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Report to Congressional Committees

October 2005

FEDERAL EMERGENCY MANAGEMENT AGENCY

Improvements Needed to Enhance Oversight and Management of the National Flood Insurance Program

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GAO-06-119

October 2005

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Highlights

Highlights of GAO-06-119, a report to congressional committees

FEDERAL EMERGENCY MANAGEMENT AGENCY

Improvements Needed to Enhance Oversight and Management of the National Flood Insurance Program

Why GAO Did This Study

In the wake of Hurricane Isabel in 2003, GAO was mandated by the Flood Insurance Reform Act of 2004 to report on issues related to the National Flood Insurance Program (NFIP) and its oversight and management by the Federal Emergency Management Agency (FEMA). Private insurance companies sell NFIP policies and adjust claims, while a private program contractor helps FEMA administer the NFIP.

To address this mandate, this report assesses (1) the statutory and regulatory limitations on coverage for homeowners under the NFIP; (2) FEMA's role in monitoring and overseeing the NFIP; (3) FEMA's response to concerns regarding NFIP payments for Hurricane Isabel claims; and (4) the status of FEMA's implementation of provisions of the Flood Insurance Reform Act of 2004.

Although impacts from Hurricane Katrina were not part of the report's scope, GAO recognizes that this disaster presents the NFIP with unprecedented challenges.

What GAO Recommends

GAO is recommending that FEMA use a statistically valid method to select claims for review and establish milestones for meeting provisions of the Flood Insurance Reform Act. FEMA reviewed a draft of this report and expressed concerns about our findings related to NFIP program management.

www.gao.gov/cgi-bin/getrpt?GAO-06-119.

To view the full product, including the scope and methodology, click on the link above. For more information, contact William O. Jenkins, Jr. at (202) 512-8777 or jenkinswo@gao.gov.

What GAO Found

The amount of insurance coverage available to homeowners under the NFIP is limited by requirements set forth in statute and FEMA's regulations, which include FEMA's standard flood insurance policy. As a result of these limitations, insurance payments to claimants for flood damage may not cover all of the costs of repairing or replacing flood-damaged property. For example, homes that could sustain more than $250,000 in damage cannot be insured to their full replacement cost, thus limiting claims to this statutory ceiling. In addition, NFIP policies cover only direct physical loss by or from flood. Therefore, losses resulting primarily from a preexisting structural weakness in a home or losses resulting from events other than flood, such as windstorms, are not covered by NFIP policies.

To meet its monitoring and oversight responsibilities, FEMA is to conduct periodic operational reviews of the 95 private insurance companies that participate in the NFIP, and FEMA's program contractor is to check the accuracy of claims settlements by doing quality assurance reinspections of a sample of claims adjustments for every flood event. FEMA did not use a statistically valid method for sampling files to be reviewed in these monitoring and oversight activities. As a result, FEMA cannot project the results of these reviews to determine the overall accuracy of claims settled for specific flood events or assess the overall performance of insurance companies and their adjusters in fulfilling responsibilities for the NFIP—actions necessary for FEMA to have reasonable assurance that program objectives are being achieved.

In the months after Hurricane Isabel, FEMA took steps intended to address concerns that arose from that flood event. In April 2004, FEMA established a task force to review claims settlements from Hurricane Isabel claimants. As a result of task force reviews, almost half of the 2,294 policyholders who sought a review received additional payments. The additional payment amount averaged $3,300 more than the original settlement—for a total average settlement of about $32,400 per claimant. In most cases, the additional funds were for repairing or replacing buildings or property not included in the initial adjuster's loss determination, or to cover additional material or labor costs.

FEMA has not yet fully implemented provisions of the Flood Insurance Reform Act of 2004 requiring the agency to provide policyholders with a flood insurance claims handbook that meets statutory requirements, to establish a regulatory appeals process, and to ensure that insurance agents meet minimum NFIP education and training requirements. The statutory deadline for implementing these changes was December 30, 2004. Efforts to implement the provisions are under way, but have not yet been completed. FEMA has not developed plans with milestones for assigning accountability and projecting when program improvements will be made, so that improvements are in place to assist victims of future flood events.

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Abbreviations

FEMA	Federal Emergency Management Agency
NFIP	National Flood Insurance Program
OMB	Office of Management and Budget
SFIP	Standard Flood Insurance Policy

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United States Government Accountability Office
Washington, DC 20548

October 18, 2005

The Honorable Richard Shelby
Chairman
The Honorable Paul Sarbanes
Ranking Minority Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Michael Oxley
Chairman
The Honorable Barney Frank
Ranking Minority Member
Committee on Financial Services
House of Representatives

Ninety percent of all natural disasters in the United States involve flooding. Although homeowner insurance policies typically cover damage and losses from fire or theft and often from wind-driven rain, they do not cover flood damage because private insurance companies are largely unwilling to bear the economic risks associated with the potentially catastrophic impact of flooding. To provide some insurance protection for flood victims, as well as incentives for communities to adopt and enforce floodplain management regulations to reduce future flood damage, Congress established the National Flood Insurance Program (NFIP) in 1968. NFIP coverage is available to owners and occupants of insurable property in flood-prone areas.[1] The Federal Emergency Management Agency (FEMA) within the Department of Homeland Security is

[1] Our report focuses on homeowners' NFIP coverage; NFIP coverage is also available for other structures such as apartment buildings, schools, churches, businesses, cooperative associations, and condominium associations.

responsible for, among other things, oversight and management of the NFIP.[2]

To implement the NFIP, FEMA principally relies on private insurance companies that sell flood insurance policies and adjust claims from policyholders after floods occur. FEMA is assisted in its management and oversight functions by a program contractor. As of August 2005, the NFIP had about 4.6 million policyholders in about 20,000 communities. As of August 2005, the program had paid a total of about $14.6 billion in insurance claims financed primarily by policyholder premiums. Without the NFIP, the costs to repair damage covered by these claims would otherwise have been paid through taxpayer-funded disaster relief or by the flood victims themselves.

Policyholders' concerns regarding the processing and payments of NFIP claims after Hurricane Isabel in 2003 focused congressional attention on the program. Specifically, some policyholders cited inadequate payments for flood damages they incurred and a lack of clarity regarding their insurance policies and the procedures for filing and adjusting claims for flood damage.

The Flood Insurance Reform Act of 2004,[3] which mandated that FEMA implement new processes and requirements for selling NFIP policies and adjusting flood insurance claims, also mandated that we study and report on issues related to the processing of flood insurance claims and FEMA's oversight and management of the program. To address this mandate, this report assesses (1) the statutory and regulatory limitations on homeowners' coverage under the NFIP; (2) FEMA's role in monitoring and overseeing the NFIP; (3) FEMA's response to concerns regarding NFIP payments for claims related to Hurricane Isabel; and (4) the status of FEMA's implementation of provisions of the Flood Insurance Reform Act of 2004.

[2] In March 2003, FEMA and its approximately 2,500 staff became part of the Department of Homeland Security (DHS). Most of FEMA—including its Mitigation Division, which is responsible for administering the NFIP—is now part of the department's Emergency Preparedness and Response Directorate. However, FEMA has retained its name and individual identity within the department. The Secretary of DHS has proposed a reorganization of DHS in which FEMA would report directly to the Secretary and Undersecretary of DHS.

[3] Bunning-Bereuter-Blumenauer Flood Insurance Reform Act of 2004, Pub. L. No. 108-264, 118 Stat. 712 (2004).

As we finalized this report, the extent of the devastation from Hurricanes Katrina and Rita in August 2005 and September 2005 was not yet fully determined, as the nation struggled to respond to the immediate needs of populations of entire cities and towns for food, water, shelter, and basic health care. Although impacts from Hurricane Katrina and Rita were not part of our mandate for this report, clearly this disaster will challenge the NFIP with demands the program has never before faced in its more than 30-year history. Already, a record number of flood insurance claims have been filed in 2005, and Congress has increased the program's authority to borrow from the United States Treasury from $1.5 billion to $3.5 billion.

To determine the statutory and regulatory limitations on homeowners' coverage under the NFIP, we researched The National Flood Insurance Act of 1968, as amended,[4] its legislative history, and FEMA's implementing regulations, which include FEMA's "Standard Flood Insurance Policy" (SFIP). We also discussed the results of our analysis with officials of the DHS Office of General Counsel. To assess FEMA's NFIP monitoring and oversight role, we examined program requirements and reports and observed NFIP training programs for insurance agents and adjusters. We also observed a FEMA review of an insurance company's operations, and we analyzed reports of the results of all reviews of insurance operations and follow-up visits at insurance companies where FEMA identified critical errors over a 10-year period, from 1996 to April 2005—a total sample of 15 reports. We interviewed officials of FEMA and its program contractor about their oversight activities and discussed aspects of the process with private-sector insurance officials from four of the five largest insurance companies participating in the NFIP based on the number of claims filed in 2004. We also obtained documentation on how reviews of a sample of claims adjustments are done after flood events and talked with staff employed by FEMA's contractor about how they reinspect the work of private-sector adjusters who prepare flood damage estimates and how they select properties to visit for these reviews. We interviewed them because they had performed quality reinspections of claims adjustments for damage from Hurricane Isabel, as well as from hurricanes in Florida in 2004.

To determine FEMA's response to concerns about Hurricane Isabel claims payments, we discussed the actions FEMA took to address concerns of

[4] The National Flood Insurance Act of 1968, as amended, is codified at 42 U.S.C. 4001 to 4129.

Hurricane Isabel claimants with FEMA officials, and we reviewed a statistically valid sample of 100 files from claimants in Maryland, Virginia, and North Carolina who were dissatisfied with their initial claims settlements resulting from Hurricane Isabel and who had their claims reviewed by a special FEMA task force. We based our analysis of these claims on the information in the files we reviewed; we did not independently verify the accuracy of the information in the claims files. To test the overall reliability of the NFIP database, we reviewed a statistically valid sample of 250 claims for all flood events that occurred in 2003 and 2004. We conducted this reliability testing to assure ourselves that information from the NFIP database was sufficiently accurate for our reporting purposes. To determine the extent to which FEMA implemented provisions of the Flood Insurance Reform Act of 2004, we examined documentation of the agency's efforts and interviewed officials. We conducted our work from December 2004 through August 2005 in accordance with generally accepted government auditing standards. Our scope and methodology are discussed in greater detail in appendix I.

Results in Brief

The amount of insurance coverage available to homeowners under the NFIP is limited by requirements set forth in statute and regulation. As a result of these limitations, insurance payments to claimants for flood damage may not cover all of the costs of repairing or replacing flood-damaged property. For example, there is a $250,000 statutory ceiling on the amount of flood insurance homeowners may purchase; thus, homes that might sustain more than $250,000 in damage cannot be insured to their full replacement cost. In addition, NFIP policies cover only direct physical loss by or from flood. Therefore, losses resulting primarily from a preexisting structural weakness defect in a home or prior water damage, and losses resulting from events other than flood, such as windstorms or earth movements, are not covered by the NFIP. Moreover, a homeowner's personal property is covered, with certain limitations, only if the homeowner has separately purchased NFIP personal property insurance in addition to coverage for the building. Finally, the method of settling losses affects the amount recovered. For example, homes that qualify only for an actual cash value settlement—which represents the cost to replace damaged property, less the value of physical depreciation—would presumably receive payments that are less than homes that qualify for a replacement cost settlement, which does not deduct for depreciation.

