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FLOOD INSURANCE

Federal Emergency Management Agency's Basement Coverage Limitations

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION

January 31, 1986

B-203633

The Honorable Daniel Patrick Moynihan
United States Senate

The Honorable Benjamin A. Gilman
House of Representatives

This report is in response to your April 13 and May 23, 1984, requests and our subsequent agreements with your offices. As agreed, we limited our work to provide information on the limitations placed on flood insurance coverage of basement contents by the Federal Emergency Management Agency's (FEMA) Federal Insurance Administration (FIA) on

--FIA's authority to change insurance coverage,

--FIA's analysis of flood insurance losses to support the basement coverage limitations,

--the reasons FIA did not select other alternatives for modifying basement coverage, and

--whether FIA adequately notified policyholders of the basement coverage limitations.

Appendix I provides detailed background information on the federal flood insurance program; provides additional details on the results of our work; and discusses our objective, scope, and methodology. The following briefly summarizes that information.

Effective October 1983, FIA limited flood insurance coverage for basements to reduce future flood claim payments in this taxpayer-subsidized program. FIA based its decision to limit coverage on its judgment that basement flooding represents a risk inconsistent with a sound federal insurance program. FIA stated that the flood insurance program should respond only to the basic needs of its policyholders as defined by FIA.

AUTHORITY OF FEMA TO CHANGE INSURANCE COVERAGE

Under the National Flood Insurance Act of 1968, the Director of FEMA is authorized to decide what should be insured by the National Flood Insurance Program. The Director is also authorized to specify the nature and limits of loss or damage; the classification (such as by type and elevation of building), limitation, and rejection of risks; and other terms and conditions relating to insurance coverage or exclusion which may be needed to carry out the program.

FIA INSURANCE LOSS ANALYSIS

FIA's analysis of its insurance claims provided analytical information as support for its decision to limit basement insurance coverage. Its analysis of actual claims for calendar years 1978 through 1982 shows that basement buildings have experienced a 5.7 percent claim loss frequency (based on the number of paid losses per 1,000 policies), four times the claim loss frequency for buildings without basements.

OTHER ALTERNATIVES CONSIDERED

The other alternatives for modifying basement coverage that FIA considered ranged from continuing basement coverage for existing buildings to offering optional coverage for an additional charge. FIA said that it did not select these alternatives because the potential risk to the taxpayers of the higher claims payments associated with the alternatives was unwarranted.

ADEQUACY OF POLICYHOLDER NOTIFICATION

The adequacy of the policyholder notification regarding the basement coverage limitations has been upheld in the federal courts. In January 1985, a federal district court ruled that FIA's notification procedure was legally adequate and a federal appellate court upheld this decision.

We received comments from FIA generally agreeing with the report message but suggesting certain clarifications, which were incorporated where appropriate.

As arranged with your offices, we are sending copies of this report to the Director, Office of Management and Budget; the Director, Federal Emergency Management Agency; interested congressional committees, subcommittees, and individual Members of Congress; and other interested parties. Copies will be available to others on request. If you have any questions about this report, please call me at (202) 275-6111.

John H. Luke

John H. Luke
Associate Director

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ABBREVIATIONS

CSC	Computer Sciences Corporation
FEMA	Federal Emergency Management Agency
FIA	Federal Insurance Administration
GAO	General Accounting Office
NFIP	National Flood Insurance Program
RCED	Resources, Community, and Economic Development Division

THE FEDERAL EMERGENCY MANAGEMENT AGENCY'S

DECISION TO LIMIT FLOOD INSURANCE FOR BASEMENTS

INTRODUCTION

Authorized in 1968 at a time when flood insurance from private insurers generally did not exist, the National Flood Insurance Program (NFIP) currently makes flood insurance available to property owners in about 17,700 flood-prone communities. The insurance program is administered by the Federal Insurance Administration (FIA) of the Federal Emergency Management Agency (FEMA). The objectives of the program include

--making flood insurance available to property owners on a nationwide basis,

--identifying all flood-prone areas in the nation,

--promoting state and local land-use controls to minimize flood loss and guide development away from flood-prone areas, and

--reducing federal expenditures for disaster relief.

As of March 1985, about 1.9 million flood insurance policies were in force with a total insurance value of $122 billion. The average amount of insurance per policy was about $65,700.

From its inception, the program has not been self-supporting. Under FEMA's legislation, subsidized flood insurance is available to all property owners in communities participating in the program, if construction or substantial improvement of the building they own started before the effective date of the initial detailed flood insurance rate map for that community or before January 1, 1975, whichever is later. For example, as of October 1985, some insurable structures (about 83 percent) qualified for subsidized flood insurance coverage and some did not (about 17 percent). As of October 1985, FEMA and its predecessor agencies have had net cumulative borrowings of about $1.2 billion from the U.S. Treasury to cover the program costs. The program deficit has, in part, resulted from providing subsidized insurance rates which do not recover the program's claim payments, payments to claims adjusters, and insurance agents' commissions. The program's deficit also resulted from methodological and data weaknesses identified by GAO and/or FIA in the approach FIA used in setting insurance rates.[1] Rate classifications used in the program are explained in appendix II.

