



# MARLOWE & COMPANY

GOVERNMENT AFFAIRS CONSULTANTS

## Memo

**To:** Marlowe & Company Clients  
**From:** Toby Hicks, Legislative Intern  
**Re:** National Flood Insurance – Write-Your-Own Program  
**Date:** November 2, 2009

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### Background

Since 2004, the Federal Emergency Management Agency (FEMA) has paid Write-Your-Own (WYO) program insurance companies (WYOs) \$2.3 billion annually, of which the WYOs have been allowed to retain around \$1 billion per year. WYO was implemented to support the National Flood Insurance Program's (NFIP's) goals of increasing flood insurance market penetration in low-risk flood zones, among homeowners without federally-related mortgages in all zones, and in geographic areas with repetitive flood damage and low penetration rates. The large percentage of FEMA payments retained by the WYOs prompted the Government Accountability Office's (GAO's) audit of WYO. GAO released a critical report in August concerning their analysis of the WYO program during the years 2005-2007. This report lays out three problems GAO found with the WYO program, four recommendations from GAO to FEMA, possible alternatives to the WYO program, and the Department of Homeland Security's (DHS') response to the critique of WYO and FEMA.

### Problems GAO found

GAO found three problems in the course of their analysis of WYO program oversight.

GAO found that FEMA does not have or use the information it needs to determine whether its WYO expenditures are reasonable or even the amount of profit WYOs gain from FEMA's payments. Flood insurance expense information has been available to FEMA since 1997 but not considered when setting WYO payment rates. Additionally, FEMA has not compared any WYOs' expenses to the payment FEMA provided them. In 1997 FEMA increased WYO payment by 1% at the request of WYOs, but GAO found that even before the 1% increase WYO payments already exceeded each WYOs' operating costs. For the calendar years of 2005-2007 GAO found that FEMA's payments exceeded WYOs' expenses by \$327.1 million, or 16.5% of the total WYO payments made.

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Secondly, FEMA has not aligned WYO bonus structure with its long term goals for the NFIP program. The current bonus program awards a 0.5 to 2% bonus if WYOs achieve a 2 to 5% net growth in flood insurance policies per year. GAO points out that this bonus formula favors companies new to NFIP when it is easy to increase policies from a low starting level. Additionally, external factors like flood events, changes in the housing market, and economic developments may be the driving force behind a WYOs' increase in policy sales. GAO observed that WYO bonuses have generally tracked flood losses between 1996 and 2006 and that the top tier 2% bonuses were received by a vastly disproportionate amount (86.4%) of small and medium WYOs than by large and very large WYOs who had accounted for 95% of the premiums written in FY 2008. Adding to the bonus program's design flaws, its unimportance can be seen in how it is regarded by WYOs. Most WYOs did not consider it critical to their marketing strategy and some offered flood insurance only when requested, and did not market it as they do their primary line.

Finally, GAO found that FEMA has not fully implemented each aspect of the Financial Control Plan for the WYO program. FEMA did collect almost all the required monthly data submissions, WYOs whose claims were selected to be reinspected were reinspected and biennial audits and underwriting, and triennial claims reviews were implemented. However, audits for cause and state insurance department audits, and marketing, litigation, and customer service triennial operation reviews were rarely implemented. Of additional concern was that within FEMA there is no centralized repository for this information. Financial Control Plan responsibilities are spread between multiple units. In special cases FEMA had exempted from biennial audits the WYOs who were overwhelmed with their administration of flood claims following the 2005 hurricane season.

### **Recommendations made by GAO**

GAO put forth four recommendations that they believe will rectify the three problems found.

First, that FEMA provide transparency and accountability over the payments it makes to WYOs. This includes determining in advance the amounts built into the payment rates for estimated expenses and profit, annually analyzing the amounts of actual expenses and profit in relation to the previously estimated amounts, considering the results of these analysis when evaluating a method of paying WYOs, and reassessing the practice of paying WYOs the current additional 1% premium. Secondly, that the data WYOs provide to the National Association of Insurance Commissioners (NAIC) is made more useful by ensuring it can be analyzed to set payment rates for the WYO participants and that the data WYOs provide can be tested annually to ensure data quality. Thirdly, that, should FEMA continue to use the WYO bonus program, they should improve it by revising its marketing goals to more closely parallel the NFIP's larger goals. Finally, that FEMA should follow its Financial Control Plan and Procedures more faithfully to improve oversight of WYO insurance companies.