To meet its monitoring and oversight responsibilities, FEMA is to conduct periodic operational reviews of the 95 private insurance companies that participate in the NFIP. In addition, FEMA's program contractor is to

check the accuracy of claims settlements by doing quality assurance reinspections of a sample of claims adjustments for every flood event. For operational reviews, FEMA examiners are to do a thorough review of the companies' NFIP underwriting and claims settlement processes and internal controls, including checking a sample of claims and underwriting files to determine, for example, whether a violation of policy has occurred, an incorrect payment has been made, and if files contain all required documentation. Separately, FEMA's program contractor is responsible for conducting quality assurance reinspections of a sample of claims adjustments for specific flood events in order to identify, for example, whether an insurer allowed an uncovered expense or missed a covered expense in the original adjustment. The operational reviews and follow-up visits to insurance companies that we analyzed followed FEMA's internal control procedures for identifying and resolving specific problems that may occur in individual insurance companies' processes for selling and renewing NFIP policies and adjusting claims. According to information provided by FEMA, the number of operational reviews completed between 2000 and August 2005 were done at a pace that allows for a review of each participating insurance company at least once every 3 years, as FEMA procedures require. In addition, the processes FEMA had in place for operational reviews and quality assurance reinspections of claims adjustments met our internal control standard for monitoring federal programs. However, the process FEMA used to select a sample of claims files for operational reviews and the process its program contractor used to select a sample of adjustments for reinspections were not randomly chosen or statistically representative of all claims. We found that the selection processes used were, instead, based upon judgmental criteria including, among other items, the size and location of loss and complexity of claims. As a result of limitations in the sampling processes, FEMA cannot project the results of these monitoring and oversight activities to determine the overall accuracy of claims settled for specific flood events or assess the overall performance of insurance companies and their adjusters in fulfilling their responsibilities for the NFIP—actions necessary for FEMA meet our internal control standard that it have reasonable assurance that program objectives are being achieved and that its operations are effective and efficient.

In the months after Hurricane Isabel, FEMA took steps intended to uniquely address concerns that arose from that flood event. In April 2004, FEMA established a task force to review claims settlements from Hurricane Isabel claimants. This was the first time in the history of the NFIP that a formal claims review process was established. As a result of task force reviews, almost half of the 2,294 policyholders who sought a

claims review received additional payments. The additional payment amount averaged $3,300 more than the original settlement—for a total average settlement of about $32,400 per claimant. In most cases, the additional funds were for repairing or replacing buildings or personal property not included in the initial adjuster's loss determination; or to cover additional material or labor costs. For example, in one instance the original adjuster had not included coverage for a kitchen countertop and a cable television outlet that the task force added to the claims settlement. In other claims, reviewers allowed higher prices for paint, dry wall, insulation, and other building materials than had been allowed in the initial loss report. An NFIP manager said that the original pricing was not an error in many cases, but that the costs of the materials had increased between the time of the initial loss and the final settlement offer. Among reasons that claims reviewed by the task force were closed with no additional payment were that the reviewer agreed with the original determination that (1) flood damage to parts of a basement were not covered and that (2) damage was not due to flood but to wind-driven rain.

As of September 2005, FEMA had not yet fully implemented provisions of the Flood Insurance Reform Act of 2004. The act requires FEMA to provide policyholders a flood insurance claims handbook and other new materials for explaining their coverage when they purchase and renew policies; to establish a regulatory appeals process for claimants; and to establish minimum education and training requirements for insurance agents who sell NFIP policies. The 6-month statutory deadline for implementing these changes was December 30, 2004. While FEMA advised us that it finalized statutorily required informational materials in September 2005, its flood insurance claims handbook does not yet fully comply with statutory requirements. The handbook contains information on anticipating, filing and appealing a claim, but does not include information regarding the appeals process that FEMA is statutorily required to establish through regulation. In its comments on our draft report, FEMA stated that it was offering claimants an informal appeals process pending the establishment of a regulatory process, and that the handbook describes this informal appeals process. However, by statute, the claims handbook must describe the regulatory process, which FEMA has yet to establish. With respect to this appeals process, FEMA has not stated how long rulemaking might take to establish the process by regulation, or how the process might work, such as filing requirements, time frames for considering appeals, and the composition of an appeals board. With respect to minimum training and education requirements for insurance agents who sell NFIP policies, FEMA published a *Federal Register* notice on September 1, 2005, which included an outline of

training course materials. In the notice, FEMA stated that, rather than establish separate and perhaps duplicative requirements from those that may already be in place in the states, it had chosen to work with the states to implement the NFIP requirements through already established state licensing schemes for insurance agents. The notice did not specify how or when states were to begin implementing the NFIP training and education requirements. Thus, it is too early to tell the extent to which insurance agents will meet FEMA's minimum standards. FEMA officials said that, because changes to the program could have broad reaching and significant effects on policyholders and private-sector stakeholders upon whom FEMA relies to implement the program, the agency is taking a measured approach to addressing the changes mandated by Congress. Nonetheless, without plans with milestones for completing its efforts to address the provisions of the act, FEMA cannot hold responsible officials accountable or ensure that statutorily required improvements are in place to assist victims of future flood events.

To strengthen and improve FEMA's monitoring and oversight of the NFIP, we are recommending that FEMA use a methodologically valid approach for sampling files selected for operational reviews and quality assurance claims reinspections. To help ensure that actions are taken in a timely manner to address legislative requirements established in the Flood Insurance Reform Act of 2004, we are recommending that FEMA establish documented plans with milestones for completing its efforts and hold NFIP officials accountable for implementing these plans.

In commenting on a draft of this report, FEMA expressed concerns about our findings related to NFIP program management and oversight. Specifically, FEMA was concerned that we did not directly address the issue of whether Congress intended the NFIP to restore flood-damaged properties to their pre-flood conditions. We believe we have addressed the issue consistent with our statutory mandate by explaining the statutory and regulatory provisions that affect both dollar ceilings and other coverage limitations. In other words, flood insurance policies can only restore victims to pre-flood conditions within, but not beyond, the dollar ceilings and other coverage limitations established by law and regulation. FEMA also questioned our characterization of its operational reviews and claims reinspection processes in the context of FEMA's overall financial and management control efforts. However, our focus was on overall NFIP program management and oversight, not on FEMA's fiduciary responsibilities or additional internal control measures. During our review, FEMA managers described the operational reviews and claims inspections

as the primary methods FEMA used for monitoring and overseeing the NFIP.

FEMA also noted that its method of selecting its sample for operational reviews was more appropriate than the statisticall y random probability sample we recommended. We believe that, although FEMA's current sampling strategy may provide an opportunity to focus on particular areas of risk, it does not provide management with the information needed to assess the overall performance of private insurance companies and adjusters participating in the program—information that FEMA needs to have reasonable assurance that program objectives are being achieved

In addition, FEMA disagreed with our characterization of the extent to which FEMA has met provisions of the Flood Insurance Reform Act of 2004. We believe that our description of those efforts and our recommendations with regard to implementing the Act's provisions remain valid. FEMA's comments are contained in appendix II. In addition, FEMA provided technical comments, which we incorporated into the report as appropriate.

Background

Nearly 20,000 communities across the United States and its territories participate in the NFIP by adopting and agreeing to enforce state and community floodplain management regulations to reduce future flood damage. In exchange, the NFIP makes federally backed flood insurance available to homeowners and other property owners in these communities. Homeowners with mortgages from federally regulated lenders on property in communities identified to be in special high-risk flood hazard areas are required to purchase flood insurance on their dwellings. Optional, lower-cost coverage is also available under the NFIP to protect homes in areas of low to moderate risk. To insure furniture and other personal property items against flood damage, homeowners must purchase separate NFIP personal property coverage. Although premium amounts vary according to the amount of coverage purchased and the location and characteristics of the property to be insured, the average yearly premium for a 1-year policy was $446, as of June 2005.

The National Flood Insurance Act of 1968[5] established the NFIP. Congress mandated that the NFIP was to be implemented "based on workable

[5] The National Flood Insurance Act of 1968, as amended, is codified at 42 U.S.C. 4001 to 4129.

methods of pooling risks, minimizing costs, and distributing burdens equitably among those who will be protected by flood insurance and the general public."[6] To make "flood insurance coverage available on reasonable terms and conditions to persons who have need for such protection,"[7] the NFIP strikes a balance between the scope of the coverage provided and the premium amounts required to provide that coverage. Coverage limitations arise from statute and regulation, including FEMA's standard flood insurance policy (SFIP), which is incorporated in regulation and issued to policyholders when they purchase flood insurance.

To the extent possible, the program is designed to pay operating expenses and flood insurance claims with premiums collected on flood insurance policies rather than by tax dollars. However, as we have reported, the program, by design, is not actuarially sound because Congress authorized subsidized insurance rates to be made available for policies covering certain structures to encourage communities to join the program. As a result, the program does not collect sufficient premium income to build reserves to meet the long-term future expected flood losses.[8] FEMA has statutory authority to borrow funds from the Treasury to keep the NFIP solvent.[9] Following Hurricane Katrina in August 2005, legislation was enacted that increased FEMA's borrowing authority from a total of $1.5 billion to $3.5 billion through fiscal year 2008.[10] FEMA has exercised its borrowing authority four times in the last decade when losses exceeded available fund balances. For example, as of August 2005, FEMA had borrowed $300 million in 2005 to pay an estimated $1.8 billion on flood insurance claims resulting from the 2004 hurricane season. As it has done when it has borrowed in the past, FEMA intends to repay these funds with interest, according to agency officials, however, the officials had not yet estimated NFIP claims amounts anticipated for flood damage from Hurricane Katrina in August 2005.

[6] 42 U.S.C. 4001(d).

[7] *Id.* 4001(a)(4).

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

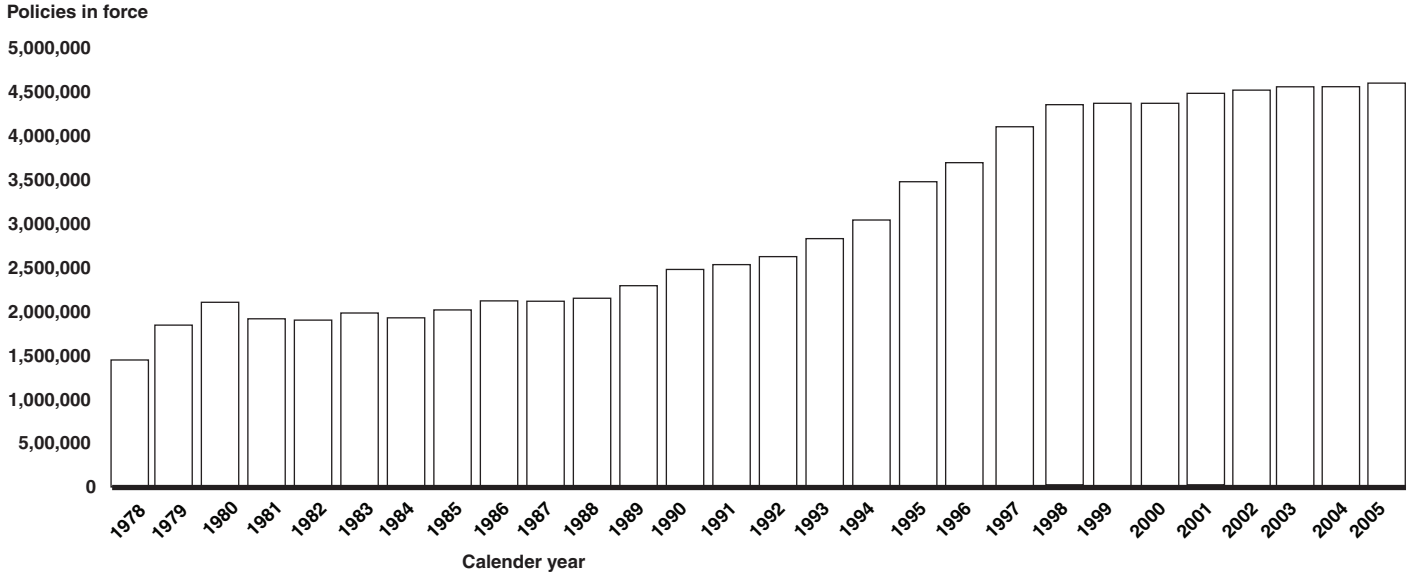
[9] See 42 U.S.C. 4016.