After the program had experienced repeated losses, FIA announced in 1981 that it planned to have a self-supporting flood insurance program by fiscal year 1988. Under this plan premiums would be sufficient to cover annual program losses based on NFIP historical averages. The premiums would not be designed to cover the truly catastrophic flooding (such as Hurricane Agnes in 1972) which the NFIP had not been subject to, according to FIA. In general, accepted actuarial principles stipulate that a sound insurance rate structure ensures the financial integrity of the insurance rate system by collecting adequate amounts of

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[1]Detailed discussions of this subject and the various subsidies of the flood insurance program are contained in National Flood Insurance Program--Major Changes Needed If It Is to Operate Without a Federal Subsidy (GAO/RCED-83-53, Jan. 3, 1983).

premium income while charging policyholders rates that equitably reflect their risk. Based on discussions we held with insurance industry officials, actuaries, and underwriters in developing our 1983 report, an actuarially sound rate provides premiums to pay all applicable costs of providing insurance, including losses and a contingency, or reserve, for extraordinary losses.

In our 1983 report, we concluded that establishing an actuarially sound program would require an increase in the rates and/or a decrease in the insurance claims payments through such means as increasing the deductible limit for claims, requiring co-insurance for a portion of the loss, or reducing coverage for minor items regularly damaged by flooding. Such actions could be harmful to the program objectives if they resulted in reduction of participation and increased federal disaster assistance and casualty loss tax write-offs. FIA monitors program participation on a monthly basis and has recognized that it may be necessary to extend the 1988 time frame for eliminating the federal subsidy. FIA has retained the 1988 time frame in its fiscal year 1986 goals.

In summary, the steps FIA has taken since 1981 to develop an actuarially sound program include

--raising the average insurance policy premium from about $79 in 1980 to about $221 in 1984;

--increasing the amounts of deductibles and options available to policyholders;

--simplifying the insurance rating structure;

--increasing the involvement of the private insurance industry in marketing flood insurance;

--adding quality control checks and reviews to help assure that premiums charged are based on accurate property descriptions;

--revising the claims and actuarial information procedures; and

--limiting insurance coverage of high risks, including building contents located under elevated buildings and in basements.[2]

FEMA's AUTHORITY TO LIMIT BASEMENT INSURANCE COVERAGE

Based on our review of the National Flood Insurance Act of 1968, as amended, and its legislative history, we believe FEMA has authority to limit insurance coverage. In response to our question on FEMA's authority to change the insurance coverage, FIA said the National Flood Insurance Act of 1968, as amended, provides FEMA with authority to implement a property insurance program that combines insurance coverage, risk assessment, loss reduction, and insurance rating. The act authorizes a nationwide insurance program based on workable methods of pooling risks, minimizing costs, and distributing costs equitably among

[2]The flood insurance program's definition of a basement is an area of a building having its floor below ground on all sides. FIA does not consider "walk out" basements as basements for insurance purposes.

policyholders and the public. Section 1307(a) authorizes studies and investigations to estimate insurance rates based on consideration of the risk involved and accepted actuarial principles.

Under section 1306, FEMA's Director is authorized to provide, by regulation, the general terms and conditions of insurability. This section includes authority to specify the nature and limits of loss or damage in any areas covered by flood insurance; the classification, limitation, and rejection of risks; and any other terms and conditions relating to insurance coverage or exclusion which may be needed to carry out the program.

FIA said its decision to limit flood insurance coverage of basement contents is authorized under several provisions of the act, including those cited above. We concur with this position.

DEVELOPMENT OF BASEMENT COVERAGE LIMITATIONS

According to the Deputy Administrator and other FIA officials, FIA developed the basement coverage limitations based largely on (1) reviews performed by contractors in 1981 and 1982 of flooding in Friendswood, Texas; Tulsa, Oklahoma; and Staten Island, New York and (2) an examination of claim data by FIA's actuarial/engineering committee.[3]

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[3]FIA established the actuarial/engineering committee in April 1982. The committee, composed of agency staff, was started as part of FIA's efforts to make the flood insurance program actuarially sound and to develop solutions to program problems by analyzing insurance, hydrologic, and engineering data.

The three reports prepared by the contractors are described below. Two of these reports do not specifically mention basement flooding but, according to program officials, were used as background material for flooding in general.

