current arrangement
Disadvantages	Fewer WYO companies would benefit from the program; non-WYO companies could lose business as they no longer would be able to provide a full package of services to customers Costs could be higher for WYO companies that currently have third-party vendors With fewer WYO companies, participating WYO companies could face initial logistical challenges scaling up to service more policies Costs could be higher as FEMA imposes federal contracting and compliance requirements	Overseeing federal contracts could require more resources from FEMA Responding to large-loss events could be challenging with fewer WYO companies	Market penetration could decrease because fewer WYO companies likely would sell coverage	WYO companies might not participate in a competitive bid process

Source: GAO analysis. | GAO-17-36

Note: To summarize the advantages and disadvantages, we compiled information from several sources, including our prior work and interviews with WYO companies and stakeholders. More specifically, we selected a nongeneralizeable sample of 10 WYO companies and 14 stakeholders with flood insurance expertise, based on their knowledge of flood insurance and the WYO program. These stakeholders included several vendors with whom WYO companies contract, officials from industry groups representing insurance companies and agents, and academics, among others.

[a]Market penetration refers to the proportion of property owners that purchase flood insurance.

Alternative 2, in which FEMA would contract with one vendor to service policies and sell them via independent insurance agents, similar to the NFIP Direct program, largely would eliminate insurance companies' involvement in NFIP (see table 11).

- Representatives of one WYO company said transitioning to this model would be a step backward for the WYO program, which evolved from a single entity in the 1980s. In addition, representatives of another

WYO company pointed out that no single insurer or vendor had the infrastructure needed to deliver NFIP coverage on such a large scale.

- Similar to Alternative 1, in which FEMA would contract with one or more insurance companies, representatives of a few WYO companies and a stakeholder said handling a large storm event could be even more challenging for a single entity and could have a negative effect on the customer experience generally, and after large-loss events.
- Furthermore, according to representatives of another WYO company and a few stakeholders, selling policies through independent agents only, rather than through independent agents and the network of agents affiliated with WYO companies currently in the program, could adversely affect market penetration.
- Lastly, representatives of some WYO companies said competition could be an issue under this option. For example, if one vendor won a long-term contract, the companies not selected might not maintain the ability to service the flood business, which could create a cycle in which the same vendor has a competitive advantage and is repeatedly selected.

Table 11: Trade-offs of Write-Your-Own (WYO) Arrangement Alternative 2: Federal Emergency Management Agency (FEMA) Contracting with a Single Vendor

	Potential costs to insurers	FEMA oversight	Market penetration[a]	WYO company participation
Advantages	Insurers would not bear any cost for selling or servicing policies	Awarding and administering a federal contract with one company could be easier for FEMA than its present oversight	None identified	None identified
Disadvantages	Less competition among WYO companies could lead to less innovation and fewer efficiency gains, as well as poorer customer service Company would need time to develop needed infrastructure to transition to this model Costs could be higher as FEMA imposes federal contracting and compliance requirements	Awarding and administering federal contracts could require more resources from FEMA and FEMA would need to change its oversight structure	A single vendor could lead to decreased market penetration and declines in customer service	Lack of competition as a single vendor would participate Responding to large loss events could be challenging for a single entity

Source: GAO analysis. | GAO-17-36

Note: To summarize the advantages and disadvantages, we compiled information from several sources, including our prior work and interviews with WYO companies and stakeholders. More specifically, we selected a nongeneralizeable sample of 10 WYO companies and 14 stakeholders with flood insurance expertise, based on their knowledge of flood insurance and the WYO program. These stakeholders included several vendors with whom WYO companies contract, officials from industry groups representing insurance companies and agents, and academics.

[a]Market penetration refers to the proportion of property owners that purchase flood insurance.

Many stakeholders generally said that Alternative 3, in which FEMA would contract with multiple vendors (to service NFIP policies) and maintain the WYO network (to sell NFIP policies), was the most appealing option of the three alternatives we identified because it would involve multiple vendors and maintain the existing WYO network (see table 12). However, this option also has significant trade-offs.

- This arrangement would maintain competition among vendors and WYO companies, but could lead to declines in customer service. Representatives of a few WYO companies said that by having FEMA set requirements for vendors that deliver customer service—rather than having WYO companies contract with vendors as is the current practice—WYO companies would have less control over customer service quality and could face reputational risks.
- However, according to representatives of two WYO companies and a stakeholder, competition among participating vendors could drive down program costs or improve customer service quality.

Table 12: Trade-offs of Write-Your-Own (WYO) Arrangement Alternative 3: Federal Emergency Management Agency (FEMA) Contracting with Multiple Vendors and Maintaining the WYO Network

	Potential costs to insurers	FEMA oversight	Market penetration[a]	WYO company participation
Advantages	Having multiple vendors from which to choose could help decrease program costs for WYO companies, particularly those with third-party vendors	If fewer than 75 WYO companies participated, awarding and administering a federal contract could be easier than under the current arrangement	Less risk of decreased market participation by maintaining WYO network	Maintaining competition among WYO companies and vendors could encourage more participation than two other alternatives we identified

	Potential costs to insurers	FEMA oversight	Market penetration[a]	WYO company participation
Disadvantages	More vendors could increase WYO costs There may be challenges for those WYO companies that are forced to switch to different vendors because their vendor can no longer participate in the program WYO companies could face reputational risks having vendors overseen by FEMA delivering customer service	Even if fewer than 75 WYO companies participated, awarding and administering a federal contract could increase FEMA's oversight responsibilities Developing oversight of vendors could be challenging and would require FEMA to create the infrastructure to oversee vendors	Possible decline in customer service with vendors administering all policies With less involvement in service delivery, WYO companies might lack incentives to market NFIP	WYO companies might not participate in an arrangement in which FEMA would determine the vendors servicing their NFIP policies WYO companies that previously contracted with FEMA's selected vendors could have a competitive advantage over other WYO companies

Source: GAO analysis. | GAO-17-36

Note: To summarize the advantages and disadvantages, we compiled information from several sources, including our prior work and interviews with WYO companies and stakeholders. More specifically, we selected a nongeneralizeable sample of 10 WYO companies and 14 stakeholders with flood insurance expertise, based on their knowledge of flood insurance and the WYO program. These stakeholders included several vendors with whom WYO companies contract, officials from industry groups representing insurance companies and agents, and academics.

[a]Market penetration refers to the proportion of property owners that purchase flood insurance.

Some WYO companies and stakeholders considered the possible impact on responses to large loss events and effects on customer service quality as important factors in evaluating potential changes to the WYO program. As mentioned previously, each alternative we identified could involve a decrease in the number of participating WYO companies. Representatives of some WYO companies and a few stakeholders said decreasing the number of WYO companies could negatively affect customer service and market penetration.

WYO Companies and Stakeholders Suggested Possible Improvements to the Current Arrangement and Other Potential Alternatives

Most WYO company representatives we interviewed preferred the current arrangement to any of the potential alternatives, while most stakeholders did not state a preference between the current arrangement and the alternatives we identified. Many WYO company representatives and several stakeholders provided suggestions for improving the current arrangement.

- **Improve guidance for WYO companies.** Representatives of several WYO companies said better communication was needed from FEMA, including following large loss events. For example, representatives of one WYO company and a stakeholder said that FEMA should post questions from the companies and the agency's responses online. This would help standardize information that WYO companies received, and address the problem of getting different answers from different FEMA officials through more informal communication channels. According to FEMA officials, the agency plans to create standards-based guidance for WYO companies and reduce the amount of prescriptive guidance FEMA provided to WYO companies.

- **Simplify the program.** Some WYO company representatives and some stakeholders said NFIP coverage is more complicated to write and adjust than other property and casualty insurance coverage. Several suggested that FEMA take steps to make it easier for agents to write policies and adjust claims. According to agency officials, FEMA planned to enhance the consistency and simplicity of the NFIP product and simplify NFIP policy language within the current legislative framework, among other changes, during 2016.
- **Reconsider agent commissions.** As discussed previously, based on our data analysis and interviews with WYO companies, some WYO companies pay more to agents than the 15 percent of net written premiums that FEMA provides in compensation. Some WYO company representatives and two stakeholders said increases in agent commissions led to higher costs for WYO companies. Among these stakeholders, one vendor said that FEMA should develop better incentives for insurance agents to address this issue and increase market penetration. For example, representatives said that FEMA could establish agent compensation based on the percentage of homeowners insurance policyholders that have flood insurance or other metrics. In addition, they said FEMA could standardize agent commissions so independent agents would focus more on selling new policies rather than transferring NFIP policies from one WYO to another that pays higher commission. As previously discussed, FEMA is currently in the process of developing a new compensation methodology through rulemaking but could not provide a timeline on when this rulemaking would be complete.
- **Provide vendor oversight.** FEMA officials said it was widely acknowledged that FEMA must address its lack of vendor oversight, and said the agency was taking steps to determine how to address this issue in any changes to its WYO program oversight. In July 2015, the agency began requesting WYO companies to submit, through their vendors when applicable, sample files demonstrating the implementation of NFIP program changes 30 days before a program

change became effective. [70] While not direct oversight of vendors, FEMA officials stated that this change was part of its efforts to better ensure that system updates for implementing NFIP program changes were properly implemented. As of July 2016, FEMA officials did not identify any other plans for addressing vendor oversight.

