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Report to the Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

August 2009

FLOOD INSURANCE

Opportunities Exist to Improve Oversight of the WYO Program

GAO-09-455

GAO Accountability·Integrity·Reliability

Highlights

Highlights of GAO-09-455, a report to the Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

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FLOOD INSURANCE

Opportunities Exist to Improve Oversight of the WYO Program

Why GAO Did This Study

Since 2004, private insurance companies participating in the Federal Emergency Management Agency's (FEMA) Write-Your-Own (WYO) program have collected an average of $2.3 billion in premiums annually and, of this amount, have been paid or allowed to retain an average of $1 billion per year. Questions have been raised about FEMA's oversight of the program in light of the debts FEMA has incurred since the 2005 hurricanes. GAO placed NFIP on its high-risk list and issued several reports addressing the challenges the program faces. This report addresses the methods FEMA uses for determining the rates at which WYOs are paid, its marketing bonus system for WYOs, its adherence to financial control requirements for the WYO program, and alternatives to the current system. To do this work, we reviewed and analyzed FEMA's data and policies and procedures and obtained the views of select WYOs and flood insurance experts.

What GAO Recommends

GAO makes recommendations to improve oversight of the WYO program. They include reviewing data on WYO companies' expenses, targeting incentive bonuses in line with NFIP goals, and providing more comprehensive oversight of program requirements and procedures. FEMA agreed with our recommendations regarding NAIC data, the incentive structure, and program oversight, but not the transparency of WYO payments. We continue to believe that FEMA could better leverage actual expense data.

View GAO-09-455 or key components.
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What GAO Found

FEMA does not systematically consider actual flood insurance expense information when it determines the amount it pays the WYO for selling and servicing flood insurance policies and adjusting claims. Rather, since the inception of the WYO program, FEMA has used various proxies for determining the rates at which it pays the WYOs. Consequently, FEMA does not have the information it needs to determine (1) whether its payments are reasonable and (2) the amount of profit to the WYOs that are included in its payments. When GAO compared expense payments FEMA made to six WYOs to the WYOs' actual expenses for calendar years 2005 through 2007, we found that the payments exceeded actual expenses by $327.1 million, or 16.5 percent of total payments made. Considering actual expense information would provide transparency and accountability over payments to the WYOs.

FEMA has not aligned its bonus structure with its long-term goals for the program. The WYOs generally offered flood insurance when requested but did not strategically market the product as a primary insurance line. FEMA has not set explicit marketing goals beyond a 5 percent goal of increasing policy growth each year, and the WYO program primarily rewards companies that are new to NFIP for sales increases that may result from external factors, including flood events. The Government Performance and Results Act states that when results could be influenced by external factors, agencies can use intermediate goals to measure contributions to specific goals. Paying bonuses based on such intermediate targeted goals could bring the bonus structure more in line with FEMA's goals for the NFIP program.

FEMA has explicit financial control requirements and procedures for the WYO program but has not implemented all aspects of its Control Plan. FEMA provides guidance for WYOs that is intended to ensure compliance with the statutory requirements for the NFIP and contains checks and balances to help ensure that taxpayer funds are spent appropriately. FEMA did most of the required biennial audits and underwriting and claims reviews but did not do most of the required audits for cause; state insurance department audits; and marketing, litigation, and customer service operational reviews. In addition, FEMA did not systematically track the outcomes of the various audits, inspections, and reviews that it performed for the 10 WYOs included in this review of FEMA's oversight of the program. Because FEMA does not implement all aspects of the Control Plan, it cannot ensure that the WYOs are fully complying with program requirements.

Three alternative administrative structures could replace NFIP's payment arrangement with a competitively awarded contract that could lower costs for selling and servicing flood insurance policies and administering claims: (1) contracting with one or more insurance companies, (2) contracting with a single vendor, or (3) contracting with multiple vendors and maintaining the WYO network. Each alternative involves trade-offs in terms of the impact on the program's basic operations that would have to be considered.

Contents

Abbreviations

Control Plan	FEMA's Financial Control Plan and Procedures
FEMA	Federal Emergency Management Agency
NAIC	National Association of Insurance Commissioners
NFIP	National Flood Insurance Program
SFHA	special high-risk flood hazard area
ULAE	Unallocated Loss Adjustment Expenses
WYO	Write-Your-Own

United States Government Accountability Office
Washington, DC 20548

August 21, 2009

The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate

Dear Senator Shelby:

Private insurers sell and service policies and adjust claims for the National Flood Insurance Program (NFIP) under an arrangement with the Federal Emergency Management Agency (FEMA) of the Department of Homeland Security. Under this program, known as the Write-Your-Own (WYO) program, these companies have collected an average of $2.3 billion in premiums annually since 2004 and have been paid or allowed to retain an average of $1 billion for each of these years. These WYO companies—around 90 in 2008—are not only compensated for their services, but are also paid a bonus for expanding NFIP's policy base by increasing the number of flood insurance policies they sell.

As we have previously reported, the amounts WYOs receive for their services represent from one-third to two-thirds of the total NFIP premiums collected annually, depending on the number of flood claims filed.[1] In fiscal year 2006, these payments peaked at more than $1.5 billion, or about 67 percent of WYO premiums collected, largely because of expenses related to the 2005 hurricanes. The amount of payments and bonuses that WYOs have received has led to increased scrutiny of FEMA's oversight of these insurance companies and its methods for determining the rates at which they are paid.

At your request, we reviewed FEMA's oversight of the WYO insurance companies that sell and service NFIP policies. Our objectives were to (1) assess FEMA's practice of determining the amounts it pays WYOs for selling and servicing flood insurance and adjusting claims; (2) examine how FEMA evaluates the effectiveness of its WYO bonus incentive

[1]See GAO, National Flood Insurance Program: FEMA's Management and Oversight of Payments for Insurance Company Services Should Be Improved, GAO-07-1078 (Washington, D.C.: Sept. 5, 2007).

structure and determine whether the bonuses it pays reflect actual efforts to market flood insurance policies; (3) evaluate the extent to which FEMA oversees the WYO companies, including reviewing external audits, reinspecting flood claims, and conducting operational reviews; and (4) evaluate the advantages and disadvantages of three alternative arrangements for selling and servicing flood insurance policies and adjusting claims using a competitively awarded contract.

On June 19, 2009, we briefed your staff on the results of our work. This letter summarizes the briefing; the briefing slides are included in appendix I of this report.

To assess FEMA's method for determining the amounts it pays WYOs for their services, we selected a sample of six WYOs that represented 53 percent of total WYO program net premiums written, 71 percent of total WYO program claim losses paid, and 59 percent of total expense payments FEMA made to the approximately 90 companies for fiscal years 2005 to 2007. We compared the payments FEMA made to these companies in calendar years 2005 to 2007 with the actual flood insurance expenses the companies reported to the National Association of Insurance Commissioners (NAIC) for those years. We also interviewed officials from FEMA, WYO companies, and NAIC. To address the remaining objectives, we selected a sample of 10 WYOs that represented more than 50 percent of the flood insurance premiums written in fiscal year 2007, including companies of various sizes that incurred different levels of flood losses and had different operating models. To assess the extent to which FEMA evaluates the effectiveness of its WYO bonus incentive structure, we discussed the bonus payment methodology with FEMA and WYO officials and reviewed documents relating to the methodology and history of the bonus payment system. To assess the extent to which FEMA was implementing its oversight requirements for WYOs, we evaluated FEMA's Financial Control Plan Requirements and Procedures (Control Plan) and requested and reviewed all documents that were required under the plan, and discussed the plan and procedures with appropriate FEMA officials, WYO insurers, and other stakeholders. To evaluate the advantages and disadvantages of alternatives to the WYO program, we identified three possible arrangements, all of which would incorporate a competitive feature. We then discussed these alternatives with WYO insurers in our sample; FEMA staff; and other stakeholders, such as flood insurance vendors and consultants. Appendix II contains a more detailed description of our scope and methodology.

We conducted this audit from December 2007 to July 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence we obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Because of the catastrophic nature of flooding and the difficulty of adequately predicting flood risks, private insurance companies have largely been unwilling to underwrite and bear the risk of flood insurance. Under NFIP, the federal government assumes liability for flood insurance losses and sets rates and coverage limitations, among other responsibilities. Since its inception, NFIP, to a large extent, has relied on the private insurance industry to sell and service policies, as Congress envisioned when it authorized the program in 1968. The authorizing legislation provides broad authority for FEMA to work with the private insurance industry, and over time, FEMA has utilized several arrangements with private insurers, including with companies themselves and with a single vendor.[2] Because of customer complaints and stagnant policy growth, in 1983, FEMA established the WYO program. According to FEMA, the goals of the WYO program are to increase the NFIP policy base and the geographic distribution of policies, improve service to NFIP policyholders through the infusion of insurance industry knowledge, and provide the insurance industry with direct operating experience with flood insurance.

In 1986—the first year of the WYO program—48 WYO insurance companies were responsible for about 50 percent of the more than 2 million policies in force. As of September 2008, about 90 WYO insurance companies accounted for 97 percent of the nearly 5.6 million policies in

[2]From 1969 through 1977, the Department of Housing and Urban Development (HUD), which administered the NFIP at the time, had an agreement with a consortium of private insurers known as the National Flood Insurers Association. Under this agreement, HUD reimbursed the association for operating costs and provided an annual operating allowance equal to 5 percent of policyholders' premiums. From 1978 to 1983, a federal contractor—not an insurance company—sold and serviced policies.

force at that time.[3] Because WYOs are not risk-sharing insurers, they are not paid an explicit profit percentage or amount.[4]

Private insurers become WYOs by entering into an arrangement with FEMA (the Financial Assistance/Subsidy Arrangement) to issue flood policies in their own name. The insurers must have experience in property and casualty insurance lines, be in good standing with state insurance departments, and be capable of adequately selling and servicing flood insurance policies. They must also comply with the provisions of FEMA's Control Plan, which outlines the companies' responsibilities for program operations, including underwriting, claims adjustments, cash management, and financial reporting, as well as FEMA's responsibilities for management and oversight.

WYOs adjust flood claims and settle, pay, and defend all claims arising from the flood policies. Insurance agents from these companies are the main point of contact for most policyholders. Based on information the insurance agents submit, WYOs issue policies, collect premiums, deduct an allowance for commission and operating expenses from the premiums, and remit the balance to NFIP. In most 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.

When flood losses occur, policyholders report them to their insurance agents, who notify the WYO insurance companies. The WYO companies review the claims and process approved claims for payment. FEMA reimburses the WYO insurance companies from the National Flood Insurance Fund for the amount of the claims plus expenses for adjusting and processing the claims, using rates that FEMA establishes. Claims amounts may be adjusted after the initial settlement is paid if claimants submit documentation showing that some costs were higher than estimated.

[3]Although WYOs handle most flood policies, FEMA still contracts with a company that serves as the insurer of last resort when an eligible customer cannot purchase insurance from a WYO. The Direct Program services both standard policies and other types, including repetitive loss and group policies.

[4]For the purpose of this review, we considered profits to be the difference between the amounts paid to the WYO companies and the companies' actual flood insurance expenses on a pretax basis. In determining profits, we excluded miscellaneous other companywide income and expenses.

FEMA Does Not Systematically Consider WYOs' Actual Expenses When Setting Payment Rates

FEMA does not systematically consider actual flood insurance expense information when it determines the amount it pays WYOs for selling and servicing flood insurance policies and adjusting claims. Since the inception of the WYO program, FEMA has used proxies to determine the rates at which it pays WYOs. For example, payments for operating expenses are determined annually based on the average industry operating expenses for five lines of property insurance. WYOs' actual flood insurance expense information has been available since 1997, when the companies began reporting the data to NAIC. However, FEMA has not systematically considered these data when setting its payment rates, and thus does not determine in advance the amounts built into payment rates for estimated expenses and profit. Further, FEMA has not, after the end of each year, compared the WYOs' actual expenses to payments it makes to the WYOs. Because FEMA does not routinely take WYOs' actual flood expenses into account when calculating payments and does not analyze actual payments and WYO flood insurance expenses, it does not have the information it needs to determine whether its payments are appropriate and how much profit is included in its payments to WYOs.

FEMA has occasionally modified its methods for determining the amount of expense payments, but only the last of these modifications, made in 2008, has taken into account the amount of actual WYO insurance expenses. In 2001, FEMA increased its payments to WYOs for servicing flood policies by an additional 1 percent of written premiums after some WYOs told FEMA that the payment amounts, based on the proxy used, were not sufficient to cover their operating expenses. FEMA did not take into consideration WYOs' actual expenses in making these additional payments, which continued each year since 2001 and totaled about $25 million in fiscal year 2007. However, we found that the payments to the six WYOs we reviewed exceeded their actual operating expenses even before these payments were increased by an additional 1 percent of written premiums. FEMA did consider actual flood insurance expenses in 2008 when it changed its method of paying claims processing expenses. Beginning in fiscal year 2008—in response to the significant increase in total payments made to WYO companies in fiscal year 2005 and 2006 following the 2004 and 2005 hurricanes—FEMA changed its method for paying claims processing expenses to take into account actual flood expense data obtained from a selected number of WYO companies. These examples illustrate the benefit of considering actual flood expense data in administering the WYO program.

We recognize that the consistency of WYOs' reporting to NAIC needs to be improved in order for data on the companies' expenses to be fully utilized.