Friendswood, Texas

--Flooding outside the 100-year flood plain[4] of Friendswood, Texas, was caused by tropical storm Claudette in July 1979. There were 869 claims valued at $19.9 million in the area of Friendswood outside the 100-year flood plain. The report concluded that, (1) Claudette's severity (estimated to be a storm with 1 chance in 500 of occurring in a given year) was the major reason for extensive flooding, (2) 15 percent of a sample of claims were incorrectly rated as outside the 100-year flood plain, and (3) the local drainage system's capacity was exceeded and resulted in flooding.

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[4]The 100-year flood plain is that area which is expected to contain the waters of hurricanes and other flooding events that have a 1 percent chance of occurring during a given year.

Tulsa, Oklahoma

--Based on a review of 88 claim files ($413,068 in claims payments), the report concluded that, (1) B and C zone[5] claims would be reduced by 20 to 25 percent if all policies were properly rated as being in the 100-year flood plain using a revised flood rate map, (2) at least an additional 10 percent of the B and C zone properties should be rezoned to reflect a higher risk than their rating, (3) about 34 percent of the claims with about 23 percent of the damage appeared to be caused by local drainage problems, (4) the community appeared to be actively attempting to reduce flood losses through regulation and storm water management, and (5) some claims appeared to be unreasonably high.

Staten Island, New York

--Between May 1977 and February 1982, 10,409 claims from this area amounting to about $24 million were paid. The report concluded that local drainage flooding was a severe and chronic problem in Staten Island and the major factor contributing to losses. The report cited improper design and/or maintenance of the local drainage sewer systems as an apparent significant cause of the condition.

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[5]The B and C zones are those areas outside the 100-year flood plain that have been identified in the community flood insurance study as areas of moderate or minimal hazard from the principal source of flooding in the area. Buildings in these rate zones, however, could be flooded by severe, concentrated rainfall. The inadequacies of local drainage systems are not normally considered in the community's flood insurance studies. The failure of a local drainage system creates areas of high flood risk within these rate zones. Flood insurance is not required but should be purchased in these zones, according to FIA.

In the fall of 1981, an engineering consulting firm reviewed a list of the 100 program communities that had the highest amounts of flood insurance claims. The firm found that the list contained several major urban centers and that there were few significant storms related to the claims history. Of the $980 million in claims paid between 1978 and 1981, $226.4 million, or 23.1 percent, was for damages caused outside the 100-year flood plain. Based on their review of 10 years of claims data and previous experience in Texas and Louisiana flooding investigations, the firm hypothesized that local drainage flooding was a significant cause of the flooding outside special flood hazard areas.

In August 1982, FIA's actuarial/engineering committee initiated a study of basement damage. Several profiles of claims experience for buildings with and without basements were prepared for and reviewed by the committee. Table I.1 is an example of such a profile.

Table I.1: Comparison of Flood Insurance Claims for Buildings With and Without Basements for Calendar Years 1978-82

	Buildings with basements	Buildings without basements
Estimated number of buildings insured	339,583	1,402,771
Premium income	$155,264,251	$674,550,136
Operating expenses	$ 83,028,467	$250,927,359
Claim payments	$626,115,487	$545,137,645
Number of claims	96,859	100,920
Average loss (claims plus expenses) per $1 of premium income	($4.56)	($1.18)

Source: FIA.

FIA concluded from these data that buildings with basements, which represented 15.5 percent of its policies, were a major source of program losses and that full coverage for finished basements and their contents was not warranted. FIA also concluded that flood insurance policies should serve the basic needs of policyholders and that coverage should be limited to the extent necessary to restore a building to a serviceable, safe, and sanitary condition. Accordingly, FIA concluded that the change in basement coverage would achieve greater administrative and fiscal effectiveness. FIA said the action to limit basement coverage is consistent with practices in the private sector.

On April 8, 1983, FIA announced in the Federal Register that it would consider public comments received over the next 60 days on the proposed basement coverage limitations. The proposal was to change the unlimited coverage of the contents of basements so that only specified items would be covered in the future. These items were oil tanks, furnaces, hot water heaters, clothes washers and dryers, air conditioners, heat pumps, electric junction and circuit breaker boxes, and related electrical connections servicing the building. FIA excluded all other contents, improvements, machinery, building equipment, and fixtures, as well as finished walls, floors, and ceilings.

FIA received 23 comments in response to the proposed changes. After considering these, FIA expanded basement coverage to include food freezers, well-water tanks, and sump pumps and published final regulations on August 29, 1983, to be effective October 1, 1983. We asked FIA officials whether they had excluded basement walls covered with drywall or finished paneling. On December 7, 1984, the FIA Administrator issued a policy interpretation stating that coverage excluded finished basement walls, but included fiberglass insulation, drywalls, and sheetrock walls to the extent of replacing such materials in their unfinished state. In an April 30, 1985, decision the FIA Administrator stated that basement coverage included elevators and related equipment located in basements. The May 1985 NFIP Policy Guidance Handbook extended coverage to replacement of finished paneling with unfinished drywalls and sheetrock walls. Revised regulations published in the Federal Register on September 4, 1985, expanded coverage effective January 1, 1986, to include items such as well-water tank pumps, cisterns, natural gas tanks, and pumps and/or tanks of solar energy systems. FIA officials told us that FIA staff is considering a clarification of "elevators and related equipment" for inclusion in future proposed rulemaking.