[10] The National Flood Insurance Program Enhanced Borrowing Authority Act of 2005, Pub. L. No. 109-65 (Sept. 20, 2005).

Participation in the NFIP and Claims Payments Have Grown

As shown in figure 1, the number of NFIP policies in force has grown steadily over the past 27 years to a total of about 4.6 million policies in force as of May 31, 2005.

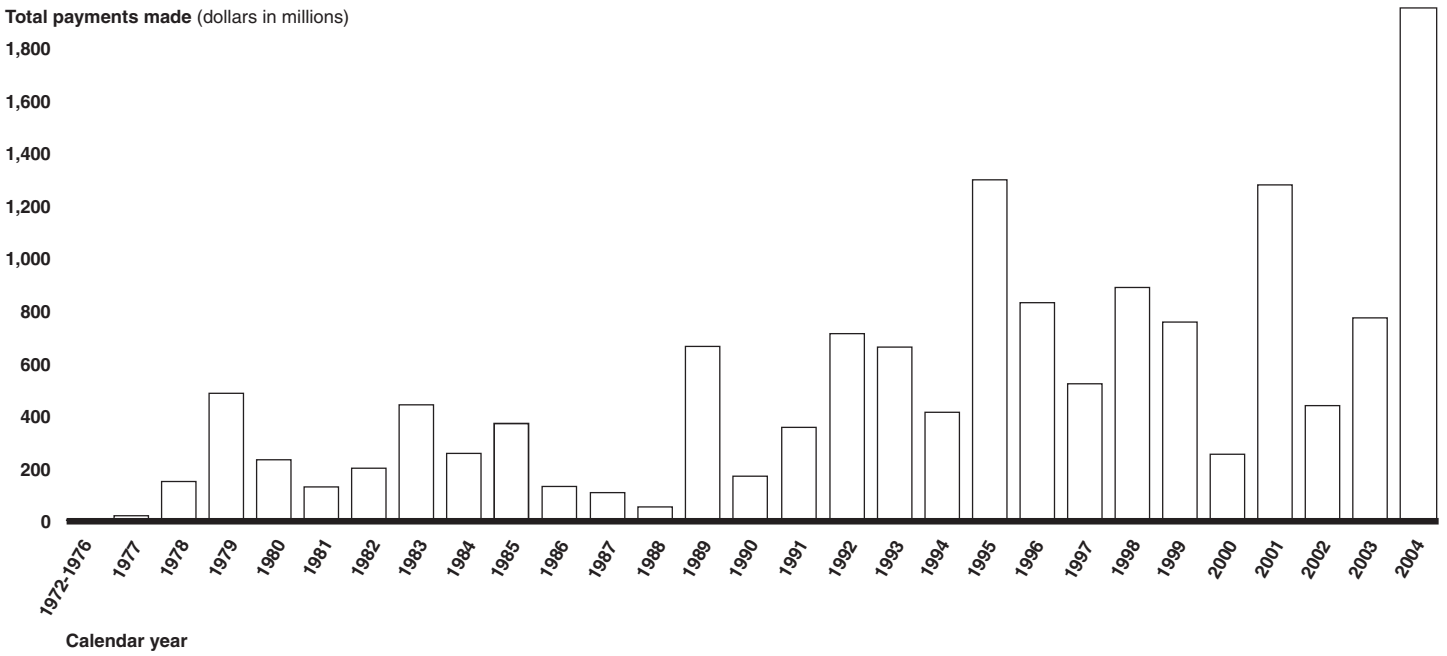
Figure 1: NFIP Policies in Force, 1978-2005



Source: FEMA.

As shown in figure 2, NFIP claims payments have varied widely by year over the life of the program depending on the number and severity of flood events; however, as the number of policies in force increased (see fig. 1), the claims payments have trended upward. Claims paid in 2004 were the highest amount in the history of the NFIP—more than $1.9 billion for all flood events.

Figure 2: Total NFIP Payments to Claimants, 1972-2004



Source: FEMA.

Tables 1 and 2 provide information on payments by flood event in 2003 and 2004. In 2003, the NFIP paid about $478 million on more than 21,000 claims from 5 named flood events and an additional $287 million on 15,232 claims filed for damage from unnamed floods. Of those claims, more than half resulted from damage from Hurricane Isabel in six states and Washington, D.C. Hurricane Isabel was a category 5 hurricane at its peak with sustained winds in excess of 165 miles per hour. It made landfall on September 18, 2003, near Drum Inlet, North Carolina, as a category 2 storm. As it traveled across Virginia, Maryland, and Pennsylvania, Isabel weakened to a tropical storm, but its heavy rains caused storm surge flooding.

Table 1: NFIP Claims Payments on Flood Events in 2003

Dollars in thousands		
Flood event/state(s)	**Number of paid losses**	**Amount paid**
Hurricane Isabel (Delaware, Maryland, North Carolina, Pennsylvania, South Carolina, Virginia, and Washington, D.C.)	19,523	$455,869
Delaware flooding (Delaware)	10	64
Torrential rain (Puerto Rico)	261	1,366
Hurricane Claudette (Texas)	1,035	10,884
Tennessee flood (Tennessee)	309	9,759
Named flood event total	21,138	477,942
Unnamed flood total	15,232	287,317
Total	**36,370**	**$765,259**

Source: GAO analysis of FEMA data.

For 2004 flood events, as of April 30, 2005, the NFIP paid more than $1.9 billion on more than 52,785 NFIP claims from storms including Hurricanes Charley, Frances, Ivan, and Jeanne that caused major damage in Florida and other East Coast and Gulf Coast states.

Table 2: NFIP Claims Payments on Flood Events in 2004

Dollars in thousands		
Flood event/state(s)	**Number of paid losses**	**Amount paid**
Kentucky Flood (Kentucky)	279	$5,717
Hurricane Alex (North Carolina)	249	2,436
Hurricane Charley (Florida and North Carolina)	2,434	46,369
Hurricane Frances (Florida)	4,737	139,866
Hurricane Ivan (Alabama, Florida, Georgia, Louisiana, Mississippi, Ohio, Pennsylvania, Virginia, and West Virginia)	25,558	1,233,964
Hurricane Jeanne (Florida and Puerto Rico)	3,994	78,355
Named flood event total	37,251	1,506,707
Unnamed flood total	15,534	442,678
Total	**52,785**	**$1,949,385**

Source: GAO analysis of FEMA data.

Private Insurers Sell Policies and Adjust NFIP Claims under FEMA Oversight and Management

The work of selling, servicing, and adjusting claims on NFIP policies is carried out by thousands of private-sector insurance agents and adjusters who work independently or are employed by insurance companies or their designated subcontractors. According to FEMA, about 95 percent of the NFIP policies in force are written by insurance agents who represent 95 private insurance companies that issue policies and adjust flood claims in their own names.[11] The companies, called write-your-own companies, receive an expense allowance from FEMA of about one-third of the premium amounts for their services and are required to remit premium income in excess of this allowance to the National Flood Insurance Fund.[12] The write-your-own companies also receive a percentage fee—about 3.3 percent of the incurred loss—for adjusting and settling claims. The insurance companies share the FEMA expense allowance and fee for claims settlements with insurance agents who sell and service the policies, a vendor, or subcontractor, if the company has subcontracted with one to handle all or part of its flood insurance business, and flood claims adjusters.[13]

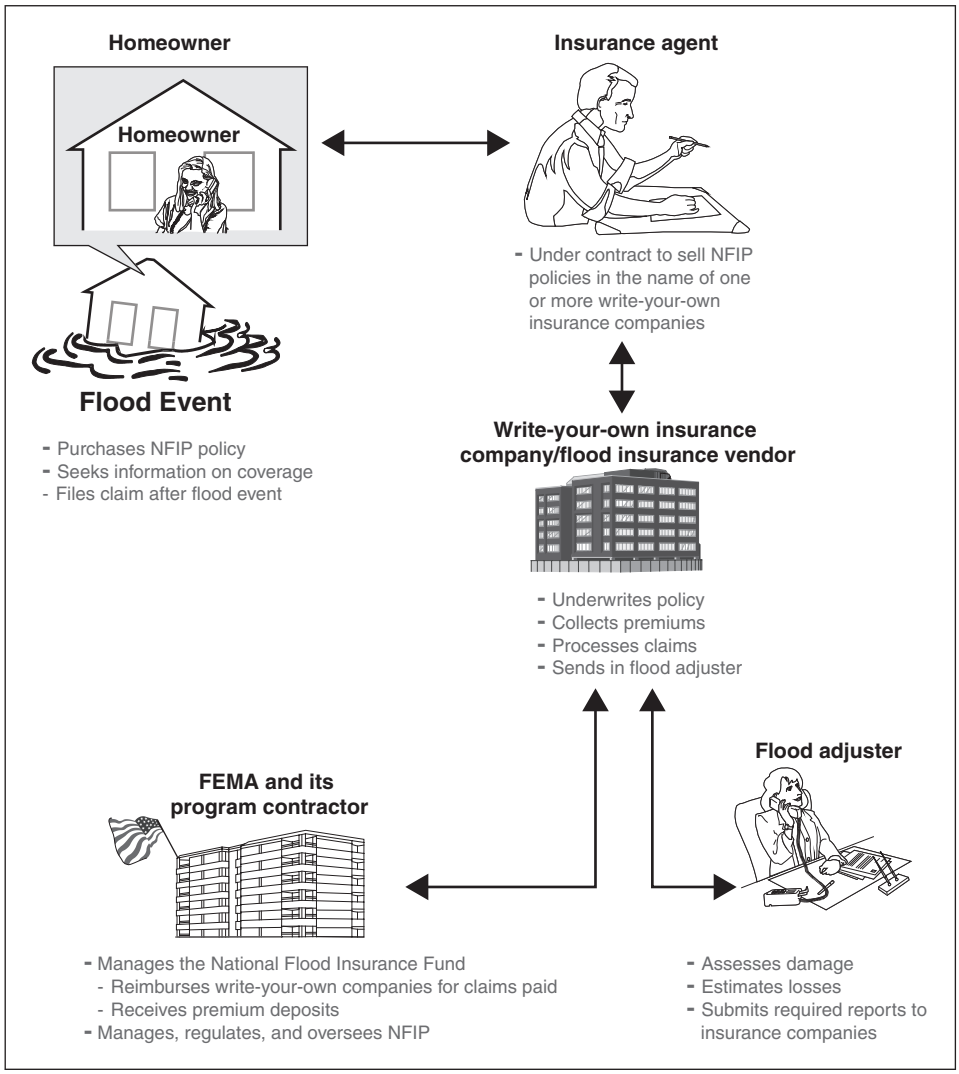
Figure 3 shows the key participants in the process: a homeowner; an insurance agent, an insurance company, and, in many cases, a flood insurance vendor, or subcontractor, to assist with aspects of the NFIP business; and a flood adjuster. FEMA and its program contractor manage and oversee the NFIP and the National Flood Insurance Fund accounts into which premiums are deposited and claims and expenses paid.

[11] The other 5 percent of policies are sold and serviced by state-licensed insurance agents and brokers who deal directly with FEMA.

[12] The fund, which was established in the Treasury by the 1968 legislation authorizing the NFIP, is the account into which premiums are deposited and from which losses and operating and administrative costs are paid. See 42 U.S.C. 4017.

[13] For example, the flood program manager from one insurance company said that agents receive a commission of 15 percent of the policy amount as an incentive to write flood insurance and may receive other incentives during special flood marketing campaigns.

Figure 3: Key Participants in the NFIP



Source: GAO analysis of FEMA data.