For example, we found that, among other things, some companies reported their flood insurance expenses to NAIC after offsetting them with the payments they received from FEMA. We also found that the actual expenses of one of the six companies we reviewed included payments made under service agreements with an affiliated company that may include profit distributions that should not be included in the expense amounts considered when setting payment rates. Nevertheless, we were able to use NAIC flood insurance data, supplemented with information obtained from WYO company officials, to compare the actual flood insurance expenses our six selected companies incurred and the payments they received for calendar years 2005 through 2007. We found that FEMA's payments exceeded the companies' actual expenses by $327.1 million, or 16.5 percent of total payments made.

Our results highlight the importance of FEMA's considering actual flood expense data in administering the WYO program. In accordance with our *Standards of Internal Control in the Federal Government*, FEMA should ensure that its payment rates to WYOs are appropriate by, for example, comparing payments with actual flood insurance expenses.[5] Further, federal managerial cost accounting standards state that reliable cost information is critical to the proper allocation and stewardship of federal resources and that actual cost information is an important element agency management should consider when setting payment rates.[6]

FEMA Has Not Aligned Its Bonus Structure with Its Long-Term Goals for NFIP

FEMA has not aligned its bonus structure for WYOs with its goals for NFIP, such as increasing penetration in low-risk flood zones, among homeowners without federally-related mortgages in all zones, and in geographic areas with repetitive losses and low penetration rates. Instead, FEMA uses a broad-based distribution formula that awards a bonus of 0.5 percent to 2 percent of the premiums collected if WYOs achieve a 2 percent to 5 percent net growth in policies on an annual basis. This formula primarily rewards companies that are new to NFIP, when it is easiest to increase the percentage of net policies from a small base. Further, we found that most WYOs generally offered flood insurance when requested but did not strategically market the product as a primary

[5] GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

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

insurance line. As a result, any sales increases may in fact result from external factors that are outside the companies' control, rather than from marketing efforts—factors such as flood events, changes in the housing market, and economic developments. For example, sales of flood insurance tend to rise after flooding events, and FEMA's Floodsmart media marketing campaign, which also has a goal of increasing flood policies by 5 percent annually, may also impact flood insurance sales. Moreover, FEMA does not review the WYOs' marketing plans and therefore lacks the information needed to assess the effectiveness of either the WYOs' efforts to increase participation or the bonus program itself.

The Government Performance and Results Act of 1993 requires agencies to conduct systematic studies to assess how well programs are working. When program results could be influenced by external factors, agencies can use intermediate goals to identify the program's discrete contribution to a specific result. Although a study funded by FEMA suggested that the agency should focus on increasing market penetration in low-risk flood zones, in targeted geographical areas, and in small, special high-risk flood hazard areas, FEMA has not set targeted market penetration goals beyond its 5 percent goal of increasing policy growth. Having intermediate targeted goals could help expand program participation, and linking such goals directly to the bonus structure could help ensure that NFIP and WYO goals were in line with each other.

FEMA Followed Some but Not All of Its Internal Control Requirements and Procedures

FEMA has explicit financial control requirements and procedures for overseeing the WYO program. FEMA's Control Plan provides guidance for WYOs that is intended to ensure compliance with the statutory requirements for NFIP and that contains several checks and balances to help ensure that taxpayers' funds are spent appropriately.[7] The plan has four major components that include requirements for: (1) monthly data and financial reporting, (2) claims reinspections by FEMA's contractor, (3) various audits by independent CPAs, including required biennial audits, audits for cause, and state insurance department audits, and (4) triennial operation reviews by FEMA staff. FEMA's Standards Committee is

[7]The WYO program is operating under a Control Plan from 1999, but NFIP has a draft plan it began in 2007. The draft revises the Control Plan to no longer require marketing, litigation, and customer service operation reviews. The plan had not been finalized as of July 2009.

responsible for ensuring that participating companies are complying with the requirements.

For the 10 WYOs in our sample, FEMA followed some but not all of the requirements and procedures of the Control Plan and did not systematically track the outcomes of the various audits, inspections, and reviews. Our review of FEMA's records for these WYOs showed the following:

- FEMA collected nearly all of the required monthly data submissions.
- WYOs from our sample whose claims were selected for reinspections were reinspected according to the Control Plan's methodology, and evidence of these activities was provided.
- Biennial audits and underwriting and claims triennial reviews were also mostly implemented. FEMA officials said that they focused on claims and underwriting reviews because these areas were the most important to determining whether claims reimbursements to WYOs were appropriate.
- Other audits, including audits for cause, state insurance department audits, and marketing, litigation, and customer service triennial operation reviews, were rarely or never implemented. FEMA officials said that they no longer performed marketing, litigation, and customer service operations reviews because each of these functions were being reviewed by other means. However, FEMA could not provide us with evidence that these reviews met the Control Plan's requirements.

In addition, we found that WYO compliance with each component of the Control Plan was the responsibility of multiple units, and FEMA did not maintain a single, comprehensive monitoring system that would allow it to ensure compliance with all components of the plan. That is, FEMA did not centrally store WYO-specific evaluations, inspections, audits, or reviews that were to be performed in accordance with the Control Plan. FEMA officials told us that various staff within FEMA or its contractor was responsible for ensuring that appropriate documentation of oversight efforts were maintained. These officials told us that there was no centralized access, either physical or electronic, to all of the documentation produced in overseeing WYOs under the Control Plan.

Systematically tracking compliance with the Control Plan could ensure that participating WYOs are collecting appropriate premiums and making appropriate claims payments. Since most payments made to WYOs are based on premiums collected and claims paid, adequate enforcement of the Control Plan is important to ensuring that WYOs are being compensated appropriately. Because FEMA does not implement all aspects of the Control Plan, it cannot ensure that the WYOs are fully complying with program requirements.

Alternative WYO Program Administrative Structures Could Be Used to Incorporate Competition into the Payment Process

FEMA's current relationship with WYOs facilitates insurance companies' participation in NFIP. But, as previously discussed in this report, this relationship is based on a payment structure that may not reflect the actual expenses these companies incur. We examined three alternative administrative structures that could replace NFIP's payment arrangement with a competitively awarded contract that could lower costs for selling and servicing flood insurance policies and administering claims:

- contracting with one or more insurance companies,
- contracting with a single vendor (similar to the NFIP Direct program), or
- contracting with multiple vendors and maintaining the WYO network.

Each of these alternatives has advantages and disadvantages in terms of the potential impact on the basic operations of administering flood insurance policies and adjusting claims, as well as on FEMA's oversight of the program and its contractors. For example, contracting with one or more insurance companies might lower FEMA's costs for the program through competitive bidding. But most insurance company officials we spoke to said that they did not want to be federal contractors because of the regulations that would apply and emphasized that they had agreed to participate in the WYO program only because it was not based on an explicit federal contract. Further, contracting with a single vendor, as FEMA does under the current NFIP Direct program, might be less expensive but would almost completely eliminate insurance companies' participation and their network of insurance agents. Experts we spoke with also pointed out that using a contractor to administer the flood program failed in the early 1980s due to the contractor's lack of experience in administering insurance policies. Finally, contracting with multiple vendors to service flood policies would allow FEMA to keep the WYO network and might make oversight more effective because FEMA would have a contractual relationship with significantly fewer companies. But experts we spoke to said that this structure would encroach on WYOs' ability to use a subcontractor to administer their flood line. Flood consultants, vendors, and trade groups we spoke to were more receptive to exploring an alternative structure using multiple vendors.

Conclusions

Given the significant risk exposure to the federal government, it is imperative that FEMA carry out its stewardship responsibilities by effectively and efficiently overseeing the WYO program and the more than 90 participating insurance companies. FEMA has taken some steps to address these issues, including taking into consideration the actual expenses of a selected number of WYOs before changing its method for paying claims expenses and preparing a revised draft of its Control Plan, which had not been updated since 1999. Additional opportunities exist for FEMA to improve its oversight of the WYO program and ensure that payments to the participating insurance companies are based on actual company expenses, thereby improving the program's cost-effectiveness. However, our review demonstrates the following:

- FEMA sets rates for paying WYOs for their services without knowing how much of its payments actually cover expenses and how much goes toward profit. Specifically, it does not determine in advance the amounts built into the payment rates for estimated expenses and profit; annually analyze the amounts of actual expenses and profit in relation to the estimated amounts used in setting payment rates; or consider the results of the analysis of payments, actual expenses, and profit in evaluating the methods for paying WYOs. Moreover, it does not have a sound basis for its practice of paying WYOs an additional 1 percent of written premiums for operating expenses. As a result, FEMA does not have the information it needs to determine whether its payments to WYOs are reasonable.

- FEMA has not tied its bonus structure to the long-term strategic goals for the program. As a result, it cannot be assured that the WYO program is achieving its intended goals in the most cost-effective manner. Moreover, FEMA does not collect the information on the WYOs' marketing efforts, which is needed to determine whether the companies' marketing efforts are aimed at helping to promote increased participation among targeted groups and in targeted areas in line with NFIP goals.

- FEMA has not consistently implemented all aspects of its current Control Plan and does not systematically track WYOs' compliance with the plan's requirements. As a result, FEMA cannot ensure that the WYOs are fully complying with NFIP requirements, including oversight of the various payments that depend on accurate premiums collected and appropriate claims made.

Recommendations for Executive Action

To provide transparency and accountability over the payments FEMA makes to WYOs for expenses and profits, we recommend that the Secretary of Homeland Security direct the Under Secretary of Homeland Security, FEMA, to

- determine in advance the amounts built into the payment rates for estimated expenses and profit;
- annually analyze the amounts of actual expenses and profit in relation to the estimated amounts used in setting payment rates;
- consider the results of the analysis of payments, actual expenses, and profit in evaluating the methods for paying WYOs; and
- in light of the findings in this report, immediately reassess the practice of paying WYOs an additional 1 percent of written premiums for operating expenses.

To increase the usefulness of the data reported by WYOs to NAIC and to institutionalize FEMA's use of such data, we recommend that the Secretary of Homeland Security direct the Under Secretary of Homeland Security, FEMA, to

- take actions to obtain reasonable assurance that NAIC flood insurance expense data can be considered in setting payment rates that are appropriate, including identifying affiliated company profits in reported flood insurance expenses, and
- develop comprehensive data analysis strategies to annually test the quality of flood insurance data that WYOs report to NAIC.

If FEMA continues to use the WYO bonus program, we recommend that the Secretary of Homeland Security direct the Under Secretary of Homeland Security, FEMA, to improve it by considering the use of more targeted marketing goals that are in line with FEMA's NFIP goals.

To improve oversight of the WYO program and compliance with program requirements, we recommend that the Secretary of Homeland Security direct the Under Secretary of Homeland Security, FEMA, to

- consistently follow the Control Plan and ensure that each component is implemented;

- ensure that any revised Control Plan include oversight of all functions of participating WYOs, including customer service and litigation expenses; and
- systematically track insurance companies' compliance with and performance under each component of the Control Plan and ensure centralized access to all the audits, reviews, and data analyses performed for each participating insurance company under the Control Plan.

Agency Comments and Our Evaluation

We received written comments on a draft of this report in a letter from the Department of Homeland Security's Director, Departmental GAO/OIG Liaison Office, which is reproduced in appendix III. FEMA concurred with our recommendations regarding (1) the usefulness of the data that WYOs report to NAIC, (2) the alignment of the bonus structure with long-term NFIP goals, and (3) the oversight of the WYO program. First, the letter noted that FEMA would work with NAIC to improve the quality of the flood expense data that WYOs report and would include the data as an additional item in determining the annual WYO expense allowance. Second, the letter stated that FEMA planned to examine the incentive bonus prior to making arrangements with WYOs for 2010 and 2011. FEMA said that this examination is to include an assessment of the incentive's effectiveness in increasing policies; the need for such an incentive; and possible alternatives to it, including identifying target markets where penetration is low and providing incentives for increasing policies in those markets only. Third, FEMA concurred with our recommendations regarding WYO program oversight, although it stated that the litigation, marketing, and customer service reviews were no longer included in the revised Control Plan because they were completed in other ways. Given the newness of these changes, this review did not include an assessment of FEMA's compliance with these alternative methods or their robustness relative to the Control Plan. Finally, the letter stated that FEMA had implemented new processes to improve the monitoring of WYOs' compliance with the Control Plan and would continue to look for ways to improve oversight in the future. While the letter did not provide details about the new monitoring processes, we are encouraged by these new steps and will be following up on these activities in our ongoing work.

FEMA did not concur with our recommendations on improving the transparency and accountability of payments made to WYOs, specifically our recommendation that FEMA consider WYOs' actual expenses and profits when setting its payment rates. In its response, FEMA provided its views on issues that it believes impacted our analysis and the conclusions we drew from our work. Also, FEMA discussed why it does not consider actual flood insurance expense information. We disagree with FEMA's assertion that the issues it raised resulted in our reaching misleading conclusions, and we continue to recommend that when setting payments rates, FEMA should consider actual flood insurance expenses and the profits that result from its payments to WYO companies.

Specifically, FEMA stated that our review was limited to only six companies, which FEMA believes are the low-cost operators for the five other lines of insurance used to determine the WYO expense allowance. FEMA stated that it seems reasonable that these companies would also have some of the lowest flood operating expenses and, therefore, conclude that the results of our analysis can be expected to significantly understate the operating expenses of the WYO companies as a whole. Our analysis of the expenses and profits of these companies, which represented 53 percent of total net premiums written, 71 percent of total claims losses paid, and 59 percent of total expense payments made by the WYO program for fiscal years 2005 to 2007, demonstrates the importance of information that FEMA does not have about actual expenses and profits that it was paying—information that we consider critical for making decisions regarding the proper administration of NFIP.