Development of insurance loss estimates

FIA's objective in analyzing basement losses was to determine the actual costs per policy for buildings with and without basements and compare them. FIA based its analysis on data such as premium income, expenses, and claims for calendar years 1978 through 1982.[6] In performing its analysis, FIA (1) separated premium income and claims between insurance for buildings with and without basements, (2) allocated expenses for the two categories, and (3) derived loss ratios by comparing claims plus expenses with

[6]Detailed loss and cost data are available only since calendar year 1978.

premium income.[7] In addition, FIA calculated a "pure premium," which is a premium amount needed to cover actual flood losses, for these categories. Table I.2 presents pertinent insurance information that FIA developed.

Table I.2: Analysis of Claim Losses for Calendar Years 1978-82

	Buildings with basements	Buildings without basements
Claim loss frequency[a] (percent)	5.7	1.4
Average claim cost[b]	$8,745.00	$7,027.00
Pure premium[c]	$498.85	$101.11
Average loss per $1 of premium income	$4.56	$1.18

[a]Claim loss frequency equals the number of paid losses per 1,000 annual policy terms. Policy terms are the number of policies adjusted for those in effect only part of the calendar year. For example, a policy in effect for 6 months would count as a half policy term.

[b]Average claim cost is based on loss and loss adjustment expenses at a March 31, 1984, cost level.

[c]Pure premium is the average loss cost per annual policy term at a March 31, 1984, cost level.

Source: FIA.

Based on its analysis, FIA concluded in May 1983 that

--the insurance experience demonstrated very poor claims experience for buildings with basements (claim frequency was about four times that of buildings without basements);

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[7]FIA's Deputy Administrator told us that FIA allocated loss adjustment expenses based on the volume of losses, allocated program administrative expenses based on premium income, and identified the number of policies on an accrual basis.

--the pure premium was almost five times that of buildings without basements; and

--the proposed limitation of coverage may help discourage unwise repairs to flood-damaged finished basements in existing buildings at taxpayers' expense and bring more attention to the risk of damage to basements.

FIA also concluded in a July 1984 report that if the basement coverage limitation and the rating system that was put into effect in response to the poor claims experience had been in place throughout the 5-year period used in its analysis, losses for buildings with basements would have decreased from $4.56 to $2.25 per dollar of premium income. FIA estimated the savings would have amounted to 5 to 10 percent of claims payments, or about $30 million.

FIA's claims analysis did not attempt to measure the potential influence of variations in storm numbers, locations, and intensities. Such information would have been useful in verifying the amount of losses and the difference in losses between basement and non-basement buildings. FIA's Deputy Administrator agreed that storm variations could affect a longer term view of the claims experience. He also stated that while these factors were not explicitly analyzed, he believed that the FIA analysis does not greatly overstate basement losses. FIA's July 19, 1983, report shows wide fluctuations in the average losses per policy that FIA attributed to storm variations. Table I.3 illustrates the program's fluctuating losses.

Table I.3: Average Losses Per Policy for Calendar Years 1970-82

Calendar year	Average losses per policy[a]
1970	$ 16.29
1971	35.00
1972	87.60
1973	204.68
1974	72.51
1975	195.65
1976	53.08
1977	96.59
1978	131.73
1979	315.08
1980	116.38
1981	77.88
1982	97.71

[a]Losses include expenses for services provided in processing flood insurance claims.

Source: FIA.

FIA's report stated that in 1978, 1979, 1980, and 1981 the three worst floods in each of those years accounted for 33 to 52 percent of the total losses over those years. While recognizing that storm experience varies, FIA's Deputy Administrator stated that during the 1978-82 period, the range of coastal and inland flooding was sufficient, in his judgment, to document the loss pattern for basement buildings.

FIA's analysis did not include a random sampling of individual claim files for in-depth review. Individual claim file information was not developed to (1) determine the extent of basement losses to contents or structure and (2) evaluate the potential causes of the higher-than-average claims rate for buildings with basements. FIA's experience, as we reported in

1983 and as discussed in the studies of flood losses in the Staten Island, Friendswood, and Tulsa areas, shows that unusually large amounts of claims, including those involving basements, could be related to several causes. The apparent causes include heavy rainfall, inadequately designed or maintained local drainage systems, and inadequate premium income due to improperly rated property or inaccuracies in mapping flood risk zones.

Following a review of overall claims information, the decision to limit coverage was, in the judgment of FIA officials, an appropriate action to take. FIA officials also told us that the final selection of specific items to continue to cover was primarily based on their judgment about the program's intent and policyholders' basic needs to put their homes into serviceable condition and not on detailed claims information. FIA estimated that the limitations in coverage, based on judgmental assumptions, would result in about a 10-percent reduction in average claim cost for buildings with basements.