Insurance agents under contract to one or more write-your-own insurance company are the main point of contact for most policyholders to purchase an NFIP policy, seek information on coverage, or file a claim. In order to sell flood insurance, agents must meet basic state insurance licensing requirements. Based on information the insurance agents submit, the insurance 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. In some cases, insurance

companies hire subcontractors—flood insurance vendors—to conduct some or all of the day-to-day processing and management of flood insurance policies.

Insurance companies work with certified flood adjusters to settle NFIP claims. When flood losses occur, policyholders contact their insurance agents to report the loss. The agent then contacts the write-your-own company to report the loss and it assigns a flood adjuster to assess damages. Flood adjusters may be independentor employed by an insurance or adjusting company. These adjusters are responsible for assessing damage, estimating losses, and submitting required reports, work sheets, and photographs to the insurance company, where the claim is reviewed and, if approved, processed for payment. Adjusters determine prices for repairs by reviewing estimates of costs prepared by policyholders and their contractors, consulting pricing software and checking local prices for materials. Claims amounts may be adjusted after the initial settlement is paid if claimants submit documentation that some costs were higher than estimated. An adjuster must have a least 4 consecutive years of full-time property loss adjusting experience and have attended an adjuster workshop, among other requirements, to be certified by FEMA to work on NFIP claims,. To keep their certifications current, adjusters are required to take a 1-day refresher workshop each year and pass a written examination testing their knowledge each year.

Flood claims adjusters employed by write-your-own companies are paid salaries and sometimes bonuses for working long hours after major flood events from a percentage fee—about 3.3 percent of the incurred loss, which the NFIP pays write-your-own companies for settling claims, according to an NFIP official. Independent adjusters who work for multiple insurance companies are also paid based on a standard NFIP fee schedule that varies adjuster compensation according to the size of the claim. For example, the fee schedule pays $1,000 for a claim settlement of between $25,000 and $35,000. If the independent adjuster is registered with an independent adjusting firm, a portion of the fee goes to the adjusting firm.

About 40 FEMA employees, assisted by about 170 contractor employees, are responsible for managing the NFIP. Management responsibilities include establishing and updating NFIP regulations, administering the National Flood Insurance Fund, analyzing data to actuarially determine flood insurance rates and premiums, and offering training to insurance agents and adjusters. In addition, FEMA and its program contractor are responsible for monitoring and overseeing the quality of the performance

of the write-your-own companies to assure that the NFIP is administered properly.

Due to Statutory and Regulatory Limitations, NFIP Payments May Not Cover All Costs to Repair or Replace Flood-Damaged Property

The amount of insurance coverage available to homeowners under the NFIP is limited, based on requirements set forth in statute and regulation.[14] First, by statute, there are limitations on the amount of insurance coverage homeowners may purchase for their dwellings and personal property. In addition, FEMA has further defined the general terms and conditions of flood insurance coverage pursuant to a broad grant of congressionally delegated authority, issuing regulations that include a SFIP. Because of these statutory and regulatory limitations, insurance payments to claimants for flood damage may not cover all of the costs of repairing or replacing damaged property.

In terms of statutory limitations, there is a ceiling on the amount of insurance coverage available for single-family homes, which is $250,000.[15] Because of this statutory ceiling, homes that could sustain more than $250,000 in damage cannot be insured to reflect full replacement costs. Furthermore, while homes whose full replacement cost is less than $250,000 may be fully insured, this is not statutorily required. There is a "mandatory purchase" requirement for homeowners in special high-risk flood hazard areas who hold mortgages from federally regulated lenders, but they are only required to insure their homes for the amount of their mortgages, which may be less than their homes' full replacement cost.[16] For homeowners in areas of low- to moderate-flood risk, the purchase and amount of insurance is optional, up to the $250,000 statutory maximum.[17] As a result of the $250,000 ceiling and the "mandatory purchase" floor, insurance on a given home may be less than its full replacement cost. Homeowners may also separately elect to insure the contents of their homes under the NFIP, although they are not required to do so. As with the $250,000 cap on building coverage, there is also a statutory limit on the

[14] As with homeowners' coverage, statutory and regulatory limitations apply to NFIP coverage for other types of property. See 44 C.F.R. Part 61, appendix A(1), "Standard Flood Insurance Policy Dwelling Form," appendix A(2), "Standard Flood Insurance Policy General Property Form," and appendix A(3), "Standard Flood Insurance Policy Residential Condominium Building Association Form."

[15] 42 U.S.C. 4013(b)(2).

[16] *Id.* 4012a(a), (b)(1).

[17] See *id.* 4012.

amount of personal property coverage homeowners can buy. By statute, homeowners can purchase no more than $100,000 in personal property coverage, even if the value of their personal property exceeds this amount.[18]

In addition to the statutory limitations on coverage amounts, Congress also gave FEMA broad authority to issue regulations establishing "the general terms and conditions of insurability," including the classes, types, and locations of properties that are eligible for flood insurance; the nature and limits of loss that may be covered; the classification, limitation, and rejection of any risks that FEMA considers advisable; and the amount of appropriate loss deductibles.[19] Pursuant to this delegation of authority, FEMA has issued regulations, including a "Standard Flood Insurance Policy," that further delineate the scope of coverage.[20] All flood insurance made available under the NFIP is subject to the express terms and conditions of the statute and regulations, including the SFIP.[21]

The SFIP is a contractual document that contains the terms of coverage and is issued to homeowners when they purchase flood insurance. Some of the principal SFIP limitations concern whether particular events, losses, building property and personal property are covered, and what deductible amounts and loss settlement methods apply when an insured files a claim. While either FEMA or private write-your-own insurance companies may issue flood insurance policies, FEMA's regulations prohibit any change to the SFIP provisions without the express written consent of the Federal Insurance Administrator, the FEMA official responsible for administering the NFIP.[22] The Administrator is also charged with interpreting the scope of coverage under the SFIP.[23]

[18] *Id.* 4013(b)(3).

[19] *Id.* 4013(a).

[20] The insurance coverage regulations appear at 44 C.F.R. Part 61, and the SFIP is an appendix to these regulations, set forth at 44 C.F.R. Part 61, appendix A(1), "Standard Flood Insurance Policy Dwelling Form."

[21] 44 C.F.R. 61.4.

[22] *Id.* 61.13(d), (f).

[23] *Id.* 61.4(b), 61.14.

The SFIP covers only "direct physical loss by or from flood."[24] It does not cover losses resulting from events other than flood, such as windstorms or earth movements. Additionally, if the losses primarily result from conditions inherent to the dwelling or within the control of the insured, they are not covered by the SFIP.[25] Nor does the SFIP provide coverage if the flood is already in progress when the policy begins or when the insured adds coverage. Finally, the SFIP only covers direct, physical flood losses, not indirect losses such as loss of revenue or profits, interruption of business, access to and use of the insured property, or living expenses incurred while property is uninhabitable.[26]

The SFIP limits what type of building property is covered, considering such things as the property's use, permanence, and degree of enclosure. For coverage purposes, the SFIP defines a "building" as a manufactured home; a travel trailer affixed to a permanent foundation; or a "structure with two or more outside rigid walls and a fully secured roof, that is affixed to a permanent site."[27] A building under construction may be covered even if not yet walled or roofed if the construction is underway at the time the losses are incurred.[28] Detached garages may be covered, but not if the garage is used for residential, business, or farming purposes,[29] in which case it must be separately insured. Certain items of property are considered part of the building. In general, these are items built in or affixed to the building, for example, stoves, ovens, refrigerators, central air conditioners, and permanently installed cabinets and carpets. At the basement level, building coverage is more limited and does not extend to finishing materials. For example, whereas the SFIP covers permanently

[24] The SFIP defines a flood as "[a] general and temporary condition of partial or complete inundation of two or more acres of normally dry land area or of two or more properties" caused by specified events such as the overflow of inland or tidal waters. SFIP section II, Definitions ("Flood").

[25] SFIP section V, Exclusions. For example, the SFIP would not cover water damage that primarily resulted from a structural defect in the insured's dwelling.

[26] SFIP section V, Exclusions.

[27] SFIP section II, Definitions ("Building").

[28] SFIP section III, Property Covered (Coverage A – Building Property). However, if the building under construction does not have at least two walls and a roof, the deductible amount is twice that which would otherwise apply. SFIP section VI, Deductibles.

[29] SFIP section III, Property Covered (Coverage A – Building Property). Coverage for a detached garage is limited to no more than 10 percent of the building's limit of liability. Use of this insurance is optional but reduces the building's limit of liability.

installed paneling and wallpaper above the basement level, coverage in the basement is limited to unfinished drywall.[30]

The SFIP only insures for personal property if the homeowner purchases personal property coverage and the personal property is inside a building.[31] Personal property includes movable items such as portable microwaves, window-type air conditioning units, and carpets that are not permanently installed. In a basement, coverage is limited to certain items installed in their functioning location and, if necessary for operation, connected to a power source, for example, portable air conditioning units and clothes washers and dryers. Certain types of personal property are specially limited to payment of no more that $2,500, regardless of the magnitude of the loss. These objects include artwork, collectibles, jewelry, furs, and property used in any business.[32] Personal property coverage does not extend to such things as currency, postage, deeds, and other valuable papers.[33]

Certain types of property are wholly excluded from both building property and personal property coverage. The first type of excluded properties are those that are generally separate from the main dwelling, such as recreational vehicles; self-propelled vehicles and machines; land, plants, and animals; walkways, driveways, patios; and hot tubs and swimming pools. The second type of excluded properties are those with a close relationship with water or that are located below ground, including buildings and personal property located entirely, in, on, or over water; boathouses, wharves, piers, and docks; underground structures or equipment; and buildings and contents where more than 49 percent of the actual cash value of the building is below ground.[34]

The amount recoverable under the SFIP is limited to the amount that exceeds the applicable deductible.[35] Applicable deductible amounts are not listed in the SFIP itself, but are shown on the Declarations Page, a

[30] SFIP section III, Property Covered (Coverage A – Building Property).

[31] SFIP section III, Property Covered (Coverage B – Personal Property).

[32] SFIP section III, Property Covered (Coverage B – Personal Property).

[33] SFIP section IV, Property Not Covered.

[34] SFIP, section IV, Property Not Covered.

[35] SFIP section VI, Deductibles.

computer-generated summary of the information provided by the insured in the insured's application. The Declarations Page is part of each insured's flood insurance policy. [36]

The final type of limitation found in the SFIP derives from the methods of settling losses. There are three loss settlement methods under the SFIP: (1) "replacement cost," which homeowners may only purchase for single-family dwellings in which they principally reside; (2) "special loss settlement," which only applies to large manufactured homes;[37] and (3) "actual cash value," which applies to any property that does not qualify for replacement cost or special loss settlement.

The only difference between replacement cost and actual cash value is the significance attached to the property's physical depreciation. An actual cash value loss settlement represents what it would cost to replace damaged property, less the value of its physical depreciation.[38] Because of depreciation, actual cash value will presumably be less than the full cost to repair or replace the damage.[39] A replacement cost loss settlement, on the other hand, does not deduct for physical depreciation. If replacement cost coverage applies, the policy will pay the actual amount spent to repair or replace the damage with materials of like kind and quality, subject to the applicable deductible and the building's limit of liability.[40]

Homeowners can only obtain replacement cost coverage for their single-family dwellings, not for multi-family dwellings or items of personal property, which are subject to actual cash value coverage. In addition, not all single-family dwellings are eligible for replacement cost coverage. To

[36] SFIP section II, Definitions ("Declarations Page").

[37] "Special Loss Settlement" combines elements of replacement cost and actual cash value settlements. Under the "Special Loss" rules, totally destroyed dwellings receive either replacement cost coverage or 1.5 times the actual cash value, whichever is less, up to the dwelling's limit of liability. Partially damaged dwellings are entitled to replacement cost coverage.

[38] SFIP section II, Definitions ("Actual Cash Value").