FEMA stated that we did not perform a review of the stability of the federal flood expenses because the results for other years were not available to us. FEMA also stated that a review of the stability of federal flood expenses would show the inadvisability of reaching any conclusions from just 1 year of data and that basing compensation on a single year of data is always questionable, especially since our analysis, and the adjustments and assumptions we made in conducting our analysis, have not been vetted. However, our analysis showed that variances in profit over the 3 years we reviewed were caused by, among other things, variations in the expenses incurred to adjust and pay claims losses that also fluctuated from year to year. Moreover, we recognize that setting payments based on a single year of data may not be appropriate. Our recommendation that FEMA consider actual flood insurance expenses and profits in setting payment rates would not limit FEMA's consideration of actual expenses and profits to a single year of data. We anticipate that FEMA would annually perform an analysis of actual expenses and profits for the current year, and then incorporate that result into its analysis of these data covering the number of years that may be appropriate in the view of FEMA management. The results of the longitudinal analysis would be used to evaluate the rates being used and to determine in advance if a change to the rates is needed. Moreover, we agree that time should be allowed for others, such as the WYO companies and NAIC, to weigh in on the methodology for analyzing payments to the WYOs and their actual flood expenses. Importantly, however, any adjustments we made to the flood expenses reported by the WYOs for the purpose of our analysis were the result of information we obtained from and numerous discussions with WYO company officials.

FEMA stated that actual expenses will be as much of a lagging indicator as the current methodology that uses A.M. Best numbers. FEMA also stated that even if actual expense data is considered to be completely reliable, by the time NFIP could use it to lower expense ratios, about 2 to 3 years would have lapsed. FEMA uses the average expenses for five lines of property insurance other than the federal flood line for setting the operating expense payment rate. We recognize that considering WYOs' actual flood expenses will be a lagging indicator of the costs to service flood insurance policies. However, it will be a better indicator than FEMA's current methodology precisely because it will not reflect the trend of expenses for other lines of property business. Importantly, data now used to set payment rates based on other lines of business are subject to events and market forces that affect their expense ratios, but which are not relevant to the WYO program. Our recommendation that FEMA use actual flood expenses to set payment rates would differ from its current methodology in one important aspect: actual expenses and not a proxy would be used to set those rates.

FEMA stated that our analysis assumes that actual WYO company expenses are stable, which FEMA concludes could yield misleading results. FEMA also stated that during the last 5 years insurance companies have managed to significantly reduce their operating expenses in other lines, and suspects that many of those efficiency gains also made it into companies' flood insurance operations. Our analysis was not based on any assumptions about the trends in WYO company expenses, in general, or flood expenses, in particular. Rather, we analyzed the actual flood expenses of selected companies over a 3-year period and compared the payments to the companies' actual flood expenses. As previously indicated, we observed fluctuations from year to year in actual flood expenses—in particular, expenses for adjusting and processing claims. Our recommendation that FEMA consider actual flood expenses and profit when setting payment rates will move FEMA from not knowing ("suspecting") the trend in actual flood expenses to considering those trends when setting rates, and not continuing to utilize proxies of other lines of business and the trends in those other lines that may not be relevant to the WYO program. Whether actual expenses are stable or otherwise is not relevant.

FEMA stated that while we acknowledge in the body of our report that the years we reviewed—2005 to 2007—included the heaviest loss years in the history of the program and that these years are not indicative of typical years for loss adjustment expenses, we do not carry these caveats forward to our conclusions. FEMA stated that this results in a significant distortion of the expense reimbursement to WYO companies for the loss adjustment expenses. We did consider the unusually high losses in 2005 and 2006 when reaching our conclusion that FEMA sets rates for paying WYOs for their services without knowing how much of its payments cover expenses and how much is for profit. An analysis of actual expenses over time would enable FEMA to identify and correlate trends in actual WYOs' flood expenses to flood events and related claims losses. In fact, such an analysis could have helped FEMA to determine before the hurricanes of 2004 and 2005 that its method for paying claims processing expenses would result in significant payments in excess of actual expenses in heavy loss years.

FEMA also stated that it addressed the problem that led to outsized WYO compensation by changing how WYOs are paid for claims processing expenses—referred to as Unallocated Loss Adjustment Expenses (ULAE). As support, FEMA cited the fact that WYOs' compensation for ULAE would have been $29 million less and $267 million less in fiscal years 2005 and 2006, respectively, and would have been $9 million more in 2007. This would have been a combined decrease of $287 million for the 3 years had this new payment schedule been in place then. Further, FEMA said that had the new payment schedule been in place in those years, it is likely that most, if not all, of the $155 million in profit from claims adjusting and processing that we reported for the six companies we reviewed would disappear. Prior to 2008, FEMA paid WYOs 3.3 percent of claim losses incurred for claims processing expenses. Beginning in 2008, FEMA began paying the WYOs 1 percent of net premiums written and 1.5 percent of claim losses incurred for their claims processing expenses. Our analysis showed that for the years 2005 to 2007 FEMA paid the six WYOs in our analysis profits of $327.1 million, including $155.2 million for claims adjusting and processing expenses, without knowing the actual flood expenses of any of these companies. FEMA's statements that it is not clear how much of its "savings" would have been borne by the six WYOs we reviewed and that FEMA can only speculate as to the effect the change would have on the companies' profit support our finding that FEMA does not know how much of its payments are for actual flood expenses and how much are for profit. Our point is that FEMA should know how much it is paying for expenses and for profit.

In our judgment, considering actual expenses and profit in setting payment rates would result in a fair and equitable treatment of policyholders and the WYO companies over time, as well as serve to better protect the interests of taxpayers who ultimately bear the risk of losses from the WYO program. In discussing why it does not consider actual flood insurance expenses in setting payment rates, FEMA said that the WYO flood insurance program is based on companies' applying their normal business practices to NFIP and that these practices are bound to vary from company to company, and that it would be impossible for NFIP to accurately calculate actual expenses for 90 companies. FEMA also said that because of these two factors, and the fact that in the early years of the program actual flood insurance expenses of the companies' were not available, the decision was made to use information on other lines of insurance business from A. M. Best as a proxy in setting rates for payments to NFIP companies. FEMA also stated that even now, when some WYOs' flood insurance expense information is available, FEMA is not certain how accurate this information is, and that its management is skeptical that using actual flood insurance expenses, as GAO recommends, would yield lower payment rates than would result from the proxies that the program uses to set payment rates. FEMA further stated that it will work with NAIC to improve the quality of the flood expense data.

We agree that business practices will vary among the participating companies and we agree with FEMA's statement that actual flood insurance expenses of WYOs were not readily available 25 years ago, when the program started. However, the National Association of Insurance Commissioners (NAIC) began requiring that companies report financial information on their federal flood insurance business in 1997. Therefore, continuing to use other lines of business as proxies for setting WYO program payment rates is no longer necessary. Moreover, continuing with the same practice without assessing the reasonableness of the payments made to WYOs by comparing those payments to the WYOs' actual expenses does not provide sufficient justification or accountability for hundreds of million of dollars in federal program expenses.

We are encouraged by FEMA's statement that, in the future, it will consider actual flood insurance expenses WYOs report to NAIC as an additional item when determining the annual WYO expense allowance, which is intended to cover the companies' operating, marketing, and administrative expenses. While this is a positive step, given the changes in the program and available information, we continue to recommend that FEMA consider all categories of expenses when setting payment rates, including payments for commissions, claims adjusting, and other claims-related expenses. Consideration of all categories of actual flood insurance expenses reported by WYOs in setting payment rates for these expenses, as well as the profits that the program pays to the companies for their participation in NFIP, is necessary for FEMA to know whether its payments to the WYOs are reasonable.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution of this report until 30 days from the report date. At that time, we will provide copies to the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs; the Chairman and Ranking Member of the Senate Committee on Homeland Security and Governmental Affairs; the Chairman and Ranking Member of the House Committee on Financial Services; the Chairman and Ranking Member of the House Committee on Homeland Security; and other interested committees. We are also sending a copy of this report to the Secretary of Homeland Security and other interested parties. In addition, the report will be available at no charge on our Web site at http://www.gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report.

If you or your staff has any questions about this report, please contact Orice Williams Brown at (202) 512-8678 or willamso@gao.gov, or Jeanette M. Franzel at (202) 512-2600 or franzelj@gao.gov. GAO staff who made major contributions to this report are listed in appendix IV.

Sincerely yours,

Orice Williams Brown

Orice Williams Brown
Director, Financial Markets
and Community Investment

Jeanette M Franzel

Jeanette M. Franzel
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Appendix I: Briefing Slides

GAO
Accountability * Integrity * Reliability

Opportunities Exist to Improve Oversight of the WYO Program

Senate Committee on Banking, Housing, and Urban Affairs
June 19, 2009

1

GAO
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Overview

- Objectives
- Summary of Findings
- Background
- Scope and Methodology
- Discussion of Findings and Recommendations

2

Objectives

Our objectives were to:

- Assess the Federal Emergency Management Agency's (FEMA) practice of determining the amounts it pays write-your-own (WYO) companies for selling and servicing flood insurance and adjusting claims.
- Examine how FEMA evaluates the effectiveness of its WYO bonus incentive structure and whether bonuses paid reflect actual efforts to market flood insurance policies.
- Evaluate the extent to which FEMA oversees the WYO companies, including collecting external audits, reinspecting flood claims, and conducting operational reviews.
- Evaluate the advantages and disadvantages of three alternative arrangements for selling and servicing flood insurance policies and adjusting claims using a competitively awarded contract.

3

Summary of Findings

- FEMA does not systematically consider the WYO companies' actual flood expenses when it determines the amount it pays the companies. Consequently, FEMA does not have the information it needs to determine (1) whether its payments are appropriate and (2) the amount of profit to the WYO companies that are included in its payments.[1]
- FEMA's bonus program lacks the necessary information to evaluate the incentive's effectiveness, and the bonus that FEMA pays WYO companies does not reflect the agency's marketing priorities.
- FEMA followed some but not all of the WYO oversight requirements for the 10 insurance companies in our sample and did not systematically track the outcomes of the audits, inspections, and reviews.
- Three alternative arrangements—each with advantages and disadvantages—could replace FEMA's current payment structure: a competitively awarded contract with either an insurance company, a single vendor, or a group of vendors. If it decides to make a change, Congress would have to balance the advantages and disadvantages of each option, particularly in regard to cost, oversight, and program coverage.

[1]For the purpose of this review, we considered profits to be the difference between the amounts paid to the WYO companies and the companies' actual flood insurance expenses on a pretax basis.

4

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Background

- Congress established the National Flood Insurance Program (NFIP) in 1968 to provide homeowners and businesses with insurance coverage against flood damage as an alternative to costly disaster assistance. As of September 2008, NFIP had 5.7 million policies in force.

- The WYO program, which was established in 1983, is administered by FEMA and as of September 2008, had about 90 participating insurance companies, 10 of which collect approximately 80 percent of NFIP's premium revenue.
  - In FY 2008, the WYO program administered 97 percent of FEMA flood insurance policies. The remaining 3 percent were administered under the NFIP Direct program, which is run by a federal contractor.
  - The federal government assumes the liability for the insurance coverage and sets rates and coverage limitations, among other responsibilities.
  - WYOs sell and service flood insurance policies and adjust and pay claims on FEMA's behalf; in turn, FEMA pays the companies for their services.

- FEMA annually enters into arrangements with WYO companies that set forth the roles and responsibilities of the federal government and the participating insurance companies, including the services the WYO companies will provide and the basis for the amounts the government will pay the companies for providing those services.

5

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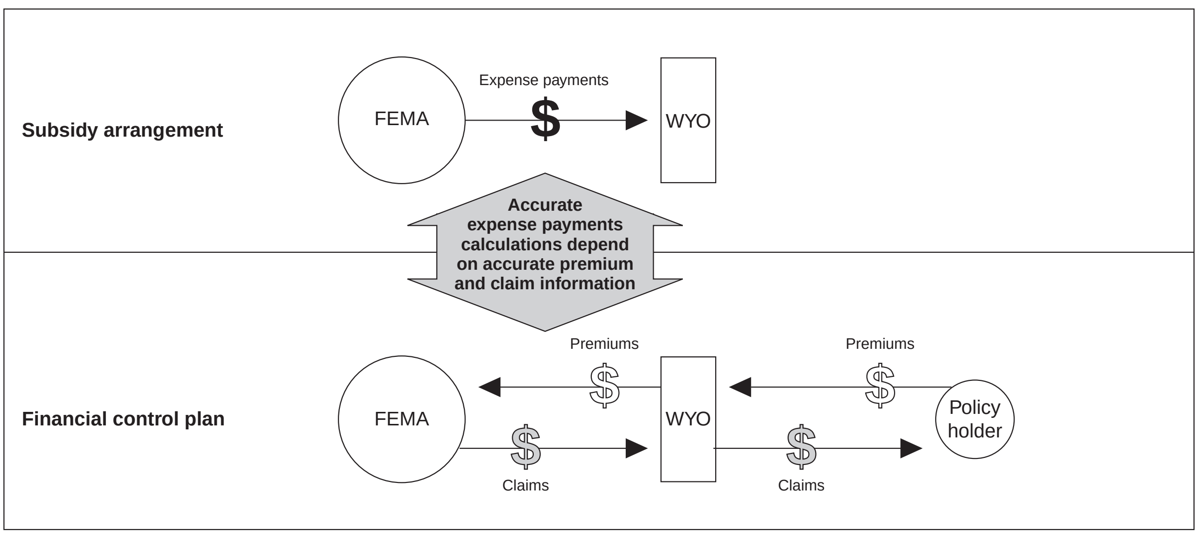
Background

- Effective oversight of the WYO program depends on having accurate premiums and claims information to ensure that participating insurance companies are complying with program requirements.