Based on an analysis of claims from flooding in Pikeville, Kentucky, which occurred soon after FIA implemented the basement coverage limitations, FIA estimated that the basement coverage limitations had reduced the average claim payment for basement buildings in that community by about $1,300, or about 9 percent. Since in the past buildings with basements accounted for about 50 percent of all claims settlements, the reduction would be about 4.5 percent in the overall program, according to FIA. FIA estimates this savings, plus a reduction of about 5 percent due to a drop in the future claim frequency, would produce a savings of about 10 percent in loss costs per policy, as FIA had earlier estimated. FIA explained that future claim frequency would decline since many small losses in the future may no longer result in a claim because of the combined effect of the basement coverage limitations and the deductible limit of the insurance policies.

Studies of individual claim files could have provided additional evidence to support the basement coverage change FIA made. An FIA contractor reviewed about 100 claims files from Staten Island as a part of its study. The contractor reported that the predominant cause of flooding most often cited in the claims adjusters' reports it reviewed was the "rapid accumulation of surface runoff." The contractor concluded that therefore the reports were not helpful in determining the actual cause of flooding. The contractor's reviews also showed that flooding was confined to basements, all damage was apparently confined to contents, and costs were for cleanup and minor repairs. An FIA technician told us that he reviewed about 50 of these claims files and reached the same conclusions.

As noted earlier however, the Friendswood and Tulsa studies--the other studies FIA said it used in developing basement coverage limitations--do not mention buildings with basements. Also, according to the president of the National Insurance Consumer Organization (a former FIA Administrator), FIA's overall analysis for developing basement coverage limitations should have included a survey of closed claims. This review of past experience would have helped determine the impact of the coverage reduction.

An FIA official said FIA had considered performing additional studies of flood claims to address the various causes of higher-than-average claims rates and has studies underway that will provide additional information on this problem. For example, since September 1984, FIA has incorporated into the claims adjustment process estimates and reports of the dollar impact of the basement property excluded from insurance coverage. As noted earlier, FIA has begun revising the basement coverage limitations and, according to FIA officials, will continue to evaluate the need for further change on at least an annual basis as part of the NFIP policy review performed by FIA's Office of Insurance Policy Analysis and Technical Services.

The FIA analysis did not provide for a loss reserve for catastrophic events. We reported on the need to develop such a reserve in our 1983 report, and FIA plans to consult insurance industry representatives and develop a policy on catastrophic reserves by 1987. FIA officials have estimated that such a reserve should be between $1 billion and $4 billion. Including a catastrophic loss reserve in the analysis would have substantially increased the loss ratios.

OTHER ALTERNATIVES CONSIDERED

In the final version of the program regulations published in the Federal Register, FIA said it considered five alternatives before deciding to limit basement contents' coverage. These alternatives were to (1) provide a grandfather clause to retain finished area[8] coverage for existing structures, (2) offer separate optional coverage for finished basements, (3) place a

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[8]A finished area as it relates to basements is an enclosed area having more than 20 linear feet of finished walls (paneling, etc.) or equipped for uses such as a kitchen, dining room, living room, family or recreational room, or workshop.

surcharge on coverage of finished basements, (4) limit coverage at a future date, and (5) provide coverage for pre-implementation-date basements but only with a larger deductible. FIA commented that it did not select these alternatives due to underwriting concerns and economic considerations. FIA's Deputy Administrator stated that FIA would incur additional costs for actions such as reprinting applications and revising rating systems, billing systems, insurance manuals, and instructions if optional coverage were made available. FIA stated that it believed that the financial risk to the taxpayers who would have to continue subsidizing program losses for full coverage of finished basements was excessive.

FIA provided us with the following additional information for not selecting one of the other alternatives.

Alternative 1. Provide a grandfather clause to retain finished area coverage for existing buildings.

FIA stated that the financial risk to the taxpayers involved in continuation of full coverage was excessive but added that significant coverage has been continued. FIA explained that flood insurance should serve the basic needs of policyholders in accordance with Section 1302(d) of the National Flood Insurance Act, as amended. This section provides that the program be based on workable methods of minimizing costs and that costs be distributed equitably between policyholders and the general taxpaying public.

In addition, FIA stated that owners of existing buildings are not prohibited from replacing at their own expense damaged basement contents that are not covered. This feature, according to FIA, is a significant grandfather privilege, since flood plain management regulations generally prohibit new or substantially improved existing buildings located in special flood hazard areas from having the lowest floor, including the basement floor, lower than the base flood elevation. For all practical purposes, these program regulations restrict new construction of buildings with basements in these flood plains, according to FIA.