[39] An actual cash settlement may be increased to reflect a greater proportion of the costs of repairing or replacing damaged property, without deduction for depreciation. The SFIP provides a formula for calculating the proportion of the repair or replacement costs an insured with actual cash coverage is eligible to receive. The SFIP will pay this proportional amount if it is greater than the actual cash settlement.

[40] SFIP section VII, General Conditions, subsection V, Loss Settlement.

qualify for such coverage, a home must be insured for 80 percent or more of its full replacement cost or the maximum coverage amount of $250,000, and it must a principal residence. If a home does not meet both criteria, the policy will pay the actual cash value for the covered damage.

An additional limitation in replacement cost coverage applies when the full cost of repair or replacement is greater than $1,000 or 5 percent of the entire amount of insurance on the dwelling. In that case, the SFIP provides that it "will not be liable for any loss unless and until the actual repair or replacement is completed," unless the insured foregoes a replacement cost settlement and makes a claim for actual cash instead.[41] If the insured eventually spends more on the repair or replacement than the actual cash settlement, the individual may file a claim for additional replacement cost liability, provided he or she provides a notice of intent to do so within 180 days after the date of loss. [42]

We developed the following hypothetical property adjustment example with the assistance of FEMA's director of NFIP claims to illustrate how applicable limitations could reduce coverage for claimants whose property is damaged by flood:

> Hypothetical: A poorly maintained 30-year-old home located in a designated flood zone was damaged when a nearby river overflowed. The home's full replacement cost was $60,000. The homeowner purchased an NFIP policy for $30,000 in coverage. Although a contractor estimated it would cost $40,000 to repair damages to the structure and personal property losses totaled another $10,000, a NFIP adjuster determined that payment on the claim was $8,000 because:
>
> - The homeowner had chosen not to insure his personal property.
> - The adjuster determined that some problems that needed to be addressed had not been caused by the flood (e.g., leaking pipes in the bathroom and preexisting mold in the basement).

[41] SFIP section VII, General Conditions, subsection V, Loss Settlement.

[42] FEMA officials told us that the agency did not require Hurricane Isabel claimants to wait until after making repairs to obtain the full replacement cost. They also said that FEMA plans to amend its regulations to delete the requirement from the SFIP.

- The basement of the home, where the largest amount of damage occurred, was finished, and coverage was limited to drywall damage.

- Actual cash value will be paid for repairs or replacement of damage to the dwelling because the homeowner did not insure the structure for at least 80 percent of its full replacement cost. Because the condition of the home before the flood was poor, the actual cash value was low. In this hypothetical case, the adjuster determined that the actual cash value of damaged property covered by the policy was $9,000.

- A $1,000 deductible applied, reducing the $9,000 actual cash value payment to $8,000.

Monitoring and Oversight of NFIP Identifies Specific Problems, but Does Not Provide Comprehensive Information on Overall Program Performance

FEMA's primary method to monitor and oversee the NFIP is to conduct operational reviews of the 95 write-your-own insurance companies participating in the NFIP. In addition, FEMA's program contractor is to reinspect a sample of claims adjustments for every flood event to identify errors, among other things. The operational reviews and follow-up visits we analyzed followed FEMA's internal control procedures on the processes for examiners to follow in conducting the reviews and for doing the reviews at a pace that allows for a review of each write-your-own company on at least a triennial basis. The processes FEMA followed also met our internal control monitoring standard that requires federal agencies to ensure that the findings of audits and other reviews are promptly resolved. However, in doing these monitoring and oversight activities, neither FEMA nor its program contractor used a statistically valid method for sampling files selected for operational reviews or claims reinspections. As a result, FEMA did not meet our internal control standard that federal agencies have internal controls in place to provide reasonable assurance that program objectives are being achieved and that program operations are effective and efficient. Without a statistically valid sampling methodology, the agency cannot project the results of these monitoring and oversight activities to determine the overall accuracy of claims settled for specific flood events or assess the overall performance of insurance companies and their adjusters in fulfilling their responsibilities for the NFIP.

FEMA's Operational Reviews of Insurers We Analyzed Identified and Followed Up on Problems

Operational reviews of flood insurance companies participating in NFIP that are conducted by FEMA staff are FEMA's primary internal control mechanism for monitoring, identifying, and resolving problems related to how insurers sell and renew NFIP policies and adjust claims. Our analysis of reports of all 15 operational reviews and follow up visits at companies that were identified as having critical errors (e.g., incorrect payments) found that FEMA checked information and conducted file reviews in accordance with the requirements and procedures outlined in its *Write Your Own Financial Control Plan*.[43] In addition, our analysis found that FEMA followed up at all of the companies where operational reviews had identified critical errors to monitor the progress these companies made over time in addressing and resolving critical errors. Monitoring the quality of performance over time and ensuring that the findings of audits and other reviews are promptly resolved is an internal control standard that we have identified for the federal government.[44]

According to the FEMA director of NFIP claims, one or two examiners from FEMA's NFIP Claims and Underwriting sections go on-site to review the operations of the 95 write-your-own companies. If vendors handle all or part of a company's NFIP business, operational reviews are conducted at the vendor locations and reviews of all of the companies doing business with the vendor can be completed during one visit. Seven FEMA staff in the Mitigation Division underwriting section and two staff in the claims section have primary responsibility for conducting operational reviews in addition to other responsibilities including writing insurance manuals and regulations, providing technical assistance, and responding to inquiries from policyholders, Members of Congress and others. As discussed below, FEMA directs examiners to conduct three steps for each operational review—a general underwriting review, a specific underwriting review, and a claims operation review of each insurance company's NFIP business. Requirements and procedures for the operational review are outlined in FEMA's *Write Your Own Financial Control Plan*.

In the general underwriting review, examiners are to review how the company has handled applications for NFIP policies and how policies are issued and cancelled among other items. The examiners are to check a

[43] National Flood Insurance Program, *The Write Your Own Program Financial Control, Plan Requirements and Procedures*, revised December 1, 1999.

[44] See GAO, Standards for *Internal Control in the Federal Government* (Washington, D.C.: Nov. 1999).

sample of files to determine, for example, whether NFIP policies were renewed using correct payment rates and whether appropriate documentation was included in the file. In the specific underwriting review and the claims operation review, examiners are to conduct detailed examinations of files to check for completeness and accuracy. For example, they must make sure that elevations are calculated correctly on new policies and that photographs document damage on flood claims.

For all aspects of the operational reviews, the examiners are to determine whether files are maintained in good order, whether current forms are used and whether staff has a proficient knowledge of requirements and procedures to properly underwrite and process flood claims. Examiners are also to look at internal controls in place at each company. When problems are identified, examiners are to classify the severity of the errors. Each file reviewed is to be classified as satisfactory or unsatisfactory. Unsatisfactory files contain either a critical error (e.g., a violation of policy or an incorrect payment) or three non-critical errors (e.g., violations of procedures that did not delay actions on claims).

Write-your-own companies with error rates of 20 percent or higher of the total number of files reviewed for the specific underwriting or claims operation review would always receive an unsatisfactory designation. If a company receives an unsatisfactory designation, FEMA requires that it develop an action plan to correct the problems identified and is to schedule a follow-up review in 6 months to determine whether progress has been made. The action plans developed by the companies generally must contain a timetable for addressing deficiencies, including a plan for making progress reports to FEMA and developing more stringent internal quality control procedures. If a company continues to have problems and fails to implement an action plan, it can ultimately be withdrawn from the NFIP. According to FEMA officials, a company has been required to withdraw from the NFIP once in the program's history in part because of issues raised in operational reviews and in part due to other financial problems.

In our analysis of reports of all 15 operational reviews and follow-up visits done at insurance companies that were identified as having critical errors, we found that examiners checked information and did file reviews in accordance with the requirements and procedures outlined in the *Write Your Own Financial Control Plan*. We also determined that FEMA followed up to monitor the progress the companies made in addressing and resolving critical errors. For example, in one instance after a write-your-own company received two unsatisfactory designations, it was

directed by FEMA to rewrite all of its policies to be sure that the correct premiums were being charged to policyholders. In another instance, FEMA required a write-your-own company to take more extensive action than was proposed in its plan to address deficiencies.

In addition, according to information provided by FEMA, operational reviews completed since 2000 were on pace to meet FEMA's policy that each of the 95 write-your-own companies be operationally reviewed at least once every 3 years. Table 3 shows the number of operational reviews reported by FEMA from January 2000 through August 2005. FEMA has scheduled a review of 31 write-your-own companies at a large vendor location for later in 2005.

Table 3: Total Number of Operational Reviews of Write-Your-Own Companies Conducted by FEMA (January 2000 to August 2005)

Year	Number of companies reviewed
2000	43
2001	10
2002	33
2003	9
2004	42
January to August 2005	11
Total	**148**

Source: FEMA.

Reinspections of NFIP Claims Conducted by Program Contractor

In addition to operational reviews done by FEMA staff, FEMA's program contractor conducts quality assurance reinspections of claims for specific flood events. The program contractor employs nine general adjusters who conduct quality assurance reinspections of a sample of open claims for each flood event.[45] Procedures for the general adjusters to follow in conducting these reinspections are outlined in FEMA's *Write Your Own Financial Control Plan*. According to the general adjusters we interviewed, in addition to preparing written reports of each reinspection, general adjusters discuss the results of the reinspections they perform

[45] In addition to doing reinspections, these general adjustors are responsible for estimating damage from flood events, coordinating claims adjustment activities at disaster locations, and conducting adjuster training.

with officials of the write-your-own companies that process the claims. If a general adjuster determines that the insurance company allowed an expense that should not have been covered, the company is to reimburse the NFIP. If a general adjuster finds that the private-sector adjuster missed a covered expense in the original adjustment, the general adjuster will take steps to provide additional payment to the policyholder. An instructor at an adjuster refresher training session, while observing that adjusters had performed very well over all during the 2004 hurricane season, cited several errors that he had identified in reinspections of claims, including improper measurement of room dimensions and improper allocation of costs caused by wind damage (covered by homeowners' policies) versus costs caused by flood damage. In addition, the instructor identified a problem that arose, namely, poor communication with homeowners on the process followed to inspect the homeowner's property and settle the claim. Overall error rates for write-your-own companies are monitored. Procedures require additional monitoring, training, or other action if error rates exceed 3 percent. According to the general adjusters we interviewed and FEMA's program contractor, quality assurance reinspections are forwarded from general adjusters to the program contractor where results of reinspections are to be aggregated in a reinspection database as a method of providing for broad-based oversight of the NFIP as its services are delivered by the write-your-own companies, adjusting firms and independent flood adjusters.

Sampling Methods Used to Conduct Operational Reviews and Quality Assurance Reinspections Do Not Provide Management Information on Overall Performance

FEMA used nonprobability sampling processes rather than random sampling to select files for operational reviews and claims for quality assurance reinspections. In nonprobability sampling, staff select a sample based on their knowledge of the population's characteristics. The major limitation of this type of sampling is that the results cannot be generalized to a larger population, because there is no way to establish, by defensible evidence, how representative the sample is. A nonprobability sample is therefore not appropriate to use if the objective is to generalize about the population from which the sample is taken.[46]

For the operational reviews, specific guidance on how to select files for review is not documented, although guidance is provided on the number of files to review based on the size of the write-your-own companies' volume of NFIP business. The process used to select claims for review, as

[46] GAO, *Policy Manual* (Washington, D.C.: Jan.1, 2004).

it is described by FEMA managers who oversee operational reviews, identifies problems at the write-your-own companies, but it is not designed to assess overall performance. For the specific underwriting portion of the review, examiners use a process described by a FEMA official as adverse selection, or selection of files for review that include the most difficult new policies that the company underwrote in the period since the last operational review under the assumption that if the company addresses difficult underwriting issues correctly, it will also be able to do routine underwriting issues correctly. According to this official, some examples of the most difficult underwriting issues are policies covering properties in the flood hazard areas closest to bodies of water and elevated buildings that have enclosures underneath them. For the claims operation portion of the operational review, like the underwriting portion, an examiner said that FEMA attempts to select the more difficult or potentially troublesome claims files to review. In addition, files that are closed without payment and those with particularly large settlements are to be included in the sample of files reviewed. Thus, the operational reviews provide FEMA with management information on specific problems that occur at write-your-own companies but, by design, do not assess the overall performance of the companies.