Figure 1: WYO Program Requirements



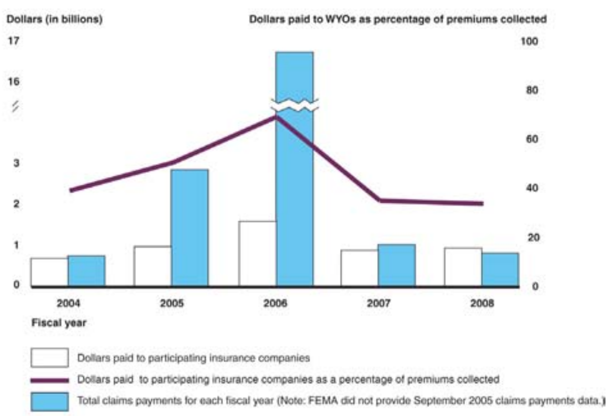
Source: GAO analysis.

6

Background

- As noted in our 2007 report, WYO payments ranged from $695 million in FY 2004 to almost $1.6 billion in FY 2006, the year most of the Hurricane Katrina payments were made.[2]
- In most years, WYOs receive between 30 and 40 percent of the total flood insurance premiums they collect, but the companies received more as a result of the 2004 and 2005 hurricanes.

Figure 2: Amounts Paid to WYOs in Dollars and as a Percentage of Premiums, FY 2004 through 2008



Source: GAO analysis.

[2]GAO, *National Flood Insurance Program: FEMA's Management and Oversight of Payments for Insurance Company Services Should Be Improved,* GAO-07-1078 (Washington, D.C.: Sept. 5, 2007).

GAO Accountability * Integrity * Reliability

Background

Table 1: Types of Payments Made to WYO Companies

Types of payments	Proxy to determine payment	Basis for calculating the payment, per the FY 2007 subsidy agreement
Commission expenses	Established in 1983 after consultations with industry representatives and have not changed since.	15 percent of net written premium.
Operating expenses	Determined annually based on the average industry operating expenses for five lines of property insurance, as reported by A.M. Best.	16.2 percent, 15.8 percent, and 15.2 percent of net written premium in fiscal years 2005, 2006, and 2007, respectively.
Claims adjustment expenses	Determined periodically based on information FEMA collects from independent adjusting firms on their cost of adjusting losses in other lines of insurance business.	From $60 to $1,250 in flat fees for claims up to $50,000; fees for claims over $50,000 are based on a percentage of the claim loss, beginning at 3 percent and declining to 2.1 percent for claim losses of more than $250,000.
Claims processing expenses	Established in 1983 based on loss adjustment expense data for other lines of insurance and remained unchanged through 2007. Beginning in 2008, FEMA changed its payment rate for these expenses.	3.3 percent per claim losses incurred.
Additional adjusting and other expenses	None	Actual expenses incurred (e.g., litigation, engineering, and appraisal).
Incentive bonuses	None	0.5 – 2 percent of net written premium.

Source: FEMA

8

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Background

- Homeowners who have mortgages from federally-regulated lenders and whose properties are located in participating communities that are identified as being in special high-risk flood hazard areas (SFHAs) are required to purchase flood insurance.
- Most home and business owners with properties in participating communities are eligible to purchase flood insurance, even if their properties do not lie in SFHAs or do not carry a mortgage.
- According to a February 2006 Rand Corporation study, about 50 percent of homeowners inside SFHAs and less than 1 percent of homeowners outside SFHAs have flood insurance policies.

Figure 3: Market Penetration in Special Flood Hazard Areas

	Single-family homes with NFIP policies as a percentage of total homes	
	Percentage	Number (in millions)
Inside special flood hazard areas	49%	1.76 out of 3.57
Outside special flood hazard areas	1%	.81 out of 75.6

Single-family homes within area

Total single-family homes within area

Source: Rand Coporation, February 2006 (data).

9

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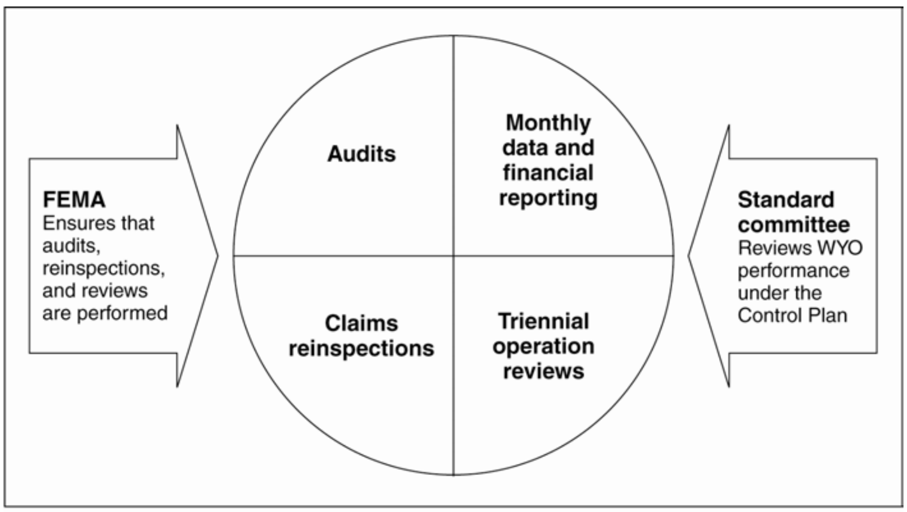
Background

- FEMA's Financial Control Plan Requirements and Procedures (Control Plan) is designed to oversee participating insurance companies and ensure that they are implementing the WYO program in accordance with NFIP regulations.

Figure 4: Four Major Components of the Control Plan



Source: GAO.

10

Scope and Methodology

- To assess FEMA's practice for determining the amount that it pays WYO companies, we compared the payments FEMA made to six WYO companies to the actual expenses that the companies reported to the National Association of Insurance Commissioners (NAIC) for calendar years 2005–2007.[3] These six companies represent 53 percent of total WYO program net premiums written, 71 percent of total WYO program claim losses paid, and 59 percent of total expense payments FEMA made to the approximately 90 companies for fiscal years 2005-2007. We also interviewed FEMA officials, WYO company officials, and NAIC officials. We did not audit the financial information the companies submitted to FEMA, NAIC, or us. We reviewed this information and performed other procedures, including converting FEMA's fiscal year WYO data to calendar year amounts, to ensure that the data were sufficiently reliable for our purposes.

- To evaluate the effectiveness of its WYO bonus incentive structure and determine whether bonuses paid reflect actual efforts to market flood insurance policies, we discussed the bonus payment methodology with FEMA staff, WYO companies, and other stakeholders and reviewed documents relating to the methodology used to make the bonus payments.

[3]NAIC is an organization of state insurance regulators that, among other things, issues financial reporting requirements and guidance for insurance companies. Property and casualty insurance companies must submit an annual statement, including separate amounts for federal flood insurance, to NAIC. Companies must also prepare audited financial statements and reconcile amounts in those statements with the annual statement.

11

Scope and Methodology

- To evaluate the extent to which FEMA oversees the WYO companies, we tested FEMA's compliance with aspects of the Control Plan. In so doing, we discussed procedures with appropriate FEMA staff, requested and reviewed all the documents that are required under the plan, and discussed these requirements with the WYO companies and other stakeholders. We also selected a sample of 10 WYO companies that represented approximately 50 percent of the flood insurance premiums written in fiscal year 2007, including companies of various sizes that incurred different levels of losses and had different operating models (e.g., vendor usage). We used a data collection instrument to facilitate our review of the required documents for the 10 WYOs selected.

- As requested, we identified three possible alternatives that would incorporate a competitive feature. To evaluate the advantages and disadvantages of these alternatives to the WYO program, we discussed the alternatives with FEMA staff; the WYO companies in our sample; and other stakeholders, such as flood insurance vendors and consultants.

12

Objective 1: FEMA Does Not Consider Actual Expenses When Paying WYO Companies

- Since the inception of the WYO program, FEMA has used various proxies to determine the amounts it pays WYO companies. FEMA officials stated that proxies were initially used in part because actual flood insurance expense data were not readily available.

- Without considering actual expense data, FEMA does not have the information it needs to determine whether its payments are appropriate. Further, FEMA does not have the information it needs to determine the amount of profit to the insurance companies that is included in its payments.

- For the purposes of this review, we considered profits to be the difference between the amounts paid to the WYO companies and the companies' actual flood insurance expenses on a pretax basis. The companies report their flood insurance expenses to NAIC, along with the expenses for their other property and casualty lines of business.[4] Our calculation of the companies' pretax profit will not equal the pretax profit for the flood line of business the companies reported to NAIC because, among other things, the NAIC amounts include allocations of miscellaneous other companywide income and expenses.

[4] For the purposes of our analysis, we adjusted the flood insurance expenses that our selected WYO companies reported to NAIC to assist in comparing expense payments made by FEMA to the WYO companies' actual expenses.

13

Objective 1: FEMA Does Not Consider Actual Expenses When Paying WYO Companies

- In accordance with on our *Standards of Internal Control in the Federal Government,* FEMA should ensure that its payment rates to WYO companies are appropriate by, for example, comparing payments to actual flood insurance expenses.[5]

- Further, federal managerial cost accounting standards state that reliable cost information is critical to the proper allocation and stewardship of federal resources and that actual cost information is an important element for agency management to consider when setting payment rates. [6]

[5]GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).
[6]Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government.*

14

Objective 1: NAIC Provides Information on WYO Companies' Actual Flood Insurance Expenses

- In response to a request by FEMA, in 1997 NAIC began requiring that companies report financial information on their federal flood insurance business as part of their annual filings.
- However, FEMA continued its practice of not systematically considering the actual historical flood insurance expense data that WYO companies submitted to NAIC when setting its expense payment rates. FEMA also did not consider this data after the fact, to compare payments it had made to companies' actual annual expenses for the year or to evaluate its payment methodologies.
- We recognize that the consistency of WYOs' reporting to NAIC needs to be improved in order for the benefits of the data to be fully realized. For example, we noted that, among other things, some companies reported their flood insurance expenses to NAIC after offsetting them with the payments they received from FEMA. However, we were able to use NAIC flood insurance data, supplemented with information obtained from WYO company officials, to compare actual flood insurance expenses that our selected companies incurred and the payments they received.

15

Objective 1: FEMA Has Made Some Changes to Its Methods for Paying WYO Companies

- Since 1983, FEMA has occasionally modified its methods for determining the amount of expense payments for certain WYO expenses. But in making these changes, FEMA has not considered the amount of actual flood insurance expenses incurred by the WYO companies, with one exception—a 2008 change in the method for paying claims processing expenses.

- FEMA also did not systematically consider actual flood insurance expenses in deciding to continue to increase the amount of operating expense payments by 1 percent of written premiums in each year since 2001.

- FEMA instituted this increase after some WYO companies told FEMA that their actual expenses to service flood insurance policies exceeded the industry average for the five lines of property insurance other than flood that are used as a proxy to set this payment rate. These five lines of property insurance are fire, allied lines, farmowners multiple peril, homeowners multiple peril, and commercial multiple peril (nonliability portion).

- FEMA's decision increased operating expense payments to the WYO companies in 2001 and each year since; in fiscal year 2007, the additional 1 percent of written premiums was about $25 million. However, we found that the payments to the WYO companies we reviewed exceeded their actual operating expenses before these additional payments.

16

Objective 1: FEMA Has Made Some Changes to Its Methods for Paying WYO Companies

- FEMA did consider actual flood insurance expenses in making a 2008 change in its method of paying claims processing expenses.

- In response to the significant increase in total payments made to WYO companies in fiscal years 2005 and 2006 after Hurricane Katrina, beginning in fiscal year 2008, FEMA began paying claims processing expenses that took into account actual flood expense data obtained from a selected number of WYO companies.

- FEMA estimated that its claims processing payments for all WYO companies would have been reduced by approximately $300 million for the period 2005 and 2006 had this new methodology been in effect.

- These examples of operating and claims payments that exceeded WYO expenses illustrate the need to consider annual actual flood expense data in administering the WYO program.

17

Objective 1: FEMA's Expense Payments to WYOs

- FEMA pays WYO companies to sell and service flood insurance policies and to adjust claims. FEMA also pays WYO companies bonuses for achieving certain marketing goals.
- FEMA expense payments to WYO companies are determined by applying various proxies to either premiums written or claim losses (see table 2).

Table 2: WYO Program Net Written Premium, Claim Losses Paid, and Expense Payments to WYO Companies, Fiscal Years 2005 to 2007 (unaudited)

(Dollars in millions)

Category	FY05	FY06	FY07
Net written premium	$1,940.5	$2,288.2	$2,535.4
Claim losses paid	$2,691.5	$16,091.7	$897.7
Expense payments to WYO companies			
-- based on net written premium	$652.6	$738.2	$793.8
-- based on claim losses	329.6	805.8	74.7
Total	$982.2	$1,544.0	$868.5

Source: NFIP financial statements.

- The increase in claim losses paid in fiscal year 2006 caused a significant increase in payments to WYO companies for adjusting and paying those claims (see table 3).