### **Alternatives to WYO:**

GAO identified three alternative administrative structures which could replace WYO. Each alternative structure is based on the goal of lowering NFIP costs through a competitive arrangement. The three alternative structures are that FEMA could contract with one or more insurance companies, a single vendor, or with multiple vendors and while still maintaining the WYO network. The best comparison of the differences, advantages, and disadvantages between these options is graphical and derived directly from the GAO report as Figures 1 and 2 in this document's appendix.

### **The Department of Homeland Security's response:**

DHS commented substantively on three specific statements from GAO's report by correcting them or explaining DHS' actions, and concurred or non-concurred with the four GAO recommendations.

Firstly, DHS clarified their perspective of why they "do not systematically consider actual WYO company expenses when setting payment rates." Their reasoning is that it would not be possible for NFIP to accurately calculate expenses for all 90 WYOs, and it is more efficient and accurate to use figures provided based on five similar lines of property coverage from the company A.M. Best. This choice to base WYO premium payments on a package of non-flood insurance types is also motivated by the fact that those insurance packages are competitive lines of coverage which minimizes expenses and therefore benefits NFIP. Flood insurance would otherwise be noncompetitive because only NFIP strives to provide it.

Additionally, DHS explained six points from which they deem the GAO study resulted in misleading conclusions. Most importantly, GAO examined only the six largest (of over 90) insurance companies that participate in WYO. These six companies represent 53% of the total WYO program net premiums written, 71% of total WYO program claim losses paid, and 59% of total expense payments FEMA made to the approximately 90 WYOs during the fiscal years 2005-2007. GAO also interviewed officials from FEMA, WYOs, and NAIC. FEMA argues that the six WYOs in the study are the low cost operators for the five non-flood lines of insurance used to determine WYO expense allowance and thus explains why these companies have such low operating expenses. GAO responded simply that their analysis and finding of vast WYO overcompensation showed that the NFIP's current system is lacking critical information.

DHS also provided five other objections to the GAO study which are summarized here. DHS objected that the GAO based their recommendation to use flood insurance costs on only one year of data. GAO agreed that basing WYO payments on one year of data was not their intent, but stated that basing payments on flood insurance data may still be better than using the A.M. Best basket of five non-flood insurance types because doing so leads to externalities and cost changes from events that are not flood related. FEMA objected that the GAO suggestion of using actual WYOs' expenses would be as much of a lagging indicator as the A.M. Best numbers; GAO reiterated that, although both are lagging indicators, using actual WYOs' expenses still reduces externalities. FEMA objected that the GAO analysis assumed WYOs' expenses to be stable; GAO acknowledged that they made that assumption, but that it is irrelevant in the analysis' context. FEMA objected that GAO results are distorted because the GAO analysis was based on the heaviest loss years on record for NFIP (2005-2007). GAO countered that their recommendations took this into account and that their methodology of payments based on actual expenses would have prevented WYO overpaying during those years. Lastly, FEMA stated that it has already fixed the problem of outsized WYO compensation by introducing the new Unallocated Loss Adjustment Expenses (ULAE) system; GAO responded that the effect of the ULAE system on fiscal years 2005-2007 can only be speculative.

Second, in their response DHS clarified their perspective of why "FEMA followed some but not all of its internal control requirements and procedures." With regard to the GAO claim that FEMA did not perform audits for case, FEMA explained that audits for case are not required unless the Federal Insurance Administrator, the Standards Committee, or the OIG require them. Departments of Insurance audits are also not required unless FEMA is alerted of an audit involving NFIP activity. With regard to expensive litigation reimbursements FEMA explained that in a more recent Financial Control Plan than was provided to GAO, litigation expenses must be approved by FEMA if they amount to \$5,000 or more. With regard to there being no central repository of

Financial Control Plan Information, FEMA explained that reinspections and biennial audits findings are internally dispersed to the relevant people. Finally, in regard to the GAO claim that litigation, marketing, and customer service reviews were not done, the FEMA response hints that they were unimportant at the time and that they are not included in the most recent Financial Control Plan.

Finally, DHS commented on why the alternative WYO program administrative structures proposed by the GAO would be unfeasible. Their rebuttal centered on the claim that the resources and expertise of the private insurance industry has been shown critically important to the selling and servicing of NFIP policies especially during catastrophic events.