In the case of local urban drainage problems, FIA stated that it is not prudent to continue to have the general public indemnify the cost of basement finishings and contents that are subject to repetitive flooding. FIA stated that the property owners or the community must be encouraged to correct the drainage problem and that this coverage limitation is one way of encouraging some local mitigation action to reduce future flood damage. According to FIA, the program is, however, indemnifying the cost of essential building and contents items. Such coverage will make residences habitable and non-residential buildings useful after the flood, thereby providing some very important insurance protection.

Alternatives 2 and 3. Offer separate coverage or place a surcharge on finished basements.

FIA stated that extremely high insurance premiums would be required, given the potential for adverse selection[9] and the current average loss cost per policy incurred on finished basement risks. The average annual premium, according to FIA, would need to be about $650 if all policyholders with basements continued to purchase full coverage. FIA concluded that since this probably would not occur, the program would be insuring only the worst risks, which in turn would necessitate even higher premiums, making this alternative even less attractive to property owners.

Alternative 4. Limit coverage at a future date.

FIA did not believe a postponement was justified given the size of the financial drain of full basement coverage on the flood insurance program.

Alternative 5. Provide coverage for basements in place before October 1, 1983, but only with a larger deductible.

FIA did not believe that using a large deductible was preferable to the coverage limitation selected. According to FIA, establishing cutoff dates as a condition of coverage also

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[9]Adverse selection occurs when insurance premiums are based on average rates (because custom tailoring of premiums is not practicable) set to cover a fairly broad spectrum of risks. Some individuals correctly perceive that their risk is smaller than that implied by the premium. Other individuals perceive that their risk is greater. If the individuals whose properties are at less risk choose not to insure, participation is lowered, the more risky individuals whose properties are at greater risk remain in the program, and a self-reinforcing cycle of higher rates occurs because average risk increases. In theory, participation could eventually drop to zero.

complicates the loss adjustment process and does not seem warranted. As time passes, it would be more difficult for claims adjusters to determine when items had been placed in the basement.

ADEQUACY OF FEMA's NOTIFICATION TO POLICYHOLDERS

The legal adequacy of the policyholder notification regarding the basement coverage limitations has been upheld in the federal courts. One issue considered was whether the policyholder notification procedure provided bold [clear and prominent] notice. The president of the National Insurance Consumer Organization stated that policyholders need to be clearly notified when a major change in insurance coverage is made. He said that good insurance practice would be to provide a boldly printed notice, that could be in red ink, or a cover letter with a renewal notice to policyholders that refers to the change.

FIA provided its policyholders with a printed notice of the change when sending an automated renewal billing notice for policies that were to expire on or after October 1, 1983. The caption on the notice referred to changes that included rate increases and the caption was boldly printed. The third paragraph of the notice included a description of the limitations on basement coverage. (See app. III.)

FIA also provided new applicants as well as existing policyholders a similar notice and explanation of the change in coverage as part of the new insurance contract sent to the new applicants and to existing policyholders following renewal. This second notice and explanation was printed on the back of the insurance declaration page. The terms of insurance contracts issued after October 1, 1983, also reflected the change in coverage.

In addition to the above steps to advise policyholders, FIA reported that in August and September 1983 it sent a series of bulletins to 110,000 agents representing flood insurance policyholders, to 85,000 mortgage lending institutions involved in the program, and to chief executive officers of the 17,000 communities then participating in the flood insurance program advising them of the change in coverage.

Despite FIA's efforts to inform them, some policyholders reported that they were unaware that coverage for finished basements changed when they renewed their flood insurance policies on or after October 1, 1983. In an undetermined number of cases, the policyholders may have relied on the declaration page to ascertain the scope of their flood insurance contract. For example, one declaration page states in pertinent part as follows:

"DESCRIPTION OF BUILDINGS AND CONTENTS

BUILDING: THREE OR MORE FLOORS INCLUDING FINISHED BASEMENT
A SINGLE FAMILY RESIDENCE

CONTENTS: HOUSEHOLD CONTENTS LOCATED
IN BASEMENT AND ABOVE"

FIA stated that the language on the declaration page does not constitute insurance coverage. The declaration page, according to FIA, is simply a computer-generated recitation of the information provided to the National Flood Insurance Program by the applicant for insurance coverage.

Whether FIA's notification of policy changes was legally adequate in cases where the policyholder, relying on the flood insurance policy's declaration page, concluded that basement contents were insured, is a question that was appealed to the U.S. 3rd Circuit Court of Appeals. This appeal stemmed from an action brought by a policyholder against FEMA alleging the inadequacy of the procedures FEMA used to inform policyholders of the changes in basement insurance coverage, effective October 1, 1983. The policyholder received a declaration page that stated on the back that a limitation in basement coverage was in effect, but the front of the declaration page stated: "CONTENTS: HOUSEHOLD CONTENTS LOCATED IN BASEMENT AND ABOVE." The language on the reverse side of the declaration page was prefaced with the following boldface word, "NOTICE", and informed the policyholder that the policy changes effective October 1, 1983, eliminated coverage for certain basement contents.