18

Objective 1: FEMA’s Expense Payments to WYOs

Table 3: Types of Expense Payments Made to WYO Companies, Basis for Payments, and Amounts Paid, Fiscal Years 2005 to 2007 (unaudited)

(Dollars in millions)

		Amounts paid		
Types of payments	**Basis for payments**	**FY05**	**FY06**	**FY07**
Commission expenses	15 percent of net written premium	$ 291.1	$ 343.2	$ 380.3
Operating expenses	16.2 percent, 15.8 percent, and 15.2 percent of net written premium in fiscal years 2005, 2006, and 2007, respectively [a]	322.5	350.7	393.5
Incentive bonuses	0.5–2 percent of net written premium [b]	39.0	44.3	20.0
Claims adjustment expenses	From $60 to $1,250 in flat fees for claims up to $50,000; fees for claims over $50,000 are based on a percentage of the claim loss, beginning at 3 percent and declining to 2.1 percent for claims losses of more than $250,000	86.5	422.4	35.7
Claims processing expenses	3.3 percent per claim losses incurred	236.7	376.5	26.2
Additional adjusting expenses [c]	Actual expenses incurred	6.4	6.9	12.8
Total		**$ 982.2**	**$1,544.0**	**$ 868.5**

Source: NFIP financial statements.

Notes: GAO calculations of commissions and operating expenses are derived from written premiums net of refunds and expense allowance amounts reported in the NFIP financial statements.

[a] Operating expense amounts include miscellaneous expenses incurred of $8.2 million, ($10.8) million, and $8.1 million for fiscal years 2005, 2006, and 2007, respectively.

[b] Incentive bonus amounts represent bonus expenses accrued during the year in which WYO companies earned them. Bonuses are paid in the fiscal year following the year in which they are earned. Bonuses paid in fiscal years 2005, 2006, and 2007 were $31.6 million, $21.4 million, and $44.6 million, respectively.

[c] Additional adjusting expenses include engineering, adjuster, litigation, and appraisal expenses.

19

Objective 1: FEMA's Payments to Six WYO Companies Exceeded Their Actual Flood Expenses

- We compared FEMA's payments to six WYO companies to the companies' actual flood expenses for the 3 calendar years 2005, 2006 and 2007.
- The total payments FEMA made to the six companies we tested exceeded the companies' actual expenses reported to NAIC (as adjusted) by $327.1 million. This profit, or excess of payments over expenses, represented 16.5 percent of the payments made to those companies for the 3-year period ending December 31, 2007.
- The significant profit in 2006 (see table 4) was primarily attributable to payments the companies received to process claim losses incurred as a result of the 2005 hurricanes. In 2007, total payments declined primarily because of reduced claim losses. These factors, combined with the companies' adjustments to their loss adjustment expenses reported to NAIC, contributed to payments in excess of expenses for 2007.
- Amounts representing profit distributions should be excluded from WYO company expenses for FEMA's purpose of considering actual expenses when setting payment rates. For example, we found that the actual expenses of one of our six WYO companies included payments of over $30 million made in 2007 under service agreements with an affiliated company. It is not known what portion of these payments represent expense and profit distributions between the affiliated companies. Excluding affiliated company profits would increase the profit-excess of payments over expenses shown in table 4.

20

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Objective 1: FEMA's Payments to Six WYO Companies Exceeded Their Actual Flood Expenses

Table 4: Total Expense Payments, Total Reported Expenses (as Adjusted), and Total Profit – Excess of Payments over Expenses, for Six Selected Companies, Calendar Years 2005 to 2007

(Dollars in millions)

Types of payments	Expense payments	Reported expenses per NAIC, adjusted	Profit – excess of payments over expenses ($)	Profit – excess of payments over expenses (%)
Commission and operating expenses	$1,130.4	$1,008.7	$121.7	10.8% [a]
Incentive bonuses	50.2	n/a [b]	50.2	
Claims adjusting and processing expenses	802.2	647.0	155.2	19.4% [c]
Total	**$1,982.8**	**$1,655.7**	**$327.1**	**16.5% [d]**

Source: GAO analysis of WYO companies' data.

[a] Profit (excess of payments over commissions and operating expenses) for calendar years 2005, 2006, and 2007 was 11.6 percent, 9.9 percent, and 10.9 percent, respectively.

[b] Reported WYO company expenses attributable to marketing activities are not separately identifiable.

[c] Profit for calendar years 2005, 2006, and 2007 was 9.1 percent, 74.5 percent, and (24.0) percent, respectively. Variances in the profit ratio per year are caused by differences in the nature and amount of claim losses, the amount of expenses to adjust and pay these losses, and differences between when companies recognize actual expenses and when they are paid for those expenses.

[d] Total profit for calendar years 2005, 2006, and 2007 was 11.6 percent, 28.2 percent, and 13.4 percent, respectively.

21

Objective 1: Recommendations

- To provide transparency and accountability over the payments FEMA makes to WYO insurance companies for expenses and profit, we recommend that the Secretary of Homeland Security direct the Under Secretary of Homeland Security, FEMA, to:
  - determine in advance the amounts built into the payment rates for estimated expenses and profit;
  - annually analyze the amounts of actual expenses and profit in relation to the estimated amounts used in setting payment rates;
  - consider the results of the analysis of payments, actual expenses, and profit in evaluating the methods for paying WYOs; and
  - in light of the findings in this report, immediately reassess the practice of paying WYOs an additional 1 percent of written premiums for operating expenses.

22

Objective 1: Recommendations (continued)

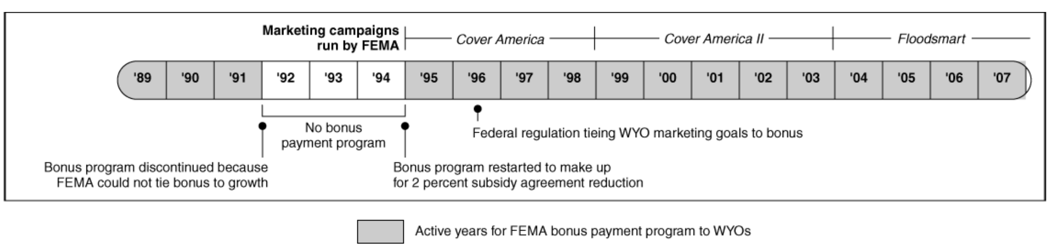
- To increase the usefulness of the data reported by WYO companies to NAIC and to institutionalize FEMA's use of such data, we recommend that the Secretary of Homeland Security direct the Under Secretary of Homeland Security, FEMA, to:
  - take actions to obtain reasonable assurance that NAIC flood insurance expense data can be considered in setting payment rates that are appropriate, including identifying affiliated company profits in reported flood insurance expenses; and
  - develop comprehensive data analysis strategies to annually test the quality of flood insurance data that WYO companies report to NAIC.

23

Objective 2: FEMA Has Made Bonus Payments to WYO Companies

- First begun in 1989, WYO marketing bonuses were discontinued in 1991 after FEMA could not evaluate whether policy growth was due to WYOs' efforts, flood events, the economy, or the mandatory purchase requirement.
- In 1995, FEMA restarted a new bonus program to allow WYOs to make up for a 2 percent reduction in the subsidy arrangement expenses (from 32.6 percent to 30.6 percent of premiums collected).
- FEMA regulations stated that the bonus was to be determined based on whether WYOs met marketing goals set each year.
- FEMA has maintained an overall goal for the WYO bonus and for its current Floodsmart media marketing campaign of increasing flood policies by 5 percent annually.
- FEMA has administratively set a distribution formula that awards a bonus of 0.5 percent to 2 percent of the premiums retained if WYOs achieve a 2 percent to 5 percent net growth in policies.

Figure 5: Timeline of FEMA's Bonus Programs



Source: GAO.

24

Objective 2: Bonuses Have Fluctuated Over Time

- In 2005, following a record storm season, 60 percent of the WYOs received over $21 million in bonus payments.
- In 2006, the year after Hurricane Katrina, payments more than doubled, with 67 of 88 WYOs receiving almost $45 million in bonuses, and 59 receiving the largest possible bonus.
- In 2007, bonuses paid were closer to the 2005 figure, with about 60 percent of WYOs receiving bonuses.
- In 2008, bonuses dropped to $9.2 million, with about 40 percent of WYOs receiving bonuses, reflecting a worsening economy and lower policy retention.

Figure 6: Bonus Payments Made to WYOs, Fiscal Years 2005 through 2008

Policy growth level (percentage)	Bonus level (percentage of premiums)	WYO companies by year (percentage, number, dollars in millions)											
		2005			2006			2007			2008		
<2.0%	0%	40%	37	$0	24%	21	$0	38%	36	$0	58%	51	$0.0
2.0	0.5	4%	4	$1.6	1%	1	$0.01	9%	8	$3.3	6%	5	$3.0
3.0	1.0	8%	7	$3.0	2%	2	$0.1	11%	10	$6.0	5%	4	$0.1
4.0	1.5	7%	6	$6.0	6%	5	$2.4	7%	7	$0.9	7%	6	$4.6
5.0	2.0	40%	39	$10.7	67%	59	$42.1	35%	33	$11.7	25%	22	$1.5
		100%	**93**	**$21.3**	**100%**	**88**	**$44.7**	**100%**	**94**	**$21.9**	**100%**	**88**	**$9.2**

Source: GAO.

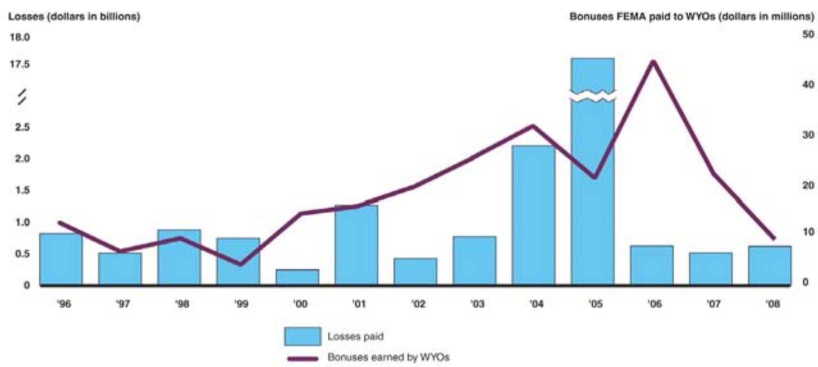
Note: Percentages may not total 100% due to rounding.

25

Objective 2: External Factors Affect Sales of Flood Insurance Policies

- FEMA and WYO officials agreed that other factors outside of the control of the WYOs may have accounted for changes in the number of flood policies, including
    - consumer awareness after a flood event,
    - FEMA's Floodsmart marketing program,
    - housing market expansion/contraction, and
    - economic growth/recession.
- WYO bonuses have generally tracked flood losses.

Figure 7: WYO Bonuses Earned and Flood Losses



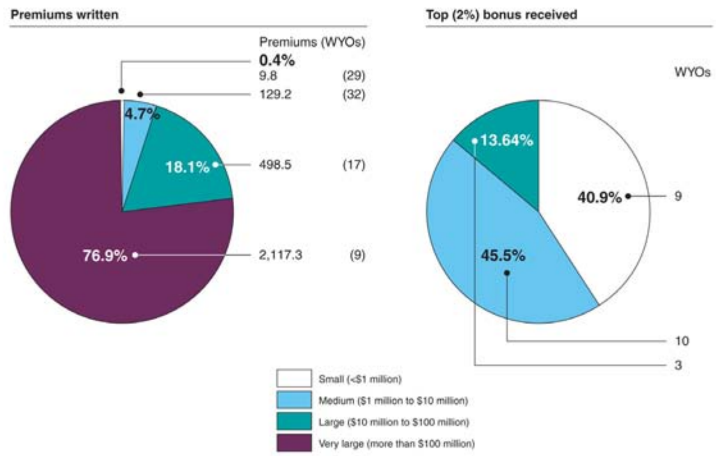
Source: GAO analysis of FEMA data.

26

Objective 2: Bonuses Benefit Mostly Newer and Smaller WYOs

- FEMA and WYO officials also agreed that the bonus formula favored newer WYOs with fewer flood insurance policies.
- For example, in FY 2008:
    - Of the nine WYOs collecting premiums of $100 million or more (74 percent of premiums written), four qualified for a bonus, and none qualified for the top (2 percent) bonus. These nine WYOs average 19 years selling flood insurance.
    - The 22 WYOs that received the top (2%) bonus accounted for less than 3 percent of all premiums. Nine had premiums of less than $1 million, and 10 had premiums of between $1 million and $10 million. The largest WYO receiving the top bonus had $14.2 million in premiums. These 22 WYOs averaged 6 years selling flood insurance.

Figure 8: FY 2008 Premiums Written and Bonuses Received by WYO Size



Source: GAO analysis.

27

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Objective 2: FEMA Has Not Evaluated WYOs' Marketing Efforts

- FEMA's bonus distribution formula is based on the number of net new policies the WYOs sell. Moreover, FEMA has not tied the bonuses to WYOs' actual marketing efforts.
- FEMA's regulations state that the purpose of the premium withheld by WYOs (including an adjustment for the bonus) is in part to pay them for marketing expenses.
- However, external factors such as recent flood events can help drive sales of flood insurance. FEMA does not take such factors into account.
- Further, FEMA has not evaluated the bonus since it was reinstated in 1996 or evaluated the feasibility of using a more targeted strategy.
- Under the Government Performance and Results Act of 1993, systematic studies should be conducted periodically or on an ad hoc basis to assess how well a program is working. The studies are often conducted by experts external to the program, either inside or outside the agency, as well as by program managers. When program results could be influenced by external factors, agencies can use intermediate goals to measure the discrete contribution to a specific result.