For quality assurance reinspections, procedures are included in the written FEMA guidance on the number of claims to sample, but not on the sample selection process. General adjusters employed by FEMA's contractor are to reinspect a sample of properties based on the total number of claims the write-your-own company is processing for the flood event. A FEMA official said that this number is up to about 4 percent of claims for each flood event based on the total number of claims filed for the flood event. Although the two general adjusters we interviewed said their inspection sample selection process was random, the selection process they described involved choosing properties to reinspect based upon criteria they considered to be important. The general adjusters said that they generally reinspected the adjustments done on properties from a variety of neighborhoods that represented different types (i.e., single family and condominium) and values of houses, and varying flood loss claims amounts. A FEMA manager said that this process was comparable to the approach used by all nine of the general adjustors. While these criteria, if properly applied, would lead to some variety in the selection of claims to review, the selection process is not random or statistically valid for purposes of projecting results to overall performance. By exercising a more rigorous sample selection process, without incurring additional costs or selecting larger sample sizes, FEMA would improve its internal control processes.

Because FEMA's primary means of providing oversight are its operational reviews and quality assurance reinspections, statistically-valid information from these oversight activities is essential. However, FEMA's use of an approach that lacks statistical validity for selecting files for operational reviews and claims for reinspections does not provide management with the information needed to assess the overall performance of the write-your-own companies, including the overall accuracy of the underwriting of NFIP policies and the adjustment of claims—information that FEMA needs to have reasonable assurance that program objectives are being achieved. Without a statistically valid sampling methodology, FEMA did not meet our internal control standard that federal agencies provide reasonable assurance that program objectives are being achieved and that program operations are effective and efficient.[47]

FEMA Task Force Closed about Half of Hurricane Isabel Claims Reviewed with Additional Payments

FEMA took unique actions to respond to concerns regarding NFIP payments for Hurricane Isabel flood claims. In April 2004, about 7 months after Hurricane Isabel, FEMA established a task force to review claims settlements based on requests by Hurricane Isabel claimants.[48] It was the first time in the history of the NFIP that a formal review process was established for NFIP claimants who were not satisfied with actions taken on their claims. According to an NFIP official, the task force was comprised of about 50 current and former certified flood adjusters from various private sector flood insurance adjusting firms, the nine general adjusters employed by FEMA's program contractor, and three FEMA staff. Adjusters were assigned to review claims outside of states where they had previously adjusted claims for Hurricane Isabel damage, according to the official.

As shown in figure 4, FEMA officials said they sent notifications to 23,770 Isabel claimants in six states[49] and Washington, D.C., to advise claimants

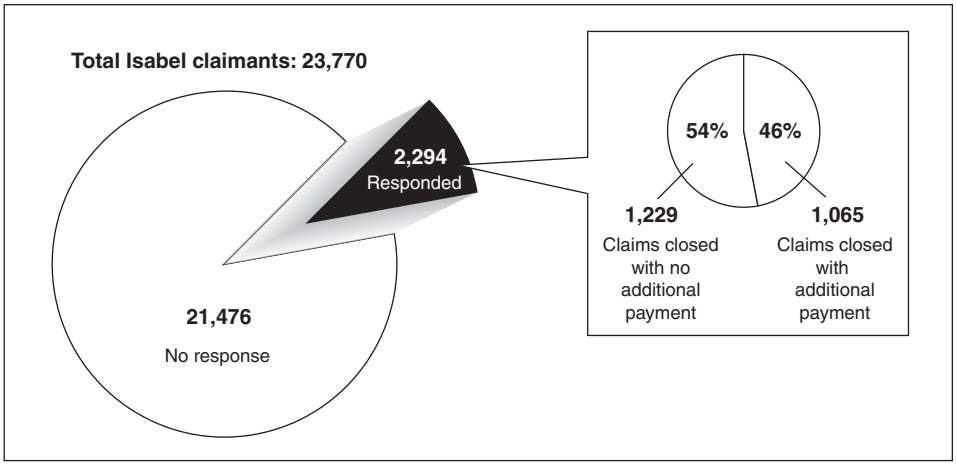
[47] In addition, the Improper Payments Information Act of 2002, Pub. L. No. 107-300, 116 Stat. 2350, (2002), requires each executive agency to review all of its programs and activities annually and identify those that may be susceptible to significant improper payments. If DHS determines during the annual review that the NFIP is susceptible to significant improper payments, it will be required, in accordance with Office of Management and Budget (OMB) guidance, to report statistically valid estimates of improper NFIP payments to Congress before March 31 of the following applicable year.

[48] After the task force was created, the Senate Committee on Banking, Housing, and Urban Affairs affirmed the need for an independent review of Hurricane Isabel claims. See S. Rep. No. 108-262, at 5 (2004).

[49] Maryland, North Carolina, Virginia, Delaware, Pennsylvania, and South Carolina.

that they could have their claims reviewed by a special FEMA task force if they were unhappy with actions taken to settle them. Claimants could request a review by the FEMA task force in person at a community meeting, by telephone, mail, or fax. About 10 percent of the claimants who were notified (2,294)—all with property in Maryland, Virginia, and North Carolina—responded. In reviewing those claims, the task force determined that 1,229 of the claims should be closed with no additional payment and that 1,065 claims should be closed with additional payments.

Figure 4: Disposition of Hurricane Isabel Claims Reviewed by the FEMA Task Force



Source: GAO analysis of FEMA data.

Based on our review of a statistically representative sample of claims files selected from the 2,294 claimants that responded to FEMA that they wanted a task force review of their claims, the task force closed claims with no additional payment for a variety of reasons. For example:

- Task force agreed with the original determination that flood damage to parts of a basement were not covered.
- Task force agreed with the original determination that damage was not due to flood but to wind-driven rain.
- Task force agreed with the original determination that a claimant did not have coverage for personal property.

Based on our analysis, reviewers allowed additional payments most frequently to:

- Repair or replace building or personal property items that the initial adjuster did not include in the loss report.
- Pay a higher amount for materials, labor, or personal property items than the original adjuster had allowed.

In more than 90 percent of claims closed by the task force with additional payment, the reviewer determined that additional payments were due for one of these two reasons.[50] In 48 percent of the claims, additional payments were allowed for items that the initial adjuster did not include in the loss report, and in 43 percent of claims, additional payments were allowed to pay a higher amount for costs than the original adjuster had allowed. For example, in one claim we reviewed, the original estimate did not include coverage for a kitchen countertop and a cable television outlet that the reviewer included in the final claim settlement. In other claims, reviewers allowed higher prices for paint, dry wall, insulation, base molding, ceramic floor tile, and window trim, among other items, than had been allowed in the initial loss report. One general adjuster for FEMA's program contractor said that the original pricing was not an error in many cases, but that the costs of the materials had increased between the time of the initial loss and the final settlement offer.

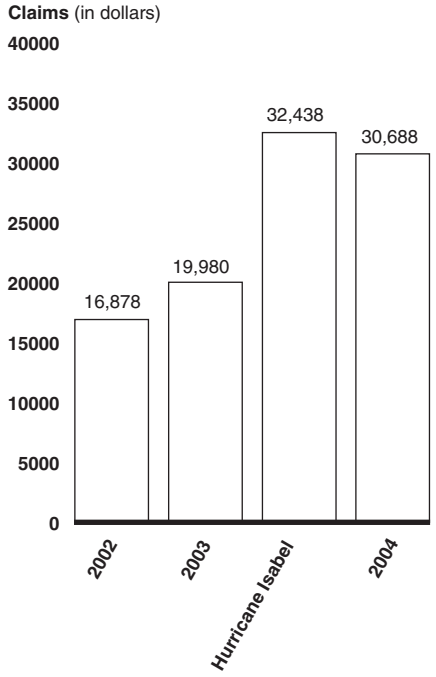
Based on our analysis of the statistically representative sample of 100 claims files reviewed by the FEMA task force, the average amount paid on claims closed with payments and for which claimants requested a review by the task force was $32,438.[51] The average additional payment amount

[50] In 9 percent of the cases, the task force allowed recoverable depreciation not allowed in the original settlement or determined that the claim should be paid for a primary residence at replacement cost value rather than for a seasonal residence at actual cash value. Some claimants received additional payments for more than one reason.

[51] This information was current at the time of the review of the claim by the task force and does not reflect any subsequent actions taken on the claim by the write-your-own companies. FEMA's program contractor reported that about 3,866 Hurricane Isabel claims were closed without any payment. Most frequently Hurricane Isabel claims were closed without payment because the adjuster report determined that the damages did not exceed the amount of the deductible on the NFIP policy. In other instances, policyholders filed a claim but failed to follow up by providing appropriate documentation of loss. In several instances, claims were filed for damage to seawalls, which are specifically excluded from coverage under the NFIP.

determined by the task force for claims that were closed with an additional payment was $3,340. In comparison, as illustrated in figure 5, the average closed payments for 2002, 2003, and 2004 for claims closed with payment were $16,878, $19,980, and $30,668, respectively.[52]

Figure 5: Comparison of Claims Settlement Amounts for Hurricane Isabel Claims Reviewed by the Task Force and All Claims Closed with Payment (2002-2004)



Source: GAO analysis of NFIP data.

[52] For claims in our file review, the median settlement amount—the point at which half of the cases were settled at higher amount and half were settled at a lower amount—was $15,583 before the task force review and $19,826 after the task force review. Data on median settlement amounts for 2002, 2003, and 2004 was not available.

FEMA Has Not Fully Implemented NFIP Program Changes Mandated by the Flood Insurance Reform Act of 2004

As of September 2005, FEMA had not fully implemented NFIP program changes mandated by the Flood Insurance Reform Act of 2004 to (1) develop supplemental materials for explaining coverage and the claims process to policyholders when they purchase and renew policies and (2) establish, by regulation, an appeals process for claimants. The 6-month statutory deadline for implementing these changes was December 30, 2004. The act also required FEMA to establish minimum training and education requirements for flood insurance agents and to publish the requirements in the *Federal Register* by December 30, 2004. Although FEMA published a *Federal Register* notice of its requirements on September 1, 2005, the notice explained that FEMA intended to work with the states to implement the minimum NFIP standards through existing state licensing schemes for insurance agents. Thus, it is too early to tell the extent to which insurance agents will meet FEMA's minimum requirements.

For purposes of explaining coverage and the claims process to policyholders, the Flood Insurance Reform Act of 2004 required FEMA to develop three types of informational materials. The required materials are: (1) supplemental forms explaining in simple terms the exact coverage being purchased; (2) an acknowledgement form that the policyholder received the SFIP and any supplemental explanatory forms, as well as an opportunity to purchase coverage for personal property; and (3) a flood insurance claims handbook describing the process for filing and appealing claims.[53] FEMA officials said they had drafted an acknowledgement form and new insurance program forms to explain coverage to policyholders when they purchase and renew their insurance. FEMA officials said that these forms were final as of September 2005, and that they expected distribution to policyholders to begin in October 2005. While FEMA appears to have completed its implementation efforts with respect to the supplemental and acknowledgement forms, its flood insurance claims handbook does not yet fully comply with statutory requirements. FEMA posted a flood insurance claims handbook, dated July 2005, on its website in September 2005. The handbook contains information on anticipating, filing and appealing a claim, but does not include information regarding the appeals process that FEMA is statutorily required to establish through regulation. In its comments on our draft report, FEMA stated that it was offering claimants an informal appeals process pending the establishment

[53] Sections 202, 203 and 204 of the Flood Insurance Reform Act of 2004 contain these requirements.

of a regulatory process, and that the handbook describes this informal appeals process. However, by statute, the claims handbook must describe the regulatory process, which FEMA has yet to establish.