On January 2, 1985, the United States District Court for the New Jersey District held that FEMA's notification procedure was legally adequate, ruling that the policyholder received actual and constructive notice of the limitation on basement coverage. The court reasoned that FEMA's publication of the revised coverage limitations in the Federal Register and in the Code of Federal Regulations placed the policyholder on constructive notice of the changes. Furthermore, the declaration page was adequate, in the court's view, to provide the insured with actual notice of the reduction in policy coverage despite any suggestion on the declaration page to the contrary.

In a bench decision the United States District Court for the Eastern District of Pennsylvania, however, reached a different result on April 26, 1985. The notification procedures FEMA used in this case were the same as mentioned in the prior case, except that the declaration page indicated that non-residential basement contents were involved, and the court concluded that the declaration page did not contain a boldly printed notice. The court held that it would be unfair to deny the policyholder's recovery under the flood insurance policy because of the policyholder's reliance on FEMA's representation of continued coverage on the front of the declaration page. Further, the court concluded that the declaration page's notice of the limitation on basement coverage was not calculated to bring the policyholder's attention to a change in the insurance coverage.

On September 9, 1985, the New Jersey District Court's decision was appealed to the U.S. 3rd Circuit Court of Appeals. The circuit court--whose rulings serve as precedents for both the districts mentioned--upheld the lower court decision in favor of FEMA on September 17, 1985.

We discussed FIA's notification efforts with FIA's Deputy Administrator. He stated that he believed the notice was adequate and agreed that FIA could have, in retrospect, provided a more prominent notice to policyholders. He added that FIA revised the front of the declaration page, effective October 1, 1984, to show that insurance for basements is limited if the policy is for insurance on a building with a basement.

EFFECT OF BASEMENT LIMITATIONS ON INSURANCE COVERAGE

At our request, FIA had an actuary of the Computer Sciences Corporation (CSC)--the contractor who handles the day-to-day operation of the National Flood Insurance Program--prepare statistics that show the effect on insurance coverage of the basement limitations that became effective on October 1, 1983. The contractor's statistics, as shown in table I.4, show that there was little change in the average dollar amount of insurance coverage for buildings with basements. As agreed with your offices, we did not verify the accuracy of these data. The CSC actuary said that it was not possible to determine what portion of this change was directly attributable to the limitations in basement coverage. Other factors, such as an adjustment in the amount of insurance to compensate for inflation, may have offset any decreases in coverage a policyholder may have requested to reflect the decreased basement coverage.

Table I.4: Basement Building Flood Insurance Policies in Force Prior to 10/1/83 and Also Renewed During the Following 12 Months

	Number of policies	Average amount of insurance		Percent of change
		Prior	Subsequent	
Building coverage	182,333	$33,666.84	$34,343.55	2.01
Contents coverage	116,129	$11,224.33	$11,326.92	0.91

Source: CSC.

FIA has not determined what effect, if any, the limitations on basement coverage may have had on nonrenewal of policies because it does not collect data on why policyholders do not renew their policies. Policies may not have been renewed for reasons such as the sale of the property or a perception of decreased risk of flooding by policyholders in areas where insurance is not required. FIA does monitor the number of policies renewed each month as a percentage of those up for renewal. FIA statistics indicate that the coverage limitations and the rate revisions have not reduced the number of renewals as a percentage of policies up for renewal.

OBJECTIVE, SCOPE, AND METHODOLOGY

As requested by Senator Moynihan and Congressman Gilman, and as agreed to in discussions with their offices, our objective in this review was to examine FIA's limitation of the flood insurance coverage available for basement damage. Specifically, we developed information on FIA's authority to change insurance coverage, FIA's analysis of flood insurance losses to support the basement coverge limitations, the reasons FIA did not select other alternatives for modifying basement coverage, and whether FIA adequately notified policyholders of the basement coverage limitations.

We (1) reviewed the National Flood Insurance Act, as amended, and its legislative history, (2) interviewed FIA and CSC officials responsible for developing, implementing, and monitoring the flood insurance program, (3) reviewed agency records, files, and court decisions pertaining to the program, the decision to limit basement insurance coverage, and alternatives to limiting coverage which FIA considered, (4) reviewed our prior work, and (5) discussed industry standards for such changes with the president of the National Insurance Consumer Organization (a former FIA Administrator) who was familiar with both the NFIP and the private insurance industry.

AGENCY COMMENTS

We received comments from FIA generally agreeing with the report message but suggesting certain clarifications, which were incorporated where appropriate.

We relied on information supplied by FEMA, its files, and discussions with program officials in preparing this report. Also, as agreed with the Senator's and Congressman's offices, we did not independently verify the accuracy of the insurance claims data or FIA/CSC data analysis. We conducted our work between June 1984 and July 1985 in accordance with generally accepted government auditing standards.