28

Objective 2: FEMA Has Not Evaluated WYOs' Marketing Efforts (cont'd)

Of the 10 WYOs that we reviewed:

- Only one WYO had submitted a marketing plan, and for only one year.
- FEMA officials had conducted only one marketing operational review, as required by their policies and procedures.
- Most WYOs did not consider the flood insurance bonus as critical to their company marketing strategy.
- Some WYOs generally offered flood insurance when requested but did not strategically market the product as a primary insurance line.
  - One of the WYOs we spoke with said that they received FEMA's performance bonus even though they did no marketing at all. They explained that they get all of their new business from those mortgage lenders that require flood insurance.
  - Also, FEMA's NFIP Direct program, which responds only to policy inquiries and does not market its services, would have qualified for the top bonus in 2006 if it were eligible for FEMA's bonus program.

29

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Objective 2: A FEMA-Funded Study Has Suggested Marketing Goals for NFIP

- FEMA does not have an explicit goal beyond the 5 percent annual increase in policies.

- The February 2006 Rand Corporation study, part of a multivolume study of NFIP funded by FEMA, suggested that FEMA
    - assess strategies to increase market penetration among homes that are not subject to the mandatory purchase requirement;
    - develop a marketing strategy to increase penetration in certain geographical areas, particularly noncoastal communities in SFHAs;
    - limit the effects of policy growth on loss variability by focusing efforts to increase market penetration outside the southeastern part of the country and the Gulf States; and
    - address the low market penetration rates in communities with fewer than 500 homes in SFHAs.

30

Objective 2: Recommendation

- As currently established, the WYO program primarily rewards companies that are small or new to NFIP for sales increases that may result from external factors.

- The bonus would be more effective if FEMA established more targeted WYO goals in line with its NFIP goals, such as increasing penetration in low-risk flood zones, among homeowners without federally backed mortgages in all zones, and in geographic areas with repetitive losses and low penetration rates.

Recommendation

- To improve the WYO marketing bonus program should FEMA decide to continue it, we recommend that the Secretary of Homeland Security direct the Under Secretary of Homeland Security, FEMA, to consider using more targeted marketing goals that are in line with FEMA's NFIP goals.

31

Objective 3: FEMA Uses Four Major Oversight Tools

- FEMA's Control Plan includes a variety of tools for overseeing WYO companies, but FEMA has not used these controls consistently.
- The Control Plan is designed to ensure that WYOs are complying with the requirements of the flood program—including assessing whether premiums received and claims payments disbursed are accurate—through
    - monthly data reporting, with participating WYO companies submitting signed certifications that are evaluated by FEMA's contractor;
    - claims reinspections performed by FEMA's contractor;
    - various audits by independent CPAs, including required biennial audits, audits for cause, and state insurance department audits; and
    - triennial operation reviews performed by FEMA staff.
- FEMA has also established a Standards Committee, composed of insurance company representatives and FEMA officials, to oversee the performance of WYO companies under the Control Plan.

32

Objective 3: FEMA Did Not Implement All Oversight Requirements

- FEMA implemented some but not all of the requirements and procedures of the Control Plan.

Figure 9: FEMA's Compliance with the Control Plan for the 10 WYOs in GAO's Sample

Oversight component (from the Control Plan)		FEMA's level of compliance
Monthly policy and claims data review		●
Claims reinspections		●
Audits	Biennial	◐
	For cause	○
	State insurance department	○
Triennial operation reviews[a]	Underwriting	●
	Claims	●
	Marketing	○
	Litigation	○
	Customer service	○

○ Rarely or never implemented
◐ Partially implemented
● Consistently implemented

Source: GAO.

[a]FEMA officials told us that they were revising the Control Plan and no longer performed marketing, litigation, and customer service operation reviews.

Objective 3: FEMA Consistently Collected, Evaluated, and Reported WYO Policy and Claims Data Submissions

Our review of FEMA's records for the 10 WYOs in our sample showed that FEMA had collected nearly all of the required monthly data submissions.

- The Control Plan requires that FEMA collect policies, claims data, and financial statements from participating WYO companies each month.[7]
- FEMA documents that we reviewed showed that the agency had collected over 90 percent of the required monthly data submissions, financial statements, and signed certifications for the 10 companies in our sample.

Our analysis also showed that FEMA had evaluated most of the monthly submissions for data errors and financial inconsistencies for the 10 companies in our sample.

- FEMA documents we reviewed showed that the agency had evaluated nearly 90 percent of the required monthly data submissions and financial statements, for the 10 companies in our sample.
  - FEMA regularly found errors in the companies' submissions, but none of these errors were above FEMA's tolerance threshold, which FEMA officials identified as errors that are 6 months old.
  - FEMA also consistently found financial inconsistencies in each submission but did not assess these variances to determine whether they were above the tolerance threshold.

FEMA documents we reviewed also showed that the agency had consistently reported and summarized WYO performance under the monthly submissions component of the Control Plan, including tracking errors, describing the causes of these errors, and logging follow-up done on WYO companies.

[7]FEMA uses a contractor to manage the data collection, evaluate the data for errors and inconsistencies, and follow up with companies as needed. FEMA hired a new contractor for FY 2009 to perform these tasks, and FEMA officials said that processing would change from monthly to daily by fall 2009.

34

Objective 3: The Claims Reinspection Program Is Consistent With the Control Plan

- The Control Plan requires that FEMA inspect claims payments on a sample of policies for large flood events. FEMA's contractor uses flood insurance adjusters to visit recently damaged properties and assess whether insurance company adjusters have accurately determined claims.

- According to the Control Plan, FEMA is to select files from those companies that have filed more than 400 claims for a single large flood event.

- Of the 10 WYO companies in our sample, FEMA officials said that 3 of them were subject to claims reinspection based on the selection methodology in the Control Plan. Using FEMA's flood insurance database, we verified that FEMA accurately applied the selection methodology, and FEMA provided evidence that claims reinspections were performed on these three WYO companies.

35

Objective 3: FEMA Reinspected a Limited Number of Claims Files for Our Sample

Of the 11,998 flood claims filed in FY 2007 by the 10 WYOs in our sample, FEMA identified 1,539 claims, or about 13 percent of the total, that were eligible for reinspection according to the methodology in the Control Plan.

- These eligible claims represent about 15 percent, or $31.2 million of the $210.2 million in claims paid in FY 2007.
- FEMA reported that it actually reinspected 243 (about 16 percent) of the eligible claims. We found that this number represented about 2 percent of the total claims (11,998) filed for these 10 companies in FY 2007.

We also confirmed that FEMA implemented a previous GAO recommendation to select claims files at random as part of their claims operation reviews. With the claims operation reviews, FEMA can potentially evaluate the accuracy of those claims files that were not selected for reinspection.

Figure 10: Claims Reinspections for FY 2007 for the 10 WYOs in GAO's Sample

Source: GAO analysis of FEMA data.

36

Objective 3: FEMA Did Not Collect All the Audits Required in the Control Plan

- FEMA collected some but not all of the required biennial audits for the 10 companies in our sample.
  - FEMA did not perform any audits for cause or collect any state insurance department audits on these 10 companies.

Table 5: Biennial Audits Collected from GAO's WYO Sample between Fiscal Years 2000 and 2007

Complete set of biennial audits collected Number of companies in our sample for which FEMA had a full set of biennial audits covering the period of review	**0**
Most biennial audits collected Number of companies in our sample for which FEMA collected biennial audits covering two-thirds or more of the years we reviewed	**2**
Some biennial audits collected Number of companies in our sample for which FEMA collected biennial audits for one-third to two-thirds of the years we reviewed	**6**
Few biennial audits collected Number of companies in our sample for which FEMA collected biennial audits for less than one third of the years we reviewed	**2**

37

Objective 3: Starting in 2006, FEMA Began Consistently Collecting Biennial Audits

- In response to findings that FEMA had failed to consistently enforce the biennial audit requirement, FEMA officials told us that they had exempted some companies from this requirement after the 2005 hurricane season.

- The officials said that they had exempted those companies that said that they were overwhelmed with administering flood claims after the 2005 hurricane season.

- Starting in fiscal year 2006, however, we found that FEMA consistently collected the biennial audits from the 10 insurance companies in our sample.

38

Objective 3: FEMA Focused on Underwriting and Claims Operation Reviews

While FEMA conducted nearly all of the required underwriting and claims reviews between FY 2000 and FY 2007, it conducted almost none of the marketing, customer service, and litigation reviews.

Table 6: Operation Reviews for GAO's Sample of 10 WYOs between FY 2000 and FY 2007

	Underwriting	Claims	Marketing	Customer Service	Litigation
Number of companies in our sample that had a complete set of operation reviews for the period	9	8	0	0	0
Number of companies in our sample that had 1 or more operation reviews missing for the period	1	2	1	1	0
Number of companies in our sample that did not undergo any operation reviews for the period	0	0	9	9	10

39

Objective 3: FEMA Focused on Underwriting and Claims Operation Reviews

Nearly all of the operation reviews FEMA conducted involved underwriting and claims.

- FEMA officials said that they focused on claims and underwriting reviews because these areas were the most important to determining whether participating insurance companies were collecting appropriate premiums and making appropriate claims payments.

FEMA officials said that they no longer performed marketing, litigation, and customer service operation reviews because each of these functions were being reviewed by other methods.

- Litigation: FEMA officials said that they collected the data to ensure correct litigation payments to insurance companies but did not do operation reviews for these cases.
- Customer Service: FEMA officials said that they relied on state insurance departments to report to them any deficiencies in customer service from participating companies.
- Marketing: FEMA officials said that companies were already incentivized to market flood insurance under the bonus program and that as a result, FEMA no longer needed to perform operation reviews to ensure that the companies were actually marketing flood polices.

40

Objective 3: FEMA's Draft Control Plan Removes Three Operation Review Requirements

FEMA officials provided a draft Control Plan showing that the agency would no longer require the marketing, litigation, and customer service operation reviews.

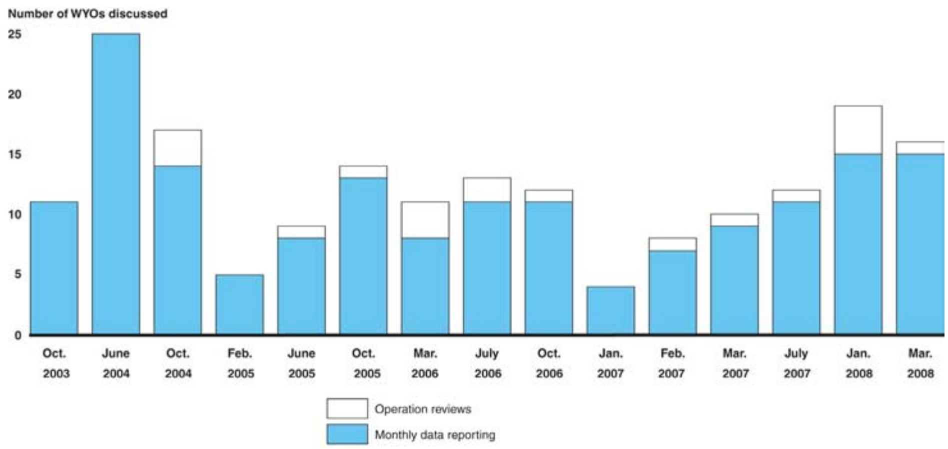
- We reviewed the draft Control Plan and found that FEMA had not replaced the litigation and customer service operation reviews with the information that they said that they had collected in lieu of these reviews.
  - FEMA officials said that they collected information on all payments made for litigation expenses and approved those that were for more than $5,000. However, their draft Control Plan did not include this oversight requirement.
  - In addition, FEMA staff said that they relied on the various state insurance departments to report deficient customer service, but their draft Control Plan did not include this review as a component of WYO oversight.
  - Furthermore, because FEMA did not obtain any state insurance department audits on the 10 WYOs in our sample, we could not determine whether this information was being collected from the states for any of the WYO companies.
- If FEMA views the Control Plan as its primary oversight tool, key components should be included in the plan to help ensure that WYOs are fully complying with program requirements.
- However, if FEMA establishes a bonus program that is more in line with its own marketing goals, FEMA will be able to measure WYO marketing efforts annually and may not need a separate marketing operation review.

41

Objective 3: The Standards Committee Focused on Data Submissions and Operation Reviews

- The Standards Committee met at least twice a year to discuss WYO performance under the Control Plan.
- Our review of committee minutes found that the discussions centered largely on monthly data reporting and claims and underwriting operation reviews.
- The committee did not discuss results from claims reinspections, biennial audits, audits for cause, or state insurance department audits.

Figure 11: Topics of Discussion at Standards Committee Meetings, October 2003 to March 2008



Source: GAO analysis.