The establishment of a regulatory appeals process is required by section 205 of the Flood Insurance Reform Act of 2004. To address this requirement, FEMA officials said they had discussed the feasibility of maintaining a permanent task force to consider appeals—like the one created to review Hurricane Isabel claims. In commenting on a draft of this report, the acting director of FEMA's Emergency Preparedness and Response Directorate said that FEMA had rejected this plan, but he did not disclose any alternative plan detailing key elements of an appeals process such as how to initiate an appeal, time frames for considering appeals, the size of an appeals board, and the qualifications for membership, or how long the rulemaking process to provide for appeals by regulation might take. Therefore, it remains unclear how or when FEMA will establish the regulatory appeals process, as directed by the Flood Insurance Reform Act of 2004.

Finally, section 207 of the Flood Insurance Reform Act of 2004 required FEMA, in cooperation with the insurance industry, state insurance regulators, and other interested parties, to establish minimum training and education requirements for all insurance agents who sell flood insurance policies and to publish the requirements in the *Federal Register*. On September 1, 2005, FEMA published a *Federal Register* notice in response to this requirement.[54] In the notice, FEMA provided a course outline for flood insurance agents, which consisted of eight sections: an NFIP Overview; Flood Maps and Zone Determinations; Policies and Products Available; General Coverage Rules; Building Ratings; Claims Handling Process; Requirements of the Flood Insurance Reform Act of 2004; and Agent Resources. FEMA further stated that, rather than establish separate and perhaps duplicative requirements from those that may already be in place in the states, it had chosen to work with the states to implement NFIP requirements through already established state licensing schemes for insurance agents. However, the notice did not specify how or when states were to begin implementing the NFIP training and education requirements. Given the recent publication of the *Federal Register* notice, and the states' eventual role in implementing FEMA's training and

[54] *See* Flood Insurance Training and Education Requirements for Insurance Agents, 70 Fed. Reg. 52,117 (2005).

education requirements, it is too early to tell the extent to which insurance agents will meet FEMA's minimum standards.

FEMA officials said that developing and implementing changes to the NFIP can have broad reaching and significant impacts for the millions of NFIP policyholders, as well as the private sector stakeholders upon whom FEMA relies to implement the program. As a result, the agency is taking a measured approach to making the mandated changes to ensure that it achieves results and minimizes any negative effects on policyholders and NFIP stakeholders. Nonetheless, without plans with milestones for completing its efforts to provide policyholders with a flood insurance claims handbook that meets statutory requirements, to establish a regulatory appeals process, and to ensure that insurance agents meet minimum NFIP education and training requirements, FEMA cannot hold responsible officials accountable and track progress to ensure that these management improvements are in place to assist victims of future flood events.

Conclusions

A key challenge that FEMA faces in its role as coordinator of the federal disaster response efforts, including the NFIP, is to ensure through its monitoring and oversight efforts that programs are implemented in accordance with statutory and regulatory requirements across the nation. It is a difficult challenge to meet, as services are delivered primarily through a decentralized system of private-sector contractors, their employees, and their subcontractors. However, it is increasingly important that FEMA have assurances that program requirements are followed in light of the growing participation and increasing costs of its programs.

While FEMA's NFIP monitoring and oversight processes have identified specific problems with the delivery of services, the lack of statistically representative samples for processes to assess the accuracy of claims and adjustments limits FEMA's ability to project the results of its analyses in order to provide management information on the private sector's overall implementation of the program. Without such information, the value of FEMA's monitoring processes—operational reviews and quality assurance reinspections—as critical internal control activities is limited. Such information could also help the agency better identify potential needs for such things as additional training requirements or clarification of NFIP coverage and claims guidance, as identified in the Flood Insurance Reform Act of 2004.

FEMA officials have been working to address the consequences of the most devastating hurricane season on record, and these efforts have understandably put pressure on FEMA's resources, particularly since claims began to be filed for the damage from Hurricane Katrina. Nonetheless, the agency may continue to face challenges like those posed by Hurricane Isabel in implementing the NFIP until plans for addressing some of the key legislative requirements of the Flood Insurance Reform Act of 2004 are developed and implemented. Without establishing a roadmap and a schedule for meeting mandated time frames that have already elapsed, FEMA is limited in its ability to project when program improvements will be made.

Recommendations for Executive Action

To improve FEMA's oversight and management of the NFIP, we recommend that the Secretary of the Department of Homeland Security direct the Under Secretary of Homeland Security for Emergency Preparedness and Response to take the following two actions:

- use a methodologically valid approach to draw statistically representative samples of claims for underwriting and claims portions of operational reviews and for quality assurance reinspections of claims by general adjusters; and
- develop documented plans with milestones for implementing requirements of the Flood Insurance Reform Act of 2004 to provide policyholders with a flood insurance claims handbook that meets statutory requirements, to establish a regulatory appeals process, and to ensure that insurance agents meet minimum NFIP education and training requirements.

Agency Comments and Our Evaluation

On October 12, 2005, the Acting Director of FEMA's Mitigation Division provided written comments on a draft of this report. FEMA offered substantive comments on three issues (App. II). FEMA offered comments principally in three areas: (1) its disappointment that we had not directly addressed the issue of whether Congress intended the flood insurance program to restore damaged property to its pre-flood condition; (2) its view that the method of choosing its sample for operational reviews was appropriate and that its financial and internal controls are wide-ranging and include processes that we did not address; and (3) its view that contrary to the impression given in our draft report, FEMA has worked diligently to implement the requirements of the Flood Insurance Reform Act of 2004.

- FEMA expressed disappointment that our report made no explicit, unambiguous statement regarding whether Congress intended flood insurance to restore damaged property to its pre-flood condition. We believe we have addressed the issue consistent with our statutory mandate by explaining the statutory and regulatory provisions that affect both dollar ceilings and other coverage limitations. Section 208 of the Flood Insurance Reform Act of 2004 mandated GAO to conduct a study of aspects of the National Flood Insurance Program (NFIP), including "the adequacy of the scope of coverage provided under flood insurance policies in meeting the intended goal of Congress that flood victims be restored to their pre-flood conditions, and any recommendations to ensure that goal is being met." To address this mandate, it was necessary to consider the legal framework of flood insurance coverage established by the National Flood Insurance Act of 1968, as amended, and FEMA's implementing regulations. The amounts and limitations of flood insurance policy coverage are affected by both the statute and the regulations. In other words, flood insurance policies can only restore victims to pre-flood conditions within, but not beyond, the limits established by law and regulation. To address our mandate, we therefore explained the statutory and regulatory provisions that placed limitations on the amount claimants could recover under their flood insurance policies. Our April 2005 testimony[55] and this report make clear that the statutory ceilings on the maximum amount of coverage that can be purchased and the policy limitations that result from FEMA regulations may result in a policyholder's insured structure not being restored to its pre-flood condition.

- FEMA highlights a number of oversight and management procedures for the program, including those for financial management. It also noted that its method of selecting its sample for operational reviews was more appropriate than the statistically random probability sample we recommended. Most of the additional oversight and management processes and controls FEMA noted in its comments are for financial management—an area not included in the scope of our work. Our work focused on program implementation and oversight. During our review, FEMA managers described the operational reviews and claims inspections as the primary methods FEMA used for monitoring and overseeing the NFIP.

[55] See GAO, *National Flood Insurance Program: Oversight of Policy Issuance and Claims*, GAO-05-523T (Washington, D.C.: April 14, 2005).

- In support of its current sampling strategy for its operational reviews, FEMA cites a report it had commissioned in 1999—a report FEMA had not previously mentioned or provided to us. Thus, we cannot comment on that report or its recommendations. Nevertheless, although FEMA's current sampling strategy may provide an opportunity to focus on particular areas of risk, it does not provide management with the information needed to assess the overall performance of the write-your-own companies, including the overall accuracy of the underwriting of NFIP policies and the adjustment of claims—information that FEMA needs to have reasonable assurance that program objectives are being achieved

- With respect to FEMA's implementation of program changes mandated by the Flood Insurance Reform Act of 2004, we described several actions FEMA had taken in its efforts to comply with the Act, while noting that it had not fully implemented the Act's requirements. In its comments on our draft report, FEMA said that it had been working diligently to meet the Act's requirements and had made further progress on certain initiatives, for example, by finalizing "Summary of Coverage" forms required by section 202 of the act and distributing them to policyholders purchasing or renewing their coverage after September 21, 2005. We have updated our draft report to reflect the new status information, but work remains to be done before FEMA fully implements other requirements of the Flood Insurance Reform Act of 2004. As we noted in our report, section 205 of the Act requires FEMA to establish a claim appeals process by regulation, and section 204 of the Act requires FEMA to describe this regulatory appeals process in its flood insurance claims handbook. Although FEMA commented that it was offering claimants an informal appeals process pending the establishment of a regulatory process, it must establish the regulatory process to be in compliance with the informational requirements of section 204 and the procedural requirements of section 205 of the act. Finally, although FEMA published minimum education and training requirements for flood insurance agents in the *Federal Register* in September 2005, FEMA has not established how or when states are to begin imposing these requirements on flood insurance agents. Thus, we believe our recommendation that FEMA develop documented plans with milestones for implementing the requirements of the Flood Insurance Reform Act of 2004 remains appropriate.

FEMA also offered a number of technical comments that we incorporated as appropriate.

We are sending copies of this report to the Secretary of the Department of Homeland Security. We will also make copies available to others upon request. In addition, the report will be available at no charge on GAO's Web site at http://www.gao.gov.

If you have any questions, please contact me at (202) 512-8777 or jenkinswo@gao.gov or Christoper Keisling, assistant director at (404) 679-1917 or keislingc@gao.gov. Contact points for our offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix III.

William O. Jenkins, Jr.
Director, Homeland Security and Justice Issues

Appendix I: Scope and Methodology

To address provisions in the Flood Insurance Reform Act of 2004 for a GAO study and report on issues related to the processing of flood insurance claims and the Federal Emergency Management Agency's (FEMA) oversight and management of the program, we assessed (1) the statutory and regulatory limitations on homeowners' coverage under the National Flood Insurance Program (NFIP); (2) FEMA's role in monitoring and overseeing the NFIP; (3) FEMA's response to concerns regarding NFIP payments for Hurricane Isabel claims; and (4) the status of FEMA's implementation of requirements of the Flood Insurance Reform Act of 2004.

To determine the statutory and regulatory limitations on homeowners' coverage under the NFIP, we reviewed the National Flood Insurance Act of 1968, as amended, its legislative history, and FEMA's implementing regulations, including its "Standard Flood Insurance Policy." We also discussed our review with officials of DHS Office of General Counsel.