- **Other suggestions.** In addition to suggestions on ways to improve the WYO program, two WYO companies and some stakeholders suggested other ways to improve NFIP. For example, representatives of two WYO companies and some stakeholders suggested encouraging private-sector participation in flood insurance (including eliminating a noncompete clause for WYO companies from the current arrangement, discussed later). In addition, one stakeholder suggested making flood coverage a mandatory component of homeowners insurance, establishing a different scale for quantifying flood risk, expanding policy choices through NFIP or private-sector coverage, and more closely coordinating NFIP and disaster assistance.[71]

FEMA officials told us they plan to reexamine and improve the WYO arrangement to allow for greater flexibility in the relationship between FEMA and WYO companies. In May 2016, FEMA issued a proposed rule to remove the WYO arrangement from regulation to make operational adjustments and corrections to the arrangement more efficiently.[72] FEMA officials told us that the agency does not plan to make changes to the arrangement for fiscal year 2017.

Additionally, several stakeholders and WYO company representatives with whom we spoke suggested other possible alternative structures for the WYO program. These included increasing requirements for WYO companies, removing a noncompete clause in the WYO arrangement, and adopting the federal crop insurance program model, which shares some similarities with NFIP but has some notable differences.

- **Limiting WYO participation or increasing WYO company requirements.** Representatives of several WYO companies

[70]See Federal Emergency Management Agency, “Implementing Program Changes,” *WYO Bulletin,* W-15035 (July 24, 2015).

[71]We have ongoing work examining options for reforming NFIP, which include options with greater involvement from private insurers and reinsurers.

[72]See 81 Fed. Reg. 32,261 (May 23, 2016). As noted previously, the Financial Assistance/Subsidy Arrangement is currently codified at 44 C.F.R. pt. 62, app. A.

suggested that maintaining the current WYO arrangement but limiting the number of WYO companies allowed to participate was another option. Under this option, according to WYO representatives, WYO companies would not necessarily become federal contractors, but would compete, in a sense, for available spots in the program. FEMA officials said adding other requirements for WYO companies—rather than determining the number of WYO companies allowed to participate—would be another way to achieve fewer participating companies.

- **Removing noncompete clause.** Three stakeholders, including two industry groups representing insurance companies and a vendor, said removing a noncompete clause from the arrangement (which generally prevents WYO companies from selling private flood policies) would encourage continued participation in the program and also encourage greater private-sector involvement in insuring flood risk.[73] The noncompete clause was also cited as a potential barrier to increased use of private flood insurance by various industry stakeholders with whom we spoke as part of work we completed in July 2016 on private sector involvement in flood insurance.[74]
- **Adopting crop insurance model.** One stakeholder suggested the federal crop insurance model as a possible alternative structure for the WYO program.[75] Similar to the agreements between FEMA and WYO companies, companies participating in the crop insurance program—17 as of September 2016—have a 1-year agreement with

[73]This restriction applies solely to policies providing only flood insurance. It does not apply to policies provided by a WYO company of which flood is one of several covered perils or where the flood insurance coverage amount is over and above the limits of liability available to the insured under NFIP.

[74]GAO, *Flood Insurance: Potential Barriers Cited to Increased Use of Private Insurance*, GAO-16-611 (Washington, D.C.: July 14, 2016).

[75]Federal costs for the crop insurance program have increased substantially since 2000 (they averaged $3.4 billion annually for fiscal years 2003—2007 and grew to an average $8.4 billion annually during 2008—2013). The Congressional Budget Office estimated federal crop insurance costs would average $8.9 billion per year for fiscal years 2015—2024. See GAO, *Crop Insurance: In Areas with Higher Crop Production Risks, Costs Are Greater, and Premiums May Not Cover Expected Losses,* GAO-15-215 (Washington, D.C.: Feb. 9, 2015). Additionally, we have found that climate change and related increases in extreme weather events may further increase the federal costs of both crop and flood insurance in coming decades. GAO, *Climate Change: Better Management of Exposure to Potential Future Losses Is Needed for Federal Flood and Crop Insurance*, GAO-15-28 (Washington, D.C.: Oct. 29, 2014).

the Federal Crop Insurance Corporation to sell and service policies.[76] The crop insurance agreement is not considered a contract for the purposes of the Federal Acquisition Regulation. But unlike in the WYO program, these companies share a percentage of the risk of loss (and opportunity for gain), and the Department of Agriculture reinsures their losses, a significant structural difference between the two programs. The Federal Crop Insurance Corporation accounted for about 1.1 million policies and $9.26 billion in premiums written as of October 2016, whereas according to the most recent data available, NFIP accounted for 5.1 million policies and about $3.4 billion in federal flood earned premiums.[77] Similar to the WYO arrangement, companies in the crop insurance program receive a percentage of the premium on policies sold to cover the administrative costs of selling and servicing these policies. In turn, insurance companies use this money to pay commissions to their agents who sell the policies and fees to adjusters when claims are filed.[78] Unlike NFIP, the Federal Crop Insurance Corporation requires that companies submit expense amounts on a standard form, but these amounts are not audited. The

[76]The Department of Agriculture's Risk Management Agency has overall responsibility for administering the federal crop insurance program, which it administers in partnership with private insurance companies. Congress sets premium subsidy rates for federal crop insurance (that is, the percentage of the premium paid by the government). Premium subsidy rates vary by the level of insurance coverage that a farmer chooses and the geographic diversity of the crops insured. For more information, see GAO, *Crop Insurance: Considerations in Reducing Federal Premium Subsidies*, GAO-14-700 (Washington, D.C.: Aug. 8, 2014).

[77]FEMA policy data are as of June 2016 and federal flood earned premiums are for 2015. These are the most recent data FEMA has published.

[78]Under the crop insurance program, the federal government pays administrative and operating expense subsidies to insurance companies as an allowance intended to cover their expenses for selling and servicing crop insurance policies. In turn, insurance companies use these subsidies to cover their overhead expenses, such as payroll and rent, and to pay commissions to insurance companies and their agents. Insurance companies also incur expenses associated with claims adjustment. For example, these expenses include adjusters' compensation and travel expenses to farmers' fields.

Department of Agriculture considers the expense information when it renegotiates its standard agreement with insurers.[79]

Large WYO Companies Wrote the Majority of NFIP Residential Policies at the State and County Levels

Our analysis of three potential alternatives to the current WYO arrangement found that each alternative could decrease the number of participating WYO companies. We analyzed NFIP policy data to understand the geographic concentration of WYO company market share under the current arrangement. Specifically, we analyzed residential policy data to understand the geographic concentration of residential NFIP coverage and the role that large and small writers of NFIP coverage and the DSA played in different states and counties.[80] We found that large WYO companies wrote the majority of NFIP residential policies across states and counties (see fig. 2). We considered large WYO companies as the top 10 companies in terms of NFIP market share in 2014.[81]

- Overall, large WYO companies accounted for the largest share of written NFIP residential policies across states, territories, and the District of Columbia (70 percent), while small WYO companies and

[79]We previously reported that the Federal Crop Insurance Corporation required that participating insurance companies submit documentation of their expenses and used the information to determine the appropriate percentage as a basis for compensation. This documentation was intended to provide a basis for program oversight to ensure that payments made to private insurance companies for their expenses in providing insurance services were reasonable. See GAO, *National Flood Insurance Program: FEMA's Management and Oversight of Payments for Insurance Company Services Should Be Improved*, GAO-07-1078 (Washington, D.C.: Sept. 5, 2007).

[80]We included only residential NFIP policies to focus our analysis on the market concentration for homeowners.

[81]The methodology for selecting these 10 WYO companies differed from the methodologies for the previous selections of WYO companies discussed. For purposes of our geographic analysis of NFIP policy data we selected a third sample of 10 WYO companies selected based on net premiums written in 2014. The term "companies" for this selection includes all WYO insurers in a related insurance group. The 10 insurers we identified as large WYO companies held an 80 percent cumulative share of the federal flood market in 2014 (not including DSA policies), with individual market shares ranging from approximately 2 percent to 20 percent. We considered all other insurers as small WYO companies, with market shares ranging from 0 to 1.5 percent and a cumulative market share of 20 percent.