42

Objective 3: FEMA Implemented Three Previous GAO Recommendations on Oversight

Table 7: Assessment of FEMA's Implementation of Previous GAO Recommendations Relating to the Control Plan

Oversight component of the Control Plan	Previous GAO recommendation	Status of recommendation
Claims reinspections	FEMA should draw a statistically representative sample of files for claim reinspections.[1]	**Partially implemented** FEMA's March 2009 draft Control Plan changes the file selection methodology to a random selection, but selects only from a population that fits a certain criteria of over 400 claims per a single event. For our sample of 10 WYOs, we found that this eligible population represented a small portion (13 percent) of all claims filed in FY 2007.
Biennial audits	FEMA should conduct and review biennial audits.[2]	**Implemented** As of FY 2006, FEMA had consistently collected the biennial audits from the 10 WYOs in our sample. Furthermore, as of FY 2008 FEMA is using a tracking schedule to document audits received and those reviewed by FEMA staff.
Underwriting operation reviews	FEMA should draw statistically representative samples of files for underwriting reviews.[1]	**Implemented** FEMA's March 2009 draft Control Plan changes the methodology to reflect this recommendation, and FEMA documentation showed that the agency is currently selecting statistically representative sample of files to review.
Claims operation reviews	FEMA should draw statistically representative samples of files for claims reviews.[1]	**Implemented** FEMA's March 2009 draft Control Plan changes the methodology to reflect this recommendation and FEMA documentation showed that the agency is currently selecting statistically representative sample of files to review.

1 See GAO, *Federal Emergency Management Agency: Improvements Needed to Enhance Oversight and Management of the National Flood Insurance Program,* GAO-06-119 (Washington, D.C.: Oct. 18, 2005).

2 See GAO, *National Flood Insurance Program: FEMA's Management and Oversight of Payments for Insurance Company Services Should Be Improved,* GAO-07-1078 (Washington, D.C.: Sept. 5, 2007).

43

Objective 3: FEMA Does Not Systematically Track or Centrally Maintain Reports, Inspections, Audits, and Reviews

FEMA tracks WYOs' compliance with each component of the Control Plan but does not have a single, comprehensive monitoring system.

- As of FY 2008, FEMA was tracking biennial audits and the results of its internal reviews of these audits.
- As of FY 2009, FEMA tracked underwriting and claims operation reviews and the results of these reviews.

FEMA does not centrally store WYO-specific evaluations, inspections, audits or reviews performed under the Control Plan.

- FEMA officials said that various staff within FEMA or their contractor manage the documentation of oversight performed on participating WYO companies. For example, FEMA's underwriting staff manage the underwriting operation reviews and store the resulting documentation.
- The officials told us that there was no centralized access, either physical or electronic, to all the documentation produced in overseeing the WYOs under the Control Plan.

44

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Objective 3: Recommendations

- Because FEMA does not implement all aspects of the Control Plan, it cannot ensure that the WYOs are fully complying with program requirements.
- Compliance with the Control Plan also ensures that participating WYO companies are being compensated appropriately according to the regulations.
- In addition, because FEMA does not systematically track and centrally store all required evaluations, inspections, audits, or reviews, FEMA management cannot have timely access to all documentation in order to help ensure that it is effectively overseeing the 90-plus participating insurance companies.

Recommendations

To improve oversight of the WYO program and compliance with program requirements, we recommend that the Secretary of Homeland Security direct the Under Secretary of Homeland Security, FEMA, to

- consistently follow the Control Plan and ensure that each component is implemented;
- ensure that any revised Control Plan includes oversight of all functions of participating WYOs, including customer service and litigation; and
- systematically track insurance companies' compliance with and performance under each component of the Control Plan and ensure centralized access to all the audits, reviews, inspections, and data analyses performed for each participating insurance company under the Control Plan.

45

Objective 4: Alternatives to the Current WYO Program Would Involve Competitive Bidding

We identified three alternatives to FEMA's current payment arrangement. Competition among firms could ensure that FEMA is incorporating the private sector into the flood program in a more cost-effective manner.

Alternative 1: FEMA contracts with one or more insurance companies.

- FEMA would solicit bids or proposals for a contract—not an arrangement—with one or more insurance companies to sell and service flood polices and adjust claims.

Alternative 2: FEMA contracts with one vendor.

- FEMA would solicit bids or proposals for a contract with a flood insurance vendor, as opposed to an insurance company, to service flood polices. This alternative is similar to the NFIP Direct program.
- FEMA's contractor would sell flood insurance policies only through independent insurance agents, excluding those agents that have contractual relationships to sell policies for only one insurance company.

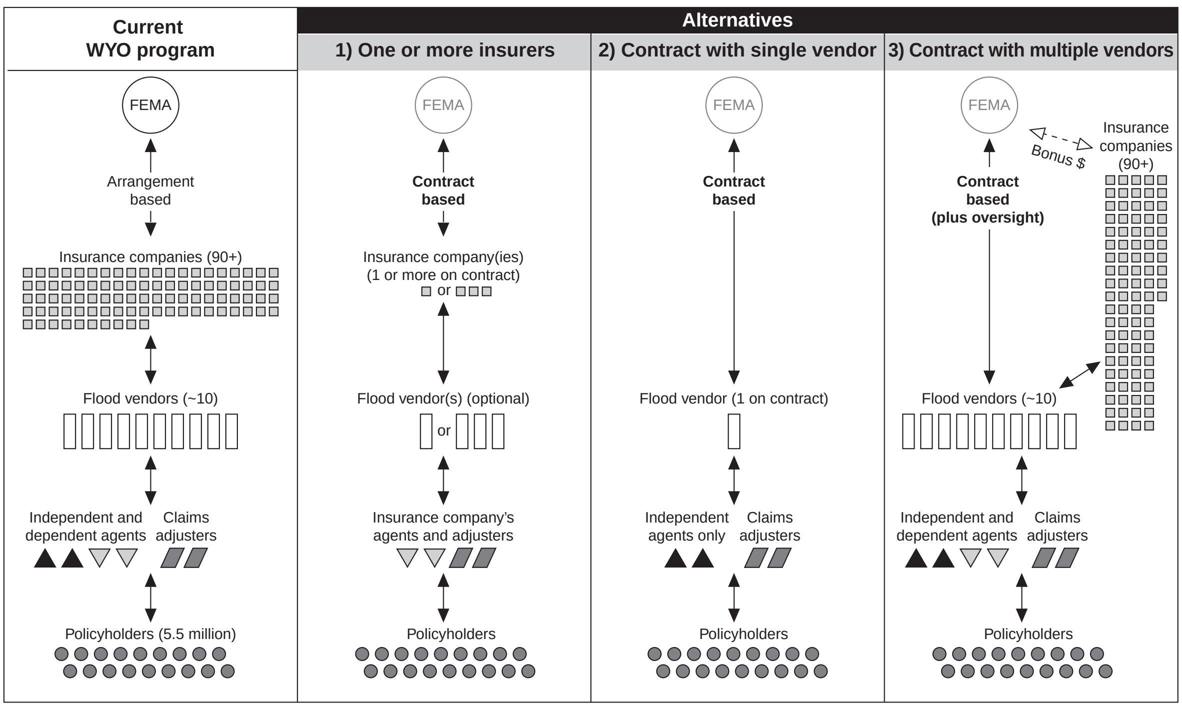
Alternative 3: FEMA contracts with multiple vendors and maintains the WYO network.

- FEMA would solicit bids or proposals for contracts from multiple flood insurance vendors to service flood polices.
- Insurance companies that want to sell flood insurance would contract with one or more of these vendors to service flood policies sold by insurance company agents.
- Since FEMA would pay vendors to administer the flood policies, participating insurance companies would not incur any operational expenses for their flood line. However, FEMA would pay the insurance companies a sales bonus for performance.

46

Objective 4: Alternatives to the Current WYO Program Would Involve Competitive Bidding

Figure 12: Alternatives to FEMA's Current Payment Structure.



Source: GAO.

Objective 4: Each Alternative Has Advantages and Disadvantages

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Table 8: Advantages and Disadvantages of Alternative WYO Structures

Alternative structures	Advantages	Disadvantages
Current program: ***WYO program***	-- Incorporates insurance industry; maximizes the number of companies and agents selling flood insurance and the number of claims adjusters. -- Offers presence in all states and territories. -- Has increased participation in the program since 1983 by 3.7 million polices.	-- Insurers are compensated per a schedule of fees rather than under a competitively awarded contract. -- FEMA has not consistently been able to oversee the large number of WYO companies. -- WYOs typically resort to using vendors to conform to the terms of the program, and FEMA does not have direct oversight of these vendors.
Alternative 1: ***FEMA contracts with one or more insurance companies***	-- Incorporates competition, potentially leading to lower costs. -- Incorporates insurance industry. -- Makes oversight easier because fewer companies are involved.	-- A competitive process may or may not reduce the price per policy. -- Insurance companies may not want to be federal contractors. -- It minimizes the number of insurance companies by reducing the number of agents, limiting choice for consumers. --Insurers may not offer presence in all states and territories.
Alternative 2: ***FEMA contracts with one vendor***	-- Incorporates competition, potentially leading to lower costs. -- Makes oversight easier, with one company to oversee. -- Improves administrative efficiency because flood vendors service most flood policies for the WYOs.	-- The insurance industry is not directly involved. -- The sales network is restricted to independent agents. -- A Direct program failed in the early 1980s because the vendor did not have the industry expertise—including long-standing relationships with agents and adjusters—to provide competent service to policyholders. -- Independent agents may prefer to sell through insurance companies that they have a relationship with rather than through a vendor.
Alternative 3: ***FEMA contracts with multiple vendors and maintains the WYO network***	-- Incorporates competition, potentially leading to lower costs. -- Incorporates insurance industry; maintains the current network of insurance companies and their sales force. -- Removes the need to pay WYOs for servicing and claims-related expenses. -- Makes oversight easier because FEMA has a contractual relationship with significantly fewer companies.	-- A competitive process may or may not reduce the price per policy. -- The direct relationship between the insurance industry and FEMA is severed, so FEMA might be less likely to incorporate insurance industry input. -- Participating insurance companies would be required to use a vendor, even if they did not currently use one.

48

Objective 4: Experts Had Similar Views on the Three Alternatives

Most WYOs said that they did not want to be federal contractors because they did not want to conform to requirements such as labor laws.

- As a potential cost savings, WYO officials said that the federal government should pass legislation to explicitly prohibit local governments from charging premium taxes on flood insurance premiums.

FEMA officials that administer the WYO program were generally not receptive to the alternative payments structures and proposed another alternative for compensating WYOs.

- FEMA officials said that insurance companies did not want to become federal contractors (alternative 1), that using a single vendor would likely result in fewer agents selling flood insurance, and that the hybrid approach would sever the long-standing relationship between FEMA and the insurance industry.

- FEMA officials stated that in the past, they had considered various alternative approaches, including a pure premium approach to reimbursing the insurance companies that would authorize the WYOs to charge any price per policy to cover their expenses. This price would be above a minimum amount that FEMA identified as necessary to cover expected flood claims (the pure premium) and would allow the insurance companies to compete on price.

49

Objective 4: Experts Had Similar Views on the Three Alternatives

Flood consultants, vendors, and trade groups were more receptive to exploring the third alternative (FEMA contracts with multiple vendors).

- For example, one vendor we spoke to emphasized the need for multiple vendors in FEMA's contract so that participating insurance companies could have a choice in determining which vendor to use, depending on their needs.

50

FEMA Comments

- We provided a draft of this presentation to FEMA for its review and they agreed with the content.

51

Appendix II: Scope and Methodology

WYO Expenses

To assess FEMA's practice of determining the amounts it pays to WYO insurance companies for their services without considering the companies' actual expenses, we compared the payments FEMA made to six WYO companies to the companies' actual flood insurance expenses. Insurance companies report flood insurance expense data in annual statements that are submitted to NAIC, which also include expenses for the companies' other property and casualty lines of business. The six WYOs we selected wrote flood insurance policies whose premiums totaled approximately 53 percent of the total WYO program premiums in fiscal year 2007. Our sample is not a representative sample of all WYOs, so the results of our analysis cannot be generalized to the universe of WYOs.

We reviewed NAIC and FEMA flood financial information to assess the reliability of the information for our purposes. Because FEMA's payments to WYOs are determined by applying various proxies to premiums written or claim losses, we identified differences between the written premiums and claim losses that the companies reported to FEMA and NAIC. We obtained from WYO company officials explanations of these differences and determined that they would not significantly impact the companies' flood expenses. Further, to review the payments and expenses for the six companies selected, we

- converted FEMA's fiscal year WYO payment data to calendar year amounts for comparison to calendar year actual expenses reported to NAIC;
- recalculated the expense payments reported by the six WYOs to FEMA on a test basis, using the written premium and claim losses incurred amounts the WYOs reported to FEMA and FEMA's payment rates, all without exception; and
- interviewed officials of the WYOs regarding their flood operations, accounting for and assignment of expenses to the flood line, and reporting of flood line data to NAIC.

To assist in comparing actual expenses to the expense payments, we adjusted the WYOs' reported flood expenses in cases where, for example, companies offset their expenses incurred with the payments they received from FEMA. We found that the data the six companies submitted to NAIC and FEMA were, as adjusted by us, sufficiently reliable for our purposes.

For the purposes of this audit, we considered profits to be to the difference between the amounts paid to the WYO companies and the companies' actual flood expenses on a pretax basis. In determining profits, we excluded miscellaneous other companywide income and expenses.

We did not audit the financial data the six WYOs submitted to FEMA, NAIC, or to us. However, the federal flood financial information the companies submitted to NAIC was included in financial statements prepared in accordance with statutory accounting principles that were audited by independent certified public accounting firms, which expressed unqualified opinions for those years covered by our review. We compared amounts in the audited financial statements for calendar year 2005 to 2007 to amounts the companies reported in their annual statements for earned premiums, losses incurred, and underwriting and loss adjustment expenses incurred for all lines of property and casualty insurance. The differences we identified did not significantly impact our analysis. Further, the federal flood financial information the companies submitted to FEMA was included in biennial financial statements prepared in accordance with generally accepted accounting principles that were also audited by independent certified public accounting firms who expressed unqualified opinions. We reviewed the audited biennial financial statements for four of the six companies that had submitted separately audited statements to FEMA. The differences we identified did not significantly impact our analysis.