To assess FEMA's role in monitoring and overseeing the NFIP, we examined program requirements and reports. We analyzed the results of 15 operational reviews and follow-up visits FEMA completed from 2001 through February 2005 to determine whether they were done in accordance with requirements and procedures outlined in FEMA's *Write Your Own Financial Control Plan* and GAO's *Standards for Internal Control in the Federal Government*. To determine whether FEMA met the standard for assessing the quality of performance over time and ensuring that findings of its operational reviews were addressed, we analyzed reports of the results of all reviews of insurance operations and follow-up visits at insurance companies where FEMA identified critical errors over a 10-year period, from 1996 to April 2005—a total of 15 reports. All of the reviews and visits for this 10-year period occurred from 2001 to April 2005 because for several years prior to 1999, FEMA did not conduct operational reviews. The reviews were restarted on a "practice" basis in 1999 and a regular basis in 2000. We also observed FEMA examiners as they conducted a portion of an operational review at a flood insurance vendor location and obtained information on the schedule of operational reviews from 2000 to June 2005. We obtained documentation on how quality assurance reinspections of claims adjustments are done after flood events and reviewed copies of several reinspection reports and examples of data maintained in the NFIP reinspection database, as well as aggregate information on the number of quality assurance reinspections done from 2000 to June 2005. We interviewed officials of FEMA and its program contractor about their oversight activities, and we discussed aspects of the process with private-sector insurance officials from four of the five largest

write-your-own companies in terms of the number of claims filed in 2004. For example, we talked with FEMA officials about how claims files were selected for each operational review to examine write your own companies' claims underwriting and adjustment activities and talked with two of the nine general adjusters employed by FEMA's program contractor about how they reinspect the work of adjusters who prepare flood damage estimates and how they select properties to visit. We interviewed these two general adjusters because they had performed reinspections of claims adjustments for damage from Hurricane Isabel and from hurricanes in Florida in 2004. We did not evaluate FEMA's methodology for selecting sample sizes for its monitoring and oversight activities.

To determine FEMA's response to concerns about Hurricane Isabel claims payments, we reviewed a statistically valid sample of 100 claims files of claimants in Maryland, Virginia, and North Carolina who were not satisfied with their initial claims settlements and had their claims reviewed by a special FEMA task force. The claims files included documentation of actions taken on the claims by the write-your-own companies and the FEMA task force, as well as correspondence and documentation provided by the claimants. For this representative sample of claims, we determined the average additional amount paid on claims that were closed with an additional payment; the average amount of claims reviewed by the task force; and reasons claims were closed by the task force with and without additional payments. We based our analysis on the information in the files we reviewed; we did not verify the accuracy of the information in the claims files. We tested the reliability of claims payments amounts for the NFIP database on a statistically valid sample of 250 claims for all flood events in 2003 and 2004. We determined that the NFIP database was sufficiently reliable for our reporting purposes. We discussed the actions FEMA took to address concerns of Hurricane Isabel claimants with FEMA officials, as well as the two general adjusters we interviewed, other officials of FEMA's program contractor, and private-sector insurance officials. We did not interview NFIP policyholders who filed claims for flood damage after Hurricane Isabel because (1) such interviews would have provided anecdotal information that could not be used to make judgments about Hurricane Isabel claimants as a group or any subset of the group; and (2) we started our review more than a year after Hurricane Isabel occurred; thus, testimonial information would have been dated.

To determine the extent to which FEMA had implemented provisions of the Flood Insurance Reform Act of 2004, we examined documentation of the agency's efforts, including draft materials FEMA had prepared for distribution to policyholders. We also interviewed officials to determine

what progress had been made and what milestones, if any, had been established to meet the legislative mandates.

We conducted our work in accordance with generally accepted government auditing standards between December 2004 and August 2005.

Appendix II: Comments from the Federal Emergency Management Agency

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

October 12, 2005

William O. Jenkins, Jr.
Director
Homeland Security and Justice
441 G St., NW
Washington, DC 20548

Dear Mr. Jenkins:

Thank you for providing the draft GAO report entitled, "Improvements Needed to Enhance Oversight and Management of the National Flood Insurance Program" for FEMA's review and comment. Based on FEMA's review, I am providing general and specific comments on this report. FEMA's primary comments fall in three areas, as follows:

- As I indicated to the GAO in my letter of September 23, 2005, to Norman J. Rabkin, I am disappointed that the issue regarding restoration of policyholders to their "pre-flood" condition and Congressional intent has not been directly addressed as FEMA would have expected based on the language in the Reform Act of 2004 and the GAO letter dated October 1, 2004 that DHS received prior to the initiation of this study. The GAO was instructed to investigate and report with regard to this issue and should provide an unambiguous statement as to its findings. Since in the subject report it is stated that the legislative history of the National Flood Insurance Program (NFIP) as well as the authorizing statute were examined, it would seem that the GAO found no expression of intent to restore properties completely to pre-flood condition.

  A relevant, similar issue was addressed by the GAO for Congress in 1986 when FEMA implemented certain limitations to basement coverage under the Standard Flood Insurance Policy. In that report, the GAO stated that:

  > "Under Section 1306, FEMA's Director is authorized to provide, by regulation, the general terms and conditions of insurability. This Section includes authority to specify the nature and limits of loss or damage in any areas covered by flood insurance; the classification, limitation, and rejection of risks; and any other terms and conditions relating to insurance coverage or exclusion which may be needed to carry out the program.
  >
  > FIA said its decision to limit flood insurance coverage of basement contents is authorized under several provisions of the act, including those cited above. We concur with this position." (Appendix I, page 8, "Flood Insurance – Federal Emergency Management Agency's Basement Coverage Limitations," GAO/RCED-86-10FS, January 1986).

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The basement coverage changes went through a public comment process as well as Congressional scrutiny and were sustained.

- The GAO has given prominence to a concern that is not the main issue and is based on only partial review of Program controls. With its report title and "highlights" section GAO has chosen to emphasize a rather arcane recommendation with regard to statistical sampling without noting, as the report itself states on Page 5 that "...the processes that FEMA had in place for operational reviews and quality assurance reinspections of claims adjustments met our internal control standard for monitoring federal programs" and later on page 21 that "The processes FEMA followed also met our internal control monitoring standard that requires federal agencies ensure that the findings of audits and other reviews are promptly resolved." Further, the report does not put operational reviews and claims reinspections in the appropriate context within the entirety of what FEMA does to provide oversight of the NFIP and the Write Your Own (WYO) Companies. It is misleading to characterize the operational reviews as "FEMA's primary method to monitor and oversee the NFIP." (Page 27) While very important, these operational reviews, as well as the claims reinspections, are only parts of a comprehensive Financial Control Plan that has effectively provided oversight and control of the WYO insurance operations of the NFIP as discussed below. Biennial audits by CPA firms, annual Inspector General financial audits, monthly editing of policy and claims transactions along with the statistical and financial reconciliations provide an abundant amount of random sampling and thorough review of WYO transactions. This information does not appear to have been considered by the GAO in its study. However, these monitoring and control mechanisms do have a bearing on the design and use of operational reviews and claims reinspections. It is difficult to understand how the GAO can reach a conclusion that FEMA is not meeting an internal control standard without a thorough consideration of all the controls and processes that FEMA has in place to provide oversight of the Program.

- FEMA is pleased to find that in one of its primary areas of inquiry, the GAO does not criticize FEMA's handling of the extensive review process of the loss settlements resulting from the devastating impact of Hurricane Isabel.

FEMA's Oversight and Management of the NFIP

The WYO Financial Control Plan was developed as part of the original implementation of the WYO Program in 1983. All WYO companies must adhere to it. The Plan consists of the following elements including the operation reviews and the claims reinspection program:

- Part 1 requires companies to have a CPA firm, on a biennial basis, conduct independent financial, underwriting and claims audits following GAO "yellow book" requirements. As part of these audits, random sampling of claims and underwriting files is required. The audit results are provided to FEMA.

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- Part 2 provides the procedures for the monthly reconciliation and review of financial statement and detailed policy and claim transactions submitted by the WYO companies.
- Part 3 is the claims reinspection program reviewed by the GAO.
- Part 4 requires monthly company certifications of the reconciled financial and statistical data submitted by the WYO companies.
- Part 5 incorporates the Transaction Record Reporting and Processing Plan (TRRP Plan) that requires the companies' monthly submissions of detailed policy and claims transactions. As already mentioned, these statistical records are reconciled each month with company financial statements. Routine system editing of the statistical transactions allows for reviews of such things as the proper rating of policies and whether claims have been submitted for valid policies in force and claim settlements being within policy limits. This requirement is for all records, not for only a sample.
- Part 6 incorporates the WYO Accounting Procedures Manual.
- Part 7 lays out the procedures for the Underwriting and Claims Operational Reviews that the GAO focused on in the report.
- A Standards Committee comprised of both insurance industry and Federal executives assists in providing oversight of WYO companies in meeting the requirements of the Financial Control Plan and provides recommendations to the FEMA Mitigation Division Director on actions that should be taken when a WYO company is failing to meet its responsibilities.

It is important to note that FEMA also continues to fund and participate with the Office of the Inspector General's annual financial statement and operations audit. Each year six WYO companies and the NFIP Direct business contractor are audited. This audit includes random sampling of policy and claims files as well as auditing of system transactions and financial statements.

As a result of the WYO Financial Control Plan activities, and conscientious follow up by FEMA with regard to various audit findings, the NFIP portion of the Inspector General's financial audit has always received a clean, unqualified audit opinion.

In 1999, prior to FEMA's reinstituting the underwriting and claims operational reviews, Deloitte and Touche, in a report commissioned by FEMA, recommended that the operational reviews should be largely based on the findings of their study to target certain areas. They further recommended that a broad based general operational review would not be effective to improve file handling weaknesses, but that there should instead be a focused approach. Additionally, they recommended that the intent of the operational reviews should not be assessment oriented. These recommendations, along with FEMA's risk assessment and determination of resource availability for this aspect of management and program control led to the current design of the operational reviews. This design is oriented to keying on certain higher risk and higher consequence aspects of underwriting and claims that might not be ferreted out through the variety of other Financial Control Plan mechanisms. Thus, there is a bias in the sampling of files. However, this affords the best opportunities to provide immediate feedback to companies on proper procedures and to rapidly effect changes.

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In summary, regarding FEMA's operations review and claims reinspection process, the draft report does state that FEMA follows the requirements of the Financial Control Plan (Page 21). The report also states that FEMA's process meets the GAO's internal control standard in that "the findings of audits and other reviews are promptly resolved" (p. 21). However, it also states that the GAO's standards are not met because FEMA does not use a statistically valid sampling technique to select files for the operations reviews or for the claims reinspections (introduction and Pages. 5, 21, 25, 26, 27, 34). In response, FEMA comments that the operations reviews do include a random sampling technique but were never intended to be based on statistically valid samples. Instead, they are used to select the more difficult cases based upon the judgment of FEMA's professional staff for the purposes of correcting improper handling by the WYO Companies and for training purposes. The claims reinspections and financial reviews are components of a more comprehensive financial control plan.

FEMA's Actions in Carrying Out the Mandates of FIRA 2004

Contrary to the impression conveyed by the draft report's other primary criticism, FEMA has worked diligently to meet the requirements of FIRA 2004. The materials required by Sections 202 (Supplemental form), 203 (Acknowledgement form), and 204 (Flood Insurance Claims Handbook) have been developed and distribution began September 21. The WYO Companies are now sending out the Supplemental (Summary of Coverage) form and at claim time the Claims Handbook. In connection with policy issuance the Bureau and Statistical Agent will begin sending out the Claims Handbook, the prior loss history required by Section 202 and the Acknowledgement form in December based on the NFIP statistical system reports for the month of October. The appeals process required by Section 205 to be established by regulation will be placed in the FEMA/DHS concurrence process this month, after which it will go to OMB for concurrence. The report to Congress on the use of Increased Cost of Compliance (ICC) coverage required by Section 206 is being prepared and will be placed in the FEMA/DHS concurrence process by the end of November 2005. The minimum training and education requirements for flood insurance agents in Section 207 have been established and published as a notice in the Federal Register on September 1, 2005, as required. A bulletin providing for the charging of additional premium only prospectively was been issued on May 23, 2005 in accordance with Section 209. In the next revision to the Standard Flood Insurance Policy, which requires regulatory action, these changes will be made in the policy.

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Thank you for giving FEMA the opportunity to provide input on the draft report.

Sincerely,

David I. Maurstad

David I. Maurstad,
Acting Director/Federal Insurance Administrator
Mitigation Division
Emergency Preparedness
and Response Directorate

Appendix III: GAO Contact and Staff Acknowledgements

GAO Contact

William O. Jenkins, Jr. (202) 512-8777

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