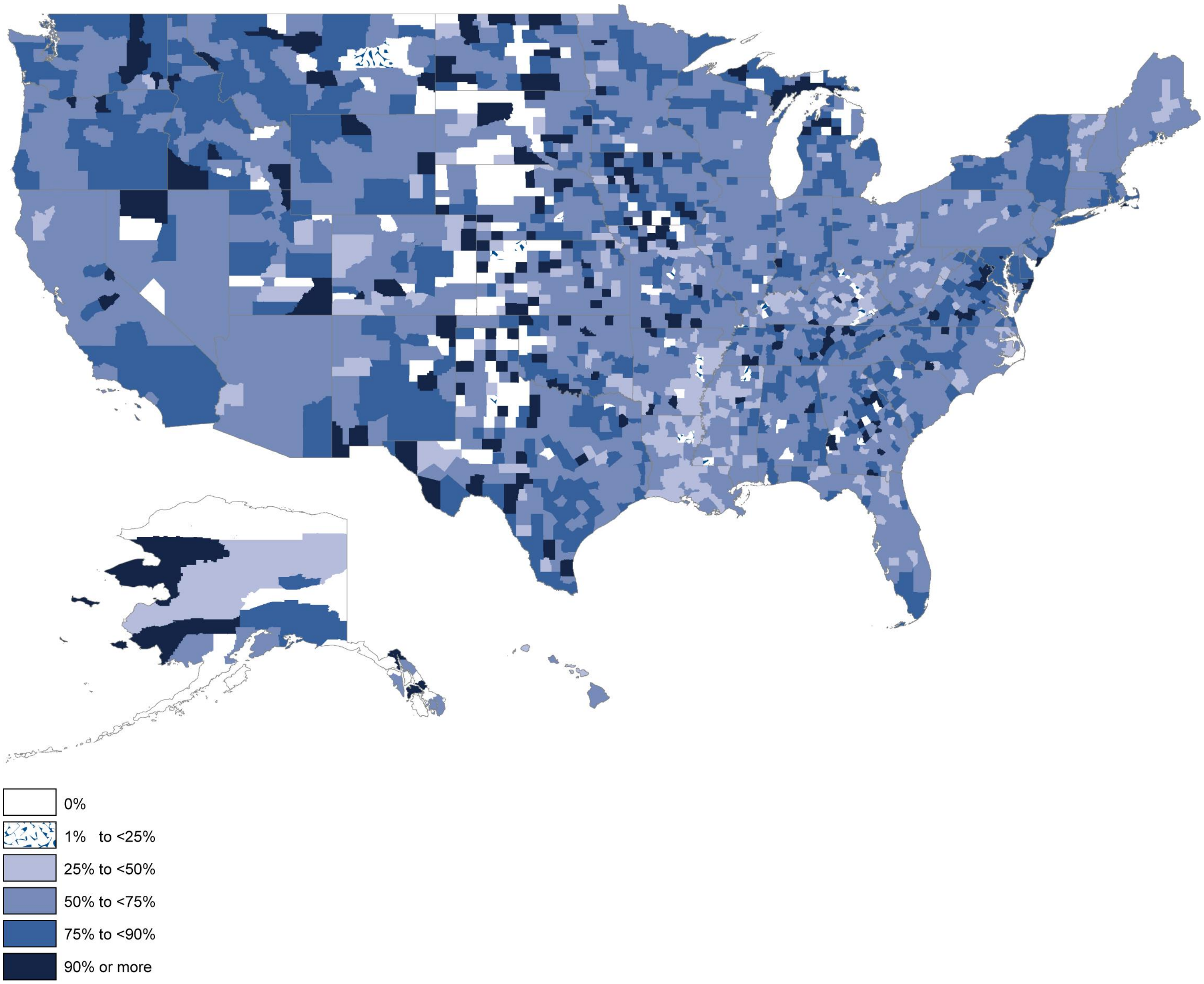
the DSA accounted for smaller shares of the market (16 and 14 percent, respectively).

- At the state level, large WYO companies wrote more than half of all NFIP residential policies in every state, while the share of policies written by small WYO companies (2 percent–38 percent) and the DSA (4 percent –28 percent) varied more.[82]
- At the county level, we found that large WYO companies wrote more than half of all NFIP residential policies in 83 percent of counties across the states, territories, and the District of Columbia.

See appendix III for additional analysis.

[82]Small WYO companies wrote less than 10 percent of the NFIP residential policies in 17 states: Alaska, Alabama, Delaware, Idaho, Maryland, Michigan, Montana, New Mexico, New York, Oklahoma, Oregon, Rhode Island, Tennessee, Texas, Virginia, Washington, and Wyoming. Two of these states—Texas and New York—had more than 100,000 written residential policies and were among the top five states with the highest NFIP losses reported by FEMA.

Figure 2: Share of National Flood Insurance Program Residential Policies Written by Large Write-Your-Own (WYO) Companies, by County, as of May 2015



Sources: GAO analysis of Federal Emergency Management Agency data; MapInfo (map). | GAO-17-36

Note: We considered large WYO companies as the top 10 companies in terms of federal flood market share in 2014.The data also account for other WYO companies and policies written by the Direct Servicing Agent.

Conclusions

FEMA has yet to implement Biggert-Waters act requirements to develop a methodology for compensating WYO companies using actual flood insurance expenses. For example, FEMA has not completed the rulemaking process and we found the flood insurance financial data WYO companies reported to NAIC are inconsistent, which limits the data's usefulness to FEMA in setting compensation rates. Additionally, FEMA currently does not systematically consider actual flood expenses and profit when establishing WYO compensation, and has yet to compare WYO companies' actual expenses and compensation. As recommended in 2009, FEMA should (1) determine in advance the amounts built into the payment rates for estimated expenses and profit; (2) annually analyze actual expenses and profit in relation to the estimated amounts used in setting payment rates; and (3) consider the results of the analysis of payments, actual expenses, and profit in evaluating methods for paying WYO companies. Additionally, FEMA should (4) take actions to obtain reasonable assurance that flood insurance expense data reported to NAIC can be considered in setting payment rates and (5) develop data analysis strategies to annually test the quality of flood insurance data the companies report to NAIC. Fully addressing these recommendations will help FEMA meet the Biggert-Waters Act requirement to develop a methodology for determining appropriate compensation for WYO companies that uses the companies' actual flood expenses.

FEMA is still in the process of revising its compensation methodology. Based on our analysis, how a WYO company operates has an effect on its expenses and profits. For example, company-specific factors such as compensating independent agents to sell policies or third-party vendors to service policies, and the manner in which a company allocates overhead expenses, can result in varying expenses and profit. Gaining such an understanding of the WYO companies' operations, which can contribute to year-to-year fluctuations in expenses and profit, would allow FEMA to more effectively revise its compensation methodology. Moreover, this understanding, coupled with improved data on WYO company expenses, also would facilitate any future consideration that FEMA might make of alternative structures for the WYO program. Finally, considering that the compensation of WYO companies is a significant part of the total premiums policyholders pay, FEMA may seek to achieve the program's objective of making flood insurance available at affordable rates in part by establishing reasonable compensation rates that appropriately consider WYO company expenses, profits, and operating characteristics.

Recommendations for Executive Action

To improve the transparency and accountability over the compensation paid to WYO companies and set appropriate compensation rates, the FEMA administrator should take into account WYO company characteristics that may impact companies' expenses and profits when developing the new compensation methodology and rates.

Agency Comments

We provided a draft of this report to FEMA within the Department of Homeland Security, NAIC, and FIO within the Department of the Treasury for review and comment.

DHS and NAIC provided technical comments, which we incorporated, as appropriate. DHS also provided a written response, reproduced in appendix IV, in which FEMA concurred with our recommendation and agreed that fully understanding the characteristics of the insurance companies that participate in the WYO program can help in determining compensation. FEMA responded that it intends to comply with the rulemaking requirement of section 224 of the Biggert-Waters Act and, when completed, will implement a new compensation methodology to track, as closely as practicably possible, the actual expenses of the WYO companies. Agency officials noted that as FEMA must implement this recommendation via rulemaking, it is unable to provide more specific information or a time frame at this time.
As agreed with your office, 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 DHS, NAIC, and Treasury, and interested congressional committees and members. In addition, the report will be available at no charge on the GAO website at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202)-512-8678 or cackleya@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 key contributions to this report are listed in appendix V.

Sincerely yours,

Alicia Puente Cackley Director Financial Markets and Community Investment

Appendix I: Objectives, Scope, and Methodology

Our objectives in this report were to describe the (1) Federal Emergency Management Agency's (FEMA) current compensation practices for Write-Your-Own (WYO) companies and the extent to which FEMA revised its practices in response to the Biggert-Waters Flood Insurance Reform Act of 2012 (Biggert-Waters Act); (2) information on over- and underpayments of National Flood Insurance Program (NFIP) policy claims; and (3) the trade-offs of selected potential alternatives to FEMA's current arrangement with WYO companies for selling and servicing flood insurance policies.