NATIONAL FLOOD INSURANCE PROGRAM RATE CLASSIFICATIONS

FEMA provides flood insurance through an emergency and a regular program. The rates charged and the insurance coverage depend on the program.

Under the emergency program, FEMA provides limited amounts of insurance at federally subsidized, or "chargeable," rates on all structures, pending completion of a flood insurance rate map which identifies the rate zones in the community. To be eligible a community is required to (1) apply officially to participate in the program and (2) adopt minimum flood plain management regulations to guide new construction in the flood-prone areas.

A community enters the regular program after two principal conditions are fulfilled. First, local officials must enact regulations that require all new or substantially improved structures to be built according to federal flood plain management criteria. Second, FEMA must prepare a flood insurance rate map to identify flood-prone areas and to assist in setting insurance rates. To receive federal financial assistance for acquisition or construction purposes, insurance is required in the special flood hazard areas. These areas are typically comprised of zones adjoining a river, stream, lake, or ocean. Insurance is optional in less hazardous zones.

The regular program has two classes of rates. Under NFIP regulations, existing structures built before December 31, 1974, or the effective date of the flood insurance rate map, whichever is later, may continue to pay the chargeable rate for a basic amount of insurance coverage. New structures whose construction was started after December 31, 1974, or on or after completion of the rate map must pay a "risk premium" rate for basic coverage. Risk premium rates are also called actuarial rates and are intended to cover the costs associated with providing flood insurance for such new or improved structures. The National Flood Insurance Act of 1968, as amended, requires that risk premium rates be charged for any additional coverage for both existing and new structures.

FIA NOTICE OF INSURANCE COVERAGE CHANGES, EFFECTIVE OCTOBER 1, 1983

PLEASE NOTE: EFFECTIVE OCTOBER 1, 1983, CHANGES ARE BEING MADE IN THE STANDARD FLOOD INSURANCE POLICY, WHICH INCLUDE RATE INCREASES FOR MANY POLICYHOLDERS.

Over the last 33 months, the cost of processing and issuing policies, in spite of inflation, has remained constant. However, increased costs and flood losses in our nation continue to produce large deficits for the National Flood Insurance Program and has made it necessary to borrow a considerable amount of money from the U.S. Treasury to meet flood insurance claims payments. During the first seven months of the current government fiscal year, over $240 million has been paid out to policyholders because of flood damage to insured property, producing an operating deficit of $129 million, which is underwritten by taxpayer funds.

In an effort to bring the National Flood Insurance Program closer to a self-supporting basis, rates have been increased. A genuine effort has been made to decrease the amount of tax dollars needed to subsidize the program and, at the same time, to distribute the rates more equitably among flood insurance policyholders. The average increase in cost is $18 a year ($1.50 per month), with the largest average increase affecting V-Zones (beach properties subject to wave action), where costs increase about $43 a year ($3.60 per month).

In addition to increasing rates, some insurance policy changes, for both new and existing construction, have also been introduced that will help to reduce the overall cost of the program. Some of the major changes are:

I. New and renewal policies ***do not cover*** flood damage to:

1. finished walls, floors, ceiling or other similar construction or improvements to a basement area
2. enclosures and building components located below (at a lower elevation or level) the lowest elevated floor of an elevated building (except for the required utility connections and the footing, foundation, posts, pilings, piers or other foundation walls and anchorage system as required for the support of the elevated building)
3. contents, building machinery and equipment located in a basement area or below the lowest elevated floor of an elevated building (except for stairways and staircases attached to the building and not separated from an elevated building by elevated walkways); and, in the case of a building the start of construction or substantial improvement of which occurred prior to October 1, 1983, coverage is provided for sump pumps, well-water tanks, oil tanks, furnaces, hot water heaters, clothes washers and dryers, food freezers, air conditioners, heat pumps and electric junction and circuit breaker boxes (located as mentioned above).

II. In addition to the basic deductible of $500 for each loss to building and contents, and the $3,000 deductible also currently available for properties located in coastal high hazard areas (Zones V and V1 to V30), optional deductibles in $1,000 increments up to a maximum of $5,000 will be available commencing April 1, 1984 in all zones, and a policy may be endorsed for a deductible higher than the basic $500 or V-Zone-optional $3,000 deductible on or after April 1, 1984. The higher deductibles will provide a means for policyholders who are primarily concerned with protection for a major catastrophe to reduce their flood insurance premiums. Reductions range from 10 percent to 35 percent.

III. The policy provides for recertification of the rating information used to rate the most recent application or renewal. This will be accomplished by the mailing of a recertification questionnaire to insureds where there may be some question concerning the accuracy of the information contained in our computer records or where the rating information has not been recently updated.

If you have any questions about the new rate changes and policy changes, please see your local insurance agent.

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