Marketing and Bonuses

To evaluate the extent to which bonus payments to WYOs for increasing the number of flood policies they sell were based on WYOs' actual marketing efforts, we discussed the bonus payment methodology with FEMA staff, WYOs, and other stakeholders and reviewed documents relating to the methodology used to make the bonus payments. We analyzed the bonus payments and evaluated the extent to which they could be attributed to the marketing efforts of WYOs or to other external factors, such as flood events and economic conditions. To determine whether the existing bonus formula benefited WYOs with fewer policies and years in NFIP, we compared those WYOs by size and year in the program to those receiving top bonuses.

For the 10 WYOs that we selected to interview, we identified those that had submitted marketing plans or undergone a marketing operations review. We also asked whether the bonus was a major factor in their marketing efforts and whether they considered flood insurance to be a primary insurance line.

Program Oversight

To evaluate FEMA's compliance with the Control Plan, we discussed procedures with appropriate FEMA staff, requested and reviewed all the documents that were required under the plan, and discussed these requirements with the WYOs and other stakeholders. To address FEMA's oversight of the WYOs, we selected a sample of 10 WYOs that administered over 50 percent of the flood insurance policies written for the year 2007. Our sample included companies that covered the spectrum of WYOs—for instance, they differed in size based on premiums written, losses incurred, and overall rank in market share and included companies that did and did not use a vendor.

We used a data collection instrument to review the required documents for the 10 WYOs selected for our review. Our data collection instrument included the four major components of FEMA's Control Plan: (1) monthly data and financial reporting ; (2) claims reinspections performed by FEMA's contractor.; (3) various audits by independent CPAs, including required biennial audits, audits for cause, and state insurance department audits; and (4) triennial operation reviews performed by FEMA staff. We used the 1999 Control Plan that was being used at the time of our review NFIP has a draft plan that it began developing in 2007.

Alternative Administrative Structures

In consultation with congressional staffers, we identified three possible alternatives that would incorporate a competitive feature. To evaluate the advantages and disadvantages of the three alternatives to the WYO program, we discussed the alternatives with staff within GAO; the WYOs in our sample; FEMA staff; and other stakeholders, such as flood insurance vendors and consultants.

We conducted this audit from December 2007 to July 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence we obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix III: Comments from the Department of Homeland Security

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

Homeland Security

July 24, 2009

Orice Williams Brown
Director, Financial Markets
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U.S. Accountability Office
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Washington, DC 20548

Thank you for providing Draft Report GAO-09-455, "FLOOD INSURANCE: Opportunities Exist to Improve Oversight of the WYO Program" to the Department of Homeland Security, Federal Emergency Management Agency (FEMA) for review and comment. FEMA completed its review and is providing the following comments on the report and its recommendations. FEMA concurs with recommendations 2, 3, and 4, however, does not concur with recommendation 1.

FEMA Does Not Systematically Consider Actual WYO Company Expenses When Setting Payment Rates

The industry's willingness to participate in the Write Your Own (WYO) Program was conditioned upon a number of factors that have been explained before, including the nature of Federal oversight, an understanding of the primary role of the States in regulating the business of insurance, and a feasible method of determining equitable compensation for expenses. Because the WYO Program is based on companies applying their normal business practices to the sale and servicing of National Flood Insurance Program (NFIP) policies, these practices are bound to vary from company to company, and it would be impossible for the NFIP to accurately calculate actual expenses for 90 companies. For that reason, and the fact that in the early years of the program flood expenses were not available, the decision was made to use as a proxy the expenses collected by A.M. Best for five similar lines of property coverage. Since these lines, unlike flood, are competitive lines of coverage, there is an inherent incentive to keep expenses ratios as low as possible, an incentive that accrues to the benefit of the NFIP. Even now, when some WYO company flood expense reports have become available, it is not certain how accurate they are, and there is serious skepticism on the part of FEMA management that they would yield a lower expense ratio for flood insurance than the A.M. Best figures.

FEMA appreciates the analysis that GAO performed in determining the WYO companies' actual expenses and we plan to use a similar type of analysis when we initiate our own ongoing annual review of company expenses. Our concerns that the conclusions drawn from the data are misleading are discussed below:

- The review was limited to only six companies, which we believe are the low cost operators for the five other lines of insurance used to determine the WYO expense allowance. It seems reasonable to expect that these companies would have some of the lowest flood operating expenses as well. Hence, the results of the analysis can be expected to significantly understate the operating expenses of the WYO companies as a whole.

- There was no review of the stability of the Federal flood expenses because the results for other years were not available to GAO. However, such a review would show the inadvisability of reaching any conclusions from just one year of data. Basing expense compensation on a single year of data is always questionable, especially since this analysis has not been vetted. There were many adjustments and assumptions made by GAO. While we believe that those assumptions were reasonable, time should be allowed for others to weigh in on the appropriateness of those responses.

- Using "actual company expenses" will be as much of a lagging indicator as the current methodology using A.M. Best's numbers. If actual expense data is considered to be completely reliable, by the time the NFIP could use it to lower expense ratios about two to three years would have lapsed.

- The analysis assumes that actual WYO company expenses are stable, varying little from year-to-year, which FEMA thinks could yield misleading results. During the last five years, insurance companies have managed to significantly reduce their operating expenses in other lines and we suspect that many of those efficiency gains also made it into their flood insurance operations.

- The time period analyzed includes the heaviest loss years in the NFIP's history, which is not indicative of typical years for loss adjustment expenses. This is acknowledged in the body of the report but, these caveats are not carried forward to the conclusions. This results in a significant distortion of the expected reimbursement to WYO companies for their Loss Adjustment Expenses (LAE) expenses.

- The NFIP has addressed the Unallocated Loss Adjustment Expenses (ULAE) problem that led to outsized WYO compensation and has determined how much less the companies would have received if the current ULAE schedule had been in place then. Based on the paid losses shown under Marketing and Bonuses of the report, the WYO companies' compensation for ULAE under the schedule in place today would have been $29M and $267M less in fiscal years 2005 and 2006, and would have been $9M more in fiscal year 2007, for a combined decrease of $287M for the entire three years. It is unclear just how much of that reduction would have been borne by the six companies reviewed in Table 4, but it is likely that most, if not all, of their $155M "profit" from claims adjusting and processing would have disappeared.

2

FEMA Has Not Aligned Its Bonus Structure with Its Long-Term Goals for the NFIP

We will be examining the marketing incentive in anticipation of the 2010-2011 WYO Arrangement Year. The examination will include the extent to which the incentive has been effective in increasing policies, whether an incentive is needed, and possible alternatives to the current incentive. Of most interest is the possibility of identifying target markets where penetration is low and incentivizing policy growth in these areas.

FEMA Followed Some but Not All of Its Internal Control Requirements and Procedures

We are providing the following clarifications in response to GAO's comments on FEMA's implementation of the Financial Control Plan.

- With regard to audits for cause, the Financial Control Plan requires them only when the Federal Insurance Administrator, the Standards Committee, or the OIG require them. During the review period, FEMA was not required to perform an audit for cause. State Departments of Insurance (DOI) audits also require a trigger. In the case of a State DOI audit, a financial officer of the insurer alerts FEMA of an audit involving NFIP activities. During the review period, no notice was given to FEMA. In recent years State DOI's understand that the responsibility for NFIP matters rests with the Federal government and are most happy to routinely send those issues directly to FEMA.

- In the most recent version of the revised but unpublished Financial Control Plan, the Litigation Operation Review is accomplished by a review of litigation expenses. Under the new process, when litigation expenses reach $5,000 or more for an individual law suit, they must be approved by FEMA before the insurer can be reimbursed.

- FEMA's claims and underwriting branches receive copies of the Biennial Audits and based on the nature of the findings, follow-up on the next Claims or Underwriting Operational Review for that insurer. In addition, copies of all Claims Operation Review Reports are provided to the FEMA Claims Monitor of the contractor performing reinspections as these findings can enrich the reinspection process. In return, when reinspections are performed, the FEMA Claims Monitor will make findings available to the Claims and Appeals Branch for use during Claims Operation Reviews.

- The litigation, marketing, and customer service reviews are no longer included in the revised, but unpublished Financial Control Plan.

Alternative WYO Program Administrative Structures Could be Used to Incorporate Competitive Bidding into the Payment Process

Considering possible alternatives to the current NFIP structure of working through private insurance companies under the WYO Program involves a degree of complexity that may not be immediately apparent. The rationale underlying the WYO Program is that it is important to the effective implementation of the NFIP that the private insurance industry, with all its resources and expertise, be the primary vehicle for selling and servicing NFIP policies. The soundness of this rationale has been demonstrated time and again, especially in catastrophic

3

flooding events that require the mobilization of vast company resources to respond quickly and efficiently. It has been generally acknowledged that the NFIP performed admirably in the response to Hurricane Katrina, which resulted in approximately 200,000 claims.

That said FEMA will give consideration to engaging a qualified firm to analyze possible alternatives to the WYO structure, including those proposed by the GAO, to determine the relative merits of such alternatives. In addition to examining the costs and benefits of each alternative, it will be important in this analysis to assess the willingness of the private insurance industry to participate in such alternatives and the extent to which various alternatives may reduce the number of companies participating in a Federal program, which would not be in the best interests of the NFIP.

Recommendation 1: "To provide transparency and accountability over the payments FEMA makes to WYOs, we recommend that the Secretary of Homeland Security direct the Under Secretary, FEMA, to:

- determine in advance the amounts built into the payment rates for estimated expenses and profit;
- annually analyze the amounts of actual expenses and profit in relation to the estimated amounts used in setting payment rates;
- consider the results of the analysis of payments, actual expenses, and profits in evaluating the methods for paying WYOs; and
- in light of the findings in this report, immediately reassess the practice of paying WYOs an additional 1 percent of written premiums for operating expenses."

Response: Non-concur. FEMA does not concur with the set of recommendations regarding providing transparency and accountability over payments made to WYOs. The large number of insurers that participate in the WYO Program benefits NFIP policyholders and supports the goal of making flood insurance widely available. Since expenses vary by company, considering profit in setting the WYO expense allowance would potentially compromise achieving the NFIP's goals. We do not believe that currently available North American Industrial Classification (NAIC) data is adequate enough to allow us to consider profit in determining company compensation.

Recommendation 2: **"**To increase the usefulness of the data reported by WYOs to NAIC and to institutionalize FEMA's use of such data, we recommend that the Secretary of Homeland Security direct the Under Secretary of Homeland Security, FEMA, to:

- take actions to obtain reasonable assurance that NAIC flood insurance expense data can be considered in setting payment rates that are appropriate, including identifying affiliated company profits in reported flood insurance expenses; and
- develop comprehensive data analysis strategies to annually test the quality of flood insurance data that WYOs report to NAIC."

Response: Concur. FEMA concurs with the set of recommendations regarding increasing the usefulness of the data being reported by WYOs to the NAIC. FEMA will continue to work with the NAIC to improve the quality of the flood expense data and will include this data as an additional item in determining the annual WYO expense allowance.

Recommendation 3: "If FEMA continues to use the WYO bonus program, we recommend that the Secretary of Homeland Security direct the Under Secretary of Homeland Security, FEMA, to improve it by considering the use of more targeted marketing goals that are in line with FEMA's NFIP goals."

Response: Concur. FEMA concurs with the recommendation to use more targeted marketing goals and will examine the marketing incentive program in anticipation of the 2010-2011 WYO arrangement year.

Recommendation 4: "To improve oversight of the WYO Program and compliance with program requirements, we also recommend that the Secretary of Homeland Security direct the Under Secretary of Homeland Security, FEMA, to:

- consistently follow the Control Plan and ensure that each component is implemented;
- ensure that any revised Control Plan include oversight of all functions of participating WYOs, including customer service and litigation expenses, and
- systematically track insurance companies' compliance with and performance under each component of the Control Plan and ensure centralized access to all the audits, reviews, and data analyses performed for each participating insurance company under the Control Plan."

Response: Concur. FEMA concurs with the set of recommendations regarding oversight of the WYO Program. It should be noted that the litigation reviews are being addressed through a review of litigation expenses. Companies are required to submit information about their marketing activities as a condition of participation in the WYO Program and FEMA will review them annually. FEMA will continue to monitor customer service complaints filed with State insurance departments or submitted to the NFIP. FEMA has implemented new processes to improve the monitoring of WYO compliance with the Financial Control Plan and will continue to look for ways to improve oversight in the future.

Thank you again for the opportunity to comment on this Draft Report and we look forward to working with you on future homeland security issues.

Sincerely,

Jacqueline L. Lacasse
for Jerald E. Levine
Director
Departmental GAO/OIG Liaison Office

5

Appendix IV: GAO Contacts and Staff Acknowledgments

GAO Contacts

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In addition to the contacts named above, the following individuals made key contributions to this report: Andrew E. Finkel (Assistant Director), Robert Owens (Assistant Director), Grace Haskins (Analyst-in-Charge), H. Donald Campbell, Emily Chalmers, Tony Eason, Fredrick Evans, Jeffrey Isaacs, Scott McNulty, Marc Molino, Roberto Pinero, Paul Revesz, and Carrie Watkins.

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