To address all three reporting objectives, we reviewed our prior reports and reports from the Office of Inspector General (OIG) of the Department of Homeland Security; relevant laws and regulations; and FEMA documentation and guidance. We also interviewed officials from FEMA and representatives from 10 WYO companies with varying NFIP premium bases. Specifically, we selected a non-generalizable, purposive sample of 10 WYO companies, selected based on net premiums written to capture companies with a large market share of premiums written, as well as to obtain the opinions of different sized WYO companies on their involvement in NFIP. Also, to obtain a broader range of perspectives, we included two WYO companies in this group of 10 because they did not use subcontractors (vendors) to service policies. This is the first group of 10 WYO companies we selected. We later identified a second and third group of 10 WYO companies to address other aspects of our reporting objectives.

Status of FEMA Revisions to Compensation Methodology

For our first objective, we reviewed the Biggert-Waters Act, other laws and regulations relevant to FEMA's compensation practices, and FEMA documentation, such as WYO Bulletins (which FEMA publishes to inform WYO companies, and the public, of updates or changes to NFIP, including compensation practices). To identify any changes FEMA made to its compensation methodology since our August 2009 report, we reviewed WYO Company Bulletins issued between January 2008 and August 2016. We also obtained and reviewed FEMA's compensation packages for WYO companies for fiscal years 2010–2016. To understand the status of FEMA's implementation of recommendations from our 2009 report and section 224 of the Biggert-Waters Act, which built on our recommendations, we interviewed FEMA officials on any steps the agency had taken to improve the quality of WYO company expense data and on its progress in implementing related Biggert-Waters Act requirements.[1] We also interviewed National Association of Insurance Commissioners (NAIC) officials about expense data WYO companies report to NAIC. In addition, we interviewed the first group of 10 WYO companies (discussed at the start of this appendix) on compensation issues, including how expenses were incurred and reported.

To compare FEMA compensation paid to WYO companies to actual expense data WYO companies reported to NAIC, we obtained and analyzed premium, loss, and compensation data for all WYO companies for fiscal years 2008–2014 from FEMA and premium, loss and expense data for all WYO companies from SNL Financial and NAIC for calendar years 2008–2014. For purposes of our analysis, we retrieved federal flood line data reported to NAIC from SNL Financial. To make the FEMA and NAIC data comparable, we converted FEMA's fiscal year data to a calendar-year basis to match the period for reporting to NAIC. We also converted FEMA reported paid losses and loss adjusted expenses to an accrual basis to be able to appropriately compare loss adjustment compensation and actual expenses. We then calculated estimated profit for each WYO company as the difference between the calendar year compensation reported to FEMA and calendar year expenses reported to NAIC. The estimated profits, calculated using the data provided by FEMA and NAIC data obtained from SNL Financial, did not correspond to our expectations of profits from our 2009 work.

To better understand WYO companies' accounting and reporting of federal flood data, we made another (second) selection of 10 WYO companies that comprised the majority of net written premiums (about 60 percent), paid losses (about 52 percent), and total compensation (about 60 percent) during 2008–2014.[2] Specifically, we selected a nongeneralizable, purposive sample of 10 WYO companies, selected based on net premiums written during 2008–2014. We overselected WYO companies with a larger share of the market because of their relevance in the flood insurance market. We interviewed these WYO companies and requested and examined additional information and data they provided.

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

[2] The use of the term "companies" for the selection of WYO companies for which we conducted additional data analysis includes all WYO companies within a related insurance group. In addition, some WYO companies in the second selection also were in our first group of 10 companies (those we interviewed for issues pertaining to all three reporting objectives).

We used this additional information and data to evaluate the causes of differences in reported premiums and losses and estimate the effect those differences had on the companies' compensation and expenses. We also used this information and data to estimate various underwriting and loss adjustment expenses to corroborate statements the companies made to us regarding the amount they pay their vendors and adjusters. We analyzed the companies' commission, underwriting, and loss expense ratios, profits as a percentage of total compensation, and reported loss and loss adjustment expense reserves to corroborate statements the companies made regarding changes in their accounting and reporting practices between 2008 and 2014. Based on the additional information and data provided and our analyses, we made adjustments to the expenses reported to NAIC for unreported expenses, reclassifications of expenses, and the effects of different loss adjustment expense estimates and recalculated estimated profit (on a pre-tax basis) for these 10 WYO companies for calendar year 2014.[3]

Our analysis and ability to estimate WYO company expenses and profit were subject to a number of limitations.

- First, the adjustments we made to the companies' reported expenses were based on information provided by the WYO companies. WYO company representatives provided supplemental financial data and made various representations to us, and while we reviewed the data and representations for reasonableness in relation to other information we had, we did not obtain all evidence necessary to fully validate this additional information.
- Second, we initially sought information from the 10 selected WYO companies that would allow us to compare compensation and actual expenses and estimate profit for each company for the years 2008-–2014. However, due to challenges in obtaining sufficient information and documentation from all companies to support their accounting and reporting practices for each of those years and assess the consistency of such reporting from company to company and year to year, we limited our calculation of profit to a single year—2014. Further, as our 2014 estimates of company expenses and profits are an outcome of our effort to understand the issues surrounding the

[3]We narrowed our analysis to calendar year 2014 data as they appeared to be of the highest quality (compared with previous years beginning with 2008) for the majority of the 10 selected WYO companies. In addition, focusing on a single year allowed us to more readily obtain complete and timely responses from the WYO companies.

inconsistent financial reporting by selected WYO companies and the various factors that can affect company expenses and profit, these estimates should not be taken to be a static or predictable indicator of WYO company profits.

- Third, two WYO companies stated that only expenses that could be specifically identified as flood-related, including vendor fees, were reported to NAIC on their Insurance Expense Exhibits. One WYO company said that overhead expenses were not allocated to the federal flood line because this line of business was not considered as significant relative to the company's other property insurance lines. We did not obtain information from the companies that would allow us to assess the significance of these unallocated overhead expenses to our estimates of flood line profits.
- Fourth, some of the companies we reviewed use affiliated companies as vendors to service flood policies. As information on the affiliated companies' activities and profits was not available to us, we could not determine the extent to which intercompany profits were reflected in the expenses reported by these WYO companies and the extent to which fees charged by these affiliated vendors might have exceeded what otherwise would be charged by a third-party vendor.

We assessed the reliability of the FEMA data by reviewing audit documentation from prior GAO engagements; and audit documentation from and related reports issued by the Department of Homeland Security's external auditor supporting its work on WYO program financial data included in the department's fiscal year 2014 financial statements. In addition, we performed electronic and manual data testing for missing data, outliers, and other obvious errors, recalculated various types of WYO compensation paid to WYO companies, and spoke with knowledgeable agency officials about the data. For the NAIC data, we reviewed related documentation and interviewed knowledgeable officials. We assessed the reliability of the SNL Financial data by comparing it to NAIC data to ensure its accuracy and consistency. We confirmed the accuracy of the FEMA and NAIC data for the 10 selected companies by requesting additional information from the companies. However, we did not audit whether the FEMA and NAIC data were in accordance with financial reporting standards and requirements. We determined that these data were sufficiently reliable for the purpose of assessing the alignment of compensation amounts with actual expenses and for estimating the profits of a selection of WYO companies.

Information on Over- and Underpayments

For our second objective, we reviewed data from FEMA documenting its WYO company oversight processes. The data we reviewed pertain to the triennial claims operation reviews, improper payment reviews (which the agency conducts as required by the Improper Payments Information Act of 2002, as amended), reinspection of claims, and biennial audits. We assessed the reliability of the data by reviewing related FEMA documentation on the data and interviewing knowledgeable agency officials. We determined that these data were sufficiently reliable for the purpose of reporting on FEMA's oversight of claims and the results of these reviews. We also reviewed other FEMA documentation on its oversight of the claims process (such as FEMA's Financial Control Plan and Financial Control Plan Monitoring Procedures) to understand FEMA's oversight processes; a recent Senate Banking Committee investigation report; and an OIG report that discussed issues associated with over- and underpayment of claims.[4] We interviewed FEMA officials about the agency's oversight of the claims process, potential causes for over- and underpayments, and how they are resolved. We also interviewed the first group of 10 selected WYO companies as well as stakeholders on their views about the over- and underpayment of claims. Specifically, we selected and interviewed 14 stakeholders representing a variety of organization types with knowledge of flood insurance and the WYO program. These stakeholders included three vendors with whom WYO companies contract, and officials from 11 organizations comprised of industry groups representing insurance companies and agents, and academics. We interviewed officials from these entities to obtain diverse perspectives on the possible extent and potential causes of over- and underpayments of claims. Our work focused on over- and underpayments and did not examine specific claims related to any specific event.

Trade-offs of Potential Alternatives to WYO Arrangement

For our third objective, we reviewed a prior GAO report and conducted a literature review to identify potential alternative approaches to FEMA's

[4]See Senate Committee on Banking, Housing, and Urban Affairs, Majority Staff Report, *Assessing and Improving Flood Insurance Management and Accountability in the Wake of Superstorm Sandy*, BIG/IR-2015-01 (Washington, D.C.: June 22, 2015) and Department of Homeland Security, Office of Inspector General, *FEMA Does Not Provide Adequate Oversight of Its National Flood Insurance Write Your Own Program,* OIG-16-47 (Washington, D.C.: Mar. 8, 2016).

agreements with WYO companies for selling and servicing flood insurance policies and examine trade-offs for these approaches. We targeted our literature review to identify academic research and published studies on flood insurance, broadly, and those that discussed alternatives to the WYO arrangement.[5] Our query identified around 60 document summaries, from which we identified 19 for further analysis. Of the 19, all provided background information on flood insurance and the NFIP program, but none presented clear alternatives to the WYO arrangement. From our prior work, we identified three potential alternative approaches to the current WYO arrangement: (1) FEMA contracts with one or more insurance companies; (2) FEMA contracts with one vendor; or (3) FEMA contracts with multiple vendors and maintains the WYO network.

After initial interviews with WYO company representatives and stakeholders indicated that alternatives to the current arrangement could decrease the number of participating WYO companies, we analyzed FEMA NFIP policy data to understand the geographic concentration of NFIP policies written for homeowners by WYO companies. Our analysis looked at policy data for residential policies under the current WYO arrangement and the geographic concentration of market share for large and small writers of NFIP coverage and the Direct Servicing Agent (DSA) in different states and counties. As part of the analysis, we reviewed the proportion of residential policies written by WYO companies and the DSA in counties by population, based on county population categories used by the Department of Agriculture's Economic Research Service.[6] For purposes of this analysis, we considered large companies as those among the 10 insurance groups whose members wrote the greatest amount of NFIP coverage in 2014, the most recent year of available data (our third group of 10 WYO companies selected).[7] The methodology for

[5]We conducted our literature review in June 2015 and selected documents published from July 2012 to June 2015. Our search preferences included scholarly and peer-reviewed material, government reports, hearings and transcripts, conference papers, and association publications.

[6]The U.S. Department of Agriculture's Economic Research Service's Rural-Urban Continuum Codes distinguish metropolitan (metro) counties by the population size of their metro area, and nonmetropolitan (nonmetro) counties by degree of urbanization and adjacency to metro areas. The Office of Management and Budget's 2013 metro and nonmetro categories were subdivided into three metro and six nonmetro groups, resulting in a nine-part county classification.

[7]The term "companies" for this selection includes all WYO insurers in a related insurance group.

selecting these 10 WYO companies differed from the methodologies for the previous two selections discussed. This third group of 10 insurers we identified as large WYO companies accounted for an 80 percent cumulative share of the federal flood market in 2014 (not including DSA policies), with individual market shares ranging from approximately 2 percent to 20 percent. We considered all other insurers as small WYO companies, with market shares ranging from 0 to 1.5 percent and a cumulative market share of 20 percent. We tested the reliability of the NFIP policy data by reviewing related documentation, conducting electronic and manual data testing, and reviewing prior GAO assessments of the data. We included only residential NFIP policies in our analysis to focus our analysis on the market penetration related to homeowners. In addition, we excluded from our analysis 1,506 policies the geographic location of which could not be determined from FEMA's data. These policies accounted for 0.03 percent of the total number of policies in the data set.[8] We found these data reliable for the purpose of identifying the geographic location of policies written by WYO companies and the DSA.

In addition, we analyzed the proportion of NFIP residential policies written by WYO companies and the DSA on a statewide basis for five states with the highest total NFIP payments since 1978. Based on FEMA data as of June 30, 2016, the five states with the highest total loss payments were (in order of magnitude) Louisiana, Texas, New Jersey, New York, and Florida.[9] We assessed the reliability of these data by reviewing FEMA data definitions and previous GAO assessments of the data. We determined that these data were sufficiently reliable for the purpose of identifying states with the highest total NFIP loss payments.

We also compared requirements of NFIP's WYO arrangement and FEMA's DSA with some federal contract requirements. As previously noted, we included several vendors among the 14 stakeholders with flood insurance expertise we selected and interviewed to understand the trade-offs for the program being run by one vendor (the second alternative approach we previously identified). Furthermore, we compared the

[8]Of the 1,506 excluded policies, large WYO companies wrote 1,110, small WYO companies wrote 130, and the DSA wrote the remaining 266.

[9]Based on FEMA NFIP loss statistics from January 1, 1978, through June 30, 2016, the five states with the highest total NFIP payments were Louisiana ($16.94 billion), Texas ($6.50 billion), New Jersey ($5.87 billion), New York ($5.28 billion), and Florida ($3.89 billion).

general structure of the insurance arrangement under the Department of Agriculture’s Federal Crop Insurance Corporation with the WYO arrangement, based on our prior work reviewing the crop insurance program. We obtained perspectives from FEMA officials, representatives of WYO companies (those selected based on net premiums written), stakeholders with flood insurance expertise, and the Federal Insurance Office of the Department of the Treasury on potential alternative structures for the WYO program. We analyzed the tradeoffs of the alternatives based on four primary factors: potential costs to participating insurers, FEMA oversight, market penetration, and WYO company participation.[10] We identified these four factors based on our prior work evaluating these arrangements and initial interviews with industry participants. We also obtained their perspectives on other possible improvements to NFIP.

We conducted this performance audit from April 2015 to December 2016 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.

[10]For purposes of this report, market penetration refers to the proportion of property owners who purchase flood insurance.

Appendix II: Federal Contract Requirements and Write-Your-Own (WYO) Company and Stakeholder Views

In 2009 and again for this report, we identified potential alternative administrative structures for the National Flood Insurance Program's (NFIP) Write-Your-Own program, which, if possible, could replace the WYO arrangement, each of which involve participating companies (WYO companies or vendors) becoming federal contractors.[1] In the WYO program, private insurers sell and service flood insurance policies and adjust claims for NFIP under an arrangement with the Federal Emergency Management Agency (FEMA). In general, executive agencies must award contracts using full and open competition. In addition, contracts generally must include certain clauses related to contract administration, such as those that provide the government the ability to terminate contracts, as well as those required by statute and executive orders that implement U.S. policy.

The following analysis discusses requirements that generally apply to contracts under the Federal Acquisition Regulation (FAR) and how they compare to the WYO arrangement and FEMA's contract with the Direct Servicing Agent (DSA). The DSA is a FEMA contractor that writes NFIP policies and provides an alternative when a WYO company is unable or unwilling to write a flood insurance policy. The analysis also includes the views of WYO companies about changing the WYO program arrangement to a contract subject to the FAR.[2]

- **Open competition.** Executive agencies generally must seek to obtain "full and open competition" in the contract award process (subject to exception). This means that all responsible sources are permitted to compete. The DSA selection process includes full and open competition, but insurance companies do not compete to participate in the WYO program. Instead, companies must apply to participate, and FEMA approves the participation of companies that meet certain criteria, rather than selecting companies based on their bids for a contract. Requirements for a company to participate in the WYO program include their experience in property and casualty insurance lines, good standing with state insurance departments, and ability to meet NFIP reporting requirements to adequately sell and service flood

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

[2]We selected and interviewed a nongeneralizeable purposive sample of 10 WYO companies, selected based on net premiums written in order to capture WYO companies with a large portion of the market share of premiums written, as well as obtain the opinions of WYO companies of different sizes, in terms of their involvement in NFIP.

insurance policies.[3] FEMA officials told us that the agency does not track how many companies failed to gain approval to participate in the program, but noted that many companies failed to obtain approval because they did not meet the requirement for having 5 years of experience as a property and casualty insurer.

- **Bid protests and dispute processes.** Federal acquisition regulations and statutes provide for bid protests—where interested parties can, for example, protest the award of a contract (e.g., if company A wins the contract, company B can challenge the award). In addition, federal acquisition statutes and regulations provide procedures and requirements for resolving claims and disputes that arise during contract performance. DSA contract awards can be thus protested. The current WYO arrangement does not include a process to protest FEMA's selection of WYO companies, but if any misunderstanding or dispute arises between a WYO and FEMA about any factual issue under the arrangement or in relation to FEMA's nonrenewal of a WYO company's participation in the program, the company can submit the dispute to arbitration.
- **Government as a party to a contract.** Federal contracts generally provide an agency the right to unilaterally terminate the contract—either for the convenience of the government or for the default of the contractor. Under a termination for convenience, the government can completely or partially terminate the work under a contract when it is in the government's interest. Agencies generally can make certain unilateral modifications to a contract during performance as long as those changes fall within the contract's scope. The DSA contract allows the Department of Homeland Security to terminate the contract if it would be in the best interest of the government in the event that a contractor discovers a conflict of interest, or in the event a contractor intentionally did not disclose a conflict of interest. In contrast, the WYO arrangement does not explicitly provide agency control over termination, but in the event that a company is unable or otherwise fails to carry out its obligations under the arrangement, the company must transfer the NFIP policies it issued to FEMA or propose that another WYO company assume responsibility for those policies.

[3] *See* 44 C.F.R. § 62.24. Each year, FEMA publishes in the *Federal Register* the terms for participation in the WYO program. This *Federal Register* notice also states that WYO companies are to comply with the provisions of NFIP's WYO Financial Control Plan Requirements and Procedures (Financial Control Plan). The Financial Control Plan outlines WYO companies' responsibilities for program operations including underwriting, claim adjustments, cash management, and financial reporting, as well as FEMA's responsibilities for management and oversight.

- **Contract type and contractor costs.** Depending on the contract type, the government may or may not have insight into contractor costs. For example, a cost reimbursement type contract—where the government pays for allowable incurred costs to the extent prescribed in the contract—can only be used if the contractor's accounting system is adequate for determining costs applicable to the contract. For fixed-price-type contracts, where full responsibility for all costs is placed on the contractor, the government would not have visibility into contract costs. For example, the DSA has a hybrid firm-fixed-price and time-and-materials contract with FEMA with a 1-year base period and 4 one-year option terms. FEMA pays a fixed price per policy on a monthly basis based on the type and number of policies the company services (standard, group flood, and severe repetitive loss), as long as the company meets the performance requirements included in the contract.[4] FEMA also pays the DSA for line items based on the amount of time and materials the company spends on certification and accreditation activities. The contract allows the contractor to recoup cost increases stemming from changes to the contract. For example, the DSA sought and obtained a series of payments from FEMA for extra work the contractor conducted as part of implementing the Biggert-Waters Act and the Homeowner Flood Insurance and Affordability Act. As discussed in more detail in the report, the WYO arrangement does not prescribe detailed cost and pricing guidance to companies but generally compensates WYO companies using proxies to determine rates at which it pays them. For example, the arrangement provides that WYO companies may retain 15 percent of net written premiums as the allowance for insurance agent commissions.
- **Ethical practices and statutory compliance.** Depending on the type of contract, there are also a variety of requirements imposed under statutes and executive orders that can have major effects on business practices.[5] These include provisions related to bribery, false claims, false statements, conflicts of interest, and kickbacks; lobbying restrictions; equal opportunity and affirmative action requirements; subcontracting and sourcing; small business and veteran

[4]The contract includes a quality assurance surveillance plan that establishes procedures and guidelines to ensure that the contractor achieves required performance standards or service levels. For example, the surveillance plan includes performance requirements for the company's timeliness of application and claims processing.

[5]Some of these requirements may not apply in all cases, but to certain types of contracts or contracts awarded for certain amounts of money, for example.

participation; and compliance with labor standards and drug-free workplace requirements. For example, the DSA contract requires the company to use Department of Labor wage determinations and outlines the types of benefits employees must receive, including health and welfare benefits, paid vacation, and paid holidays. The current WYO arrangement does not speak to all of the factors outlined above, but provides that a WYO shall not discriminate against any applicant for insurance because of race, color, religion, sex, age, handicap, marital status, or national origin.

Representatives of seven of 10 WYO companies we interviewed (for all three objectives, as described in app. I) opposed WYO companies becoming federal contractors, citing burdensome requirements.[6] Of the other three, one said the costs of becoming a federal contractor would depend on the structure of the contract, and the other two did not comment. Representatives of one WYO company said a positive aspect of having a contract is that it could provide a mechanism for establishing an annual maximum to FEMA's possible changes to the contract for NFIP regulatory changes. This could allow WYO companies or vendors to recoup some costs of implementing unexpected changes to the program. The DSA contractor has the ability to recoup the expenses it incurs in response to changes, for example to law or regulation, which affect its performance of the services under the contract.

FEMA officials said WYO companies historically had opposed structuring the WYO program as a federal contractual relationship between FEMA and WYO companies since the WYO program was established and said a federal contract might not be compatible with the structure of the insurance industry and how WYO companies deliver coverage. In addition, they said that as a federal contractor, a WYO company or vendor would need to convert its information technology systems to accommodate new federal security requirements, which would be time consuming and costly.

Stakeholders who commented about the use of a federal contract for the WYO program had mixed perspectives. We selected and interviewed 14 stakeholders with flood insurance expertise, based on their knowledge of

[6]Similarly, we reported in 2009 that most insurance company officials with whom we spoke said that they did not want to be federal contractors because of the regulations that would apply and emphasized that they had agreed to participate in the WYO program only because it was not based on an explicit federal contract. See GAO-09-455.

flood insurance and the WYO program.[7] One stakeholder said FEMA's oversight might improve because the agency would have more authority to direct how WYO companies administered claims. One stakeholder—a vendor—said that although the current arrangement is not a federal contract, it can feel like a contractual agreement for WYO companies because the financial control plan outlines requirements for participating companies. Another stakeholder said that use of a federal contract for the WYO program could create more stringent requirements for WYO companies and could lead to declines in their participation and NFIP market penetration, and result in the DSA having to administer more policies.

[7]These stakeholders included several vendors with whom WYO companies contract, officials from industry groups representing insurance companies and agents, and academics.

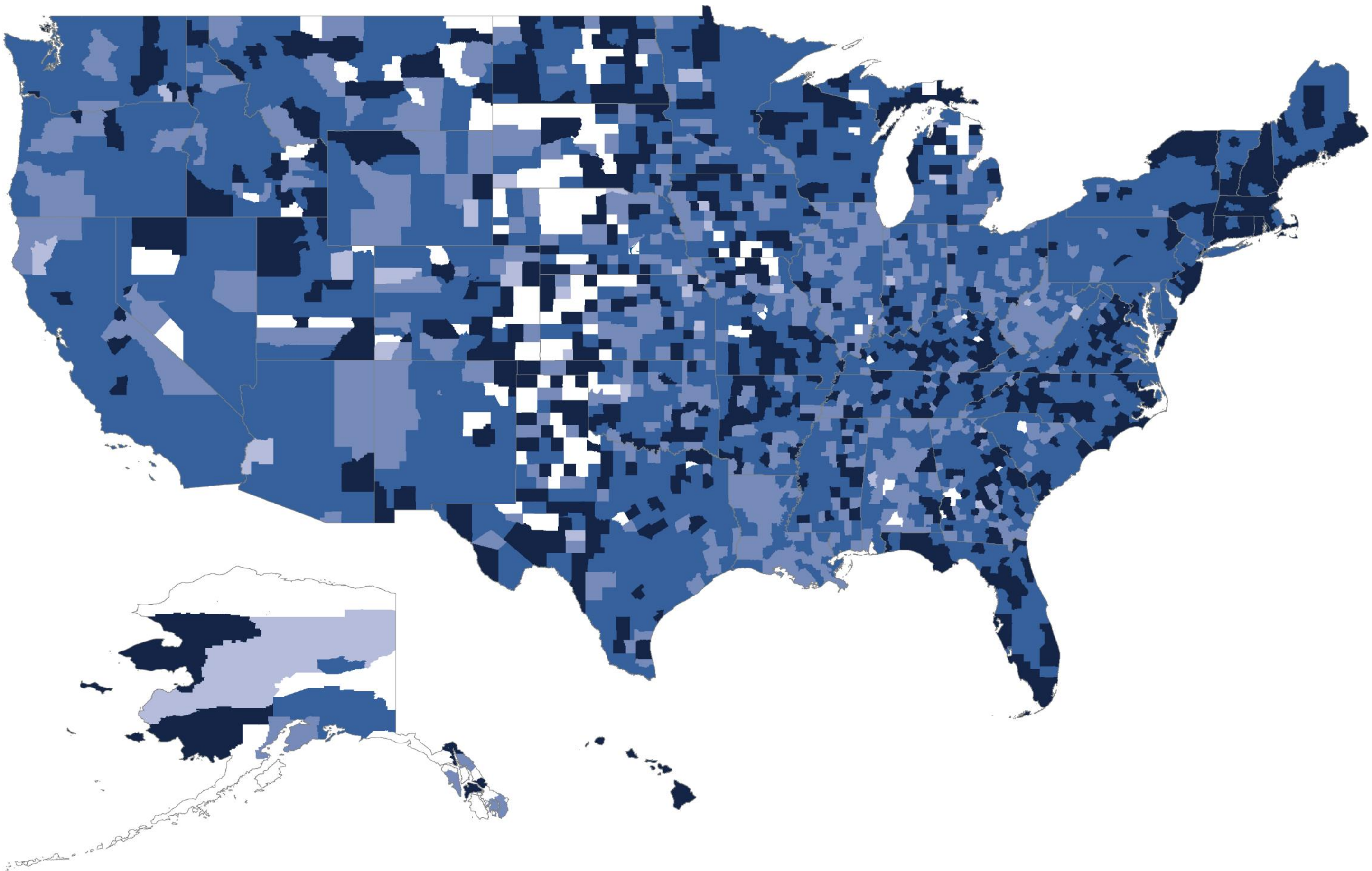
Appendix III: Geographic Concentration of National Flood Insurance Program (NFIP) Residential Policies Written by Write-Your-Own (WYO) Companies

Our analysis of three potential alternatives to the current WYO arrangement found that each alternative could decrease the number of participating WYO companies. We analyzed NFIP policy data to understand the geographic concentration of WYO company market share under the current arrangement, including what proportion of NFIP residential coverage large and small WYO companies and the Direct Servicing Agency (DSA) wrote in counties and in states with high NFIP losses. We included only residential NFIP policies in our analysis to focus on market share related to homeowners. We classified WYO companies as large or small, with large companies being the top 10 WYO companies in terms of NFIP market share in 2014.[1] The DSA is a Federal Emergency Management Agency (FEMA) contractor that writes NFIP policies and provides an alternative when a WYO company is unable or unwilling to write a flood insurance policy.

We compared the share of NFIP residential policies written by WYO companies nationwide to those written by the DSA. As shown in figure 3, in more than 83 percent of counties where residential NFIP coverage was present, WYO companies wrote more than half of all policies.

[1]The term "companies" for this selection includes all WYO insurers in a related insurance group. The 10 insurers we identified as large WYO companies held an 80 percent share of the federal flood market in 2014 (not including DSA policies), with individual market shares ranging from approximately 2 percent to 20 percent. We considered all other insurers as small WYO companies with market shares ranging from 0 to 1.5 percent and a cumulative market share of 20 percent.

Figure 3: Share of National Flood Insurance Program Residential Policies (NFIP) Written by Write-Your-Own (WYO) Companies by County, as of May 2015



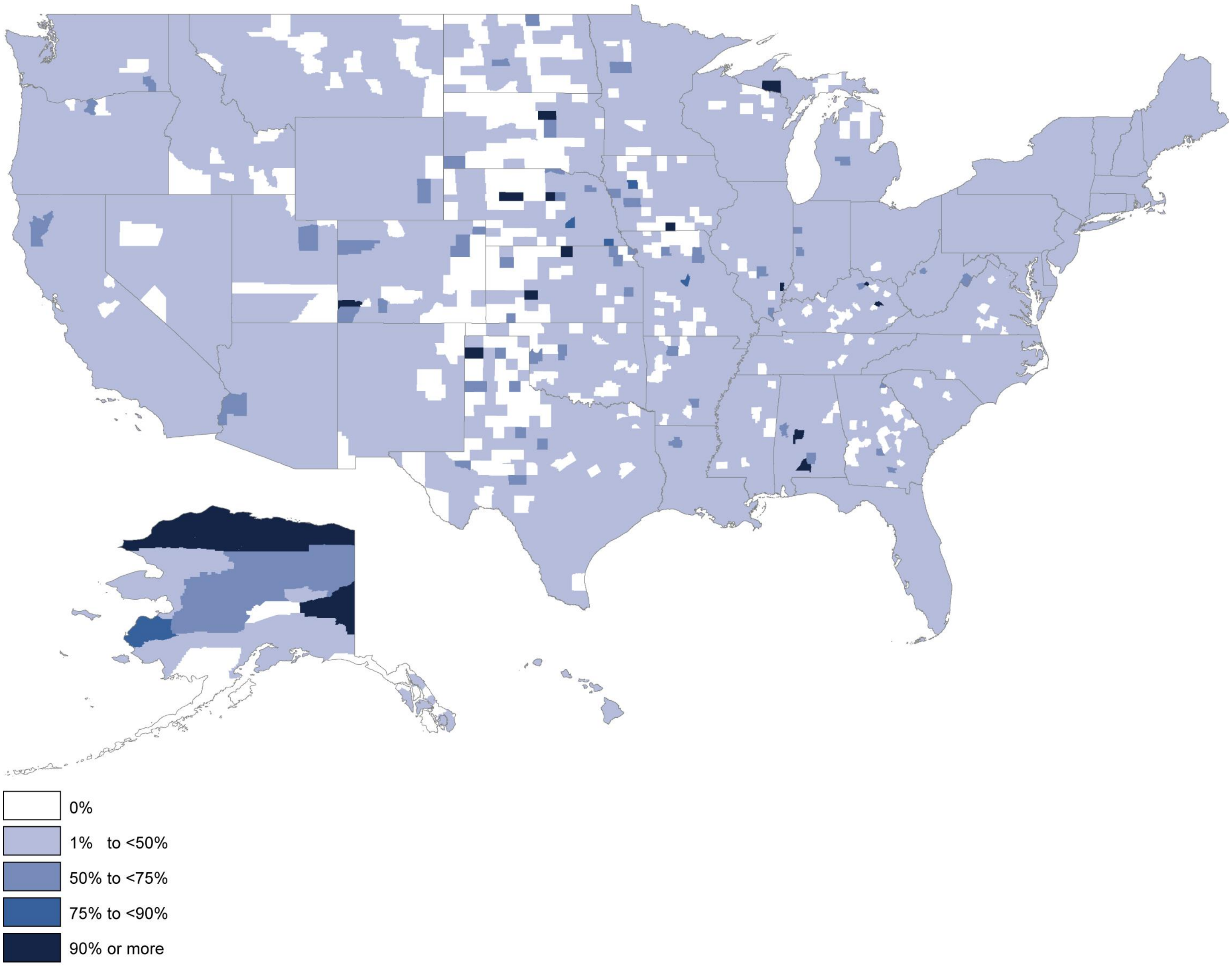
Sources: GAO analysis of Federal Emergency Management Agency data; MapInfo (map). | GAO-17-36

Note: Data are for the 50 states and the District of Columbia.

In contrast, the DSA wrote at least 50 percent of NFIP residential policies in 1.8 percent of counties, as shown in figure 4. In 17 counties across 11 states, the DSA wrote 100 percent of the NFIP residential policies, which accounted for 21 policies total.[2]

[2]These states were (in alphabetical order): Alaska, Alabama, Colorado, Iowa, Illinois, Kansas, Kentucky, Michigan, Nebraska, South Dakota, and Texas.

Figure 4: Share of National Flood Insurance Program (NFIP) Residential Policies Written by the Direct Servicing Agent (DSA) by County, as of May 2015



Sources: GAO analysis of Federal Emergency Management Agency data; MapInfo (map). | GAO-17-36

Note: Data are for the 50 states and the District of Columbia.

As shown in table 13, 81 percent of NFIP residential policies were written for properties in metropolitan counties (areas with populations of 250,000 or more). Large WYO companies accounted for the majority of the policies in states, territories, and the District of Columbia (70 percent), while small WYO companies and the DSA accounted for smaller shares of the market (16 percent and 14 percent, respectively). We also analyzed the proportion of residential policies written in counties by different categories (population and urban and rural). Large WYO companies wrote more than half of all policies in each category.[3] The share for small WYOs ranged from 15 percent to 23 percent (with the highest share in sparsely populated rural counties) and the DSA's share ranged from 13 percent to 18 percent in the different areas.

Table 13: National Flood Insurance Program (NFIP) Residential Policies Written by Write-Your-Own (WYO) Companies and the Direct Servicing Agent (DSA) in Metropolitan and Nonmetropolitan Counties, as of May 2015

	Counties by population	Total NFIP policies	Total NFIP policies Percentage	Large WYO company policies	Large WYO Percentage	Small WYO company policies	Small WYO Percentage	DSA policies	DSA policies Percentage
Metropolitan areas	Counties in metropolitan areas of 1 million or more	2,652,966	54	1,871,632	71	396,556	15	384,808	15
	Counties in metropolitan areas of 250,000 -1 million	1,343,051	27	930,842	69	239,058	18	173,151	13
	Counties in metropolitan areas of less than 250,000	525,341	11	367,303	70	88,335	17	69,703	13
Nonmetropolitan areas adjacent to a metropolitan area	Urban population of20,000 or more	169,969	3	116,582	69	28,405	17	24,982	15
	Urban population of 2,500-19,999	87,005	2	56,485	65	14,573	17	15,947	18
	Completely rural or less than 2,500 urban population	15,540	0	10254	66	2,826	18	2,460	16
Nonmetropolitan areas not adjacent to a metropolitan	Urban population of 20,000 or more	38,317	1	24,426	64	7,846	21	6,045	16
	Urban population of 2,500-19,999	44,217	1	27,935	63	8,317	19	7,965	18

[3]The Department of Agriculture's Economic Research Service's Rural-Urban Continuum Codes distinguish metropolitan (metro) counties by the population size of their metro area and nonmetropolitan (nonmetro) counties by degree of urbanization and adjacency to metro areas. The Office of Management and Budget's 2013 metro and nonmetro categories were subdivided into three metro and six nonmetro groups, resulting in a nine-part county classification.

area	Completely rural or less than 2,500 urban population	13,428	0	8,045	60	3,148	23	2,235	17
All		4,891,370	100	3,414,614	70	789,194	16	687,562	14

Source: GAO analysis of Federal Emergency Management Agency data. | GAO-17-36

Note: Data are for the 50 states, U.S. territories, and the District of Columbia. We excluded 1,506 policies for which we could not determine geographic location from FEMA's data. These policies accounted for 0.03 percent of the total number of policies in the data set. Of these policies, large WYO companies wrote 1,110, small WYO companies wrote 130, and the DSA wrote 266.

In addition to reviewing the data on a nationwide basis, we analyzed the proportion of NFIP residential policies written by WYO companies and the DSA for five states with the highest total NFIP payments according to FEMA historical claims data since 1978. Based on FEMA data as of June 30, 2016, the five states with the highest total loss payments were (in order of magnitude) Louisiana, Texas, New Jersey, New York, and Florida.[4]

In each of these states, at least 95 percent of NFIP residential policies were located in metropolitan areas, with the majority of policies located in counties in metropolitan areas with a population of 1 million or more.

- In Louisiana, large WYO companies had 55 percent market share of residential policies, the DSA had 27 percent (its highest share among the five states), and small WYO companies had 18 percent.
- In New York and New Jersey, large WYO companies achieved their highest market share of NFIP residential policies among the five states—78 percent and 81 percent respectively. Additionally, county-level shares for large WYO companies in New York ranged from 60 percent to 93 percent (small WYO companies had 3 percent–21 percent and the DSA had 4 percent–27 percent).
- In Florida, large WYO companies had 70 percent of the NFIP residential market and small WYOs had 22 percent (their highest share among the five states). Large WYO companies wrote NFIP residential coverage in all Florida counties, with county-level shares ranging from 39 percent to 88 percent, (and from 11 percent to 50 percent for small WYO companies and from 2 percent to 20 percent for the DSA).

[4]Based on FEMA loss statistics from January 1, 1978, through June 30, 2016, the losses were Louisiana ($16.94 billion), Texas ($6.50 billion), New Jersey ($5.87 billion), New York ($5.28 billion), and Florida ($3.89 billion).

Appendix IV: Comments from Department of Homeland Security

U.S. Department of Homeland Security
Washington, DC 20528

Homeland Security

November 22, 2016

Alicia Puente Cackley
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Re: Management's Response to Draft Report GAO-17-36, "FLOOD INSURANCE: FEMA Needs to Address Data Quality and Consider Company Characteristics When Revising its Compensation Methodology"

Dear Ms. Cackley:

Thank you for the opportunity to review and comment on this draft report. The U.S. Department of Homeland Security (DHS) appreciates the U.S. Government Accountability Office's (GAO) work in planning and conducting its review and issuing this report.

The Department is pleased to note GAO's recognition of the Federal Emergency Management Agency's (FEMA) efforts to monitor and correct over- and underpayments of National Flood Insurance Program (NFIP) claims as part of the Write Your Own (WYO) Program. The WYO Program is a cooperative undertaking between the private insurance industry and FEMA that seeks to:

1. Increase the NFIP policy base and the geographic distribution of policies;
2. Improve service to NFIP policyholders through the infusion of insurance industry knowledge; and
3. Provide the insurance industry with direct operating experience with flood insurance.

FEMA remains committed to strengthening its oversight of the WYO program and aligning company performance with FEMA's customer experience transformation.

More specifically, FEMA will continue to prioritize improving oversight of the WYO companies and identify ways to incentivize exceptional customer service. To that end, FEMA established a team to evaluate WYO oversight and identify clear goals and measures against which FEMA can assess company performance. When WYO companies renew their participation for Fiscal Year (FY) 2018, FEMA will require them to report data on these performance measures.

FEMA also continues to address the Biggert-Waters Flood Insurance Reform Act of 2012 requirement to develop a compensation methodology based on actual flood expenses as possible and practical. FEMA believes that actual flood expenses reported to the National Association of Insurance Commissioners (NAIC) are the best source for data on company expenses, but may choose to supplement that information with data calls to the WYO companies. FEMA recognizes there are opportunities to improve the quality of NAIC-reported data and will continue to monitor the reported data and work with the NAIC to correct it. As noted in the draft report, the differing operating methods of the many WYO companies, including how they compensate agents and third-party vendors, demonstrates the complexity of the issue.

Beginning in FY 2017, WYO companies are now required to submit their NAIC flood data to FEMA and attest to its accuracy. FEMA will employ analytic procedures to provide a robust analysis of individual company's data, such as comparing reported expenses to payments, and to facilitate more consistent reporting to the NAIC. FEMA will use this information to work with the companies to quantify any over- and under reporting of expenses in their NAIC submissions.

In addition, FEMA is reviewing and improving all aspects of NFIP customer experience with particular emphasis on ensuring all policyholders receive a fair settlement of their flood insurance losses. The new WYO oversight plan includes performance goals and measures that target the claims process to ensure WYO companies resolve claims in the most favorable way possible to the policyholder, in accordance with the terms of the flood policy. FEMA will ask companies to report on claims during actual flood events to spot trends as they occur, which should help reduce the error rates on claim payments.

The draft report contained one recommendation with which the Department concurs. Attached find our detailed response to the recommendation.

Again, thank you for the opportunity to review and comment on this draft report. Technical comments were previously provided under separate cover. Please feel free to contact me if you have any questions. We look forward to working with you in the future.

Sincerely,

JIM H. CRUMPACKER, CIA, CFE
Director
Departmental GAO-OIG Liaison Office

Attachment

2

Attachment: DHS Management Response to the Recommendation Contained in Draft Report GAO-17-36

GAO recommended that the FEMA Administrator:

Recommendation: Take into account WYO company characteristics that may impact companies' expenses and profits as it develops its new compensation methodology and rates.

Response: Concur. FEMA's Federal Insurance and Mitigation Administration (FIMA) manages the NFIP and agrees that fully understanding the characteristics of the insurance companies that participate in the WYO Program can help in determining compensation and ensuring that all policyholders receive the highest level of service from their carrier. FEMA will comply with the rulemaking requirement of Section 224 of Biggert-Waters Flood Insurance Reform Act of 2012 (BW-12). When completed, FIMA will implement a new compensation methodology that will track, as closely as practicably possible, the actual expenses of the WYO companies, as required by statute.

Per BW-12, FEMA must implement this recommendation via rulemaking. FEMA is unable to further elaborate on the status or substance of a rulemaking other than the information that appears in the *Unified Agenda of Regulatory and Deregulatory Actions* (Unified Agenda) or until it issues a regulatory action. This rulemaking does not appear in the Unified Agenda. FEMA is unable to provide more specific information at this time. Estimated Completion Date: To Be Determined.

3

Appendix V: GAO Contacts and Staff Acknowledgments

GAO Contacts

Alicia Puente Cackley, (202)512-8678 or cackleya@gao.gov

Staff Acknowledgments

In addition to the contact named above, Allison Abrams (Assistant Director); Rhonda Rose (Analyst-in-Charge); Christina S. Cantor; Heather Chartier; Pamela R. Davidson; May M. Lee; Scott E. McNulty; John Mingus; Marc W. Molino; Patricia Moye; and Barbara Roesmann made key contributions to this report.

Appendix VI: Accessible Data

Agency Comment Letter

Text of Appendix IV: Comments from Department of Homeland Security

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November 22, 2016

Alicia Puente Cackley

Director, Financial Markets and Community Investment

U.S. Government Accountability Office

441 G Street, NW

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Page 2

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Jim H. Rumpacker

Director

CIA, CFE

Departmental GAO-OIG Liaison Office

Attachment

<u>Page 3</u>

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