Having explained their clarifications, DHS proceeded to specifically review the four GAO recommendations. DHS did not concur with GAO's first recommendation concerning increased transparency and accountability, and specifically that FEMA should consider WYOs' actual expenses and profits when setting payment rates. Their decision was based on the aforementioned objections to the GAO's methodology and that calculating profit to set WYO expense allowance would negatively affect the overall NFIP goals by reducing the number of WYOs who choose to participate. DHS concurs with GAO's second recommendation that improving the quality of flood expense data reported to the NAIC is a good suggestion and that FEMA will include this improved data as an additional variable when calculating annual WYO expense allowance. DHS concurs with GAO's third recommendation that the WYO bonus program is not perfectly aligned with NFIP's goals and states that they will examine it and look for ways to improve it for the 2010-2011 fiscal year. DHS concurs with GAO's fourth recommendation concerning improved oversight of the WYO program and stated their intent to adhere to the Financial Control Plan.

## **End**

For more information please refer to the original August 2009 GAO document entitled "Report to the Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate." The referred to Table 8, Figure 12, and DHS Comments Letter can be found in that document on pages 70, 69, and 77-81 respectively.

## **Common acronyms used**

FEMA	Federal Emergency Management Agency
WYO	Write-Your-Own [program]
WYOs	Write-Your-Own [insurance companies]
NFIP	National Flood Insurance Program
GAO	[The] Government Accountability Office
DHS	Department of Homeland Security
NAIC	National Association of Insurance Commissioners

*For further information on this issue, please contact your Marlowe & Company team leader or email [legislation@marloweco.com](mailto:legislation@marloweco.com)*

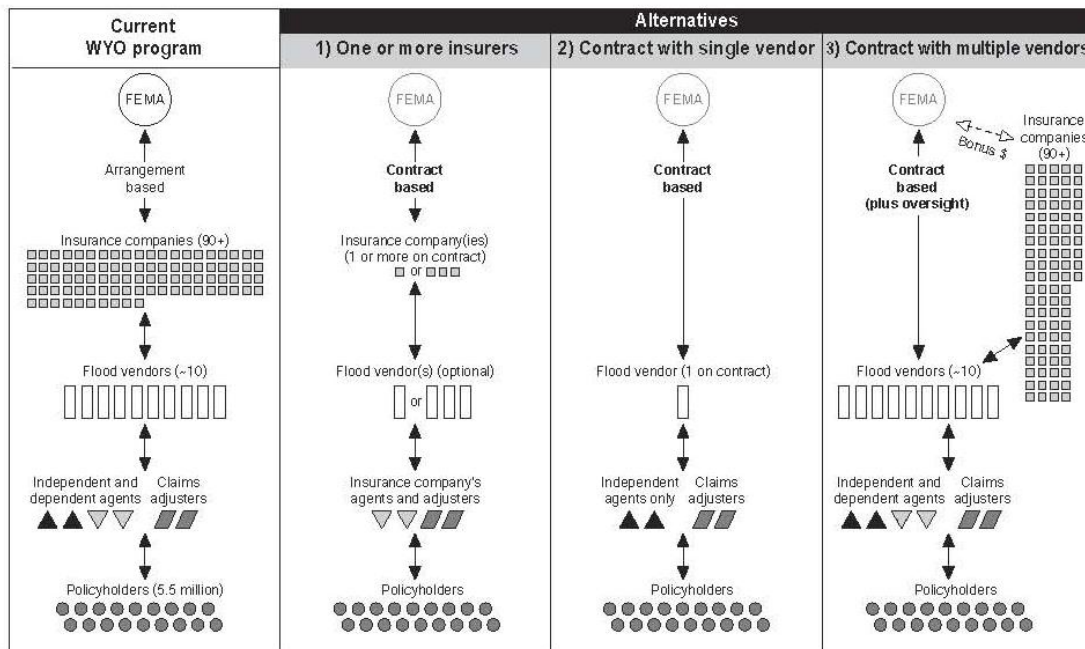
Figure 1. Reproduced from p. 70 of the August 2009 GAO document entitled “Report to the Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate.”

Table 8: Advantages and Disadvantages of Alternative WYO Structures

Alternative structures	Advantages	Disadvantages
<b>Current program: WYO program</b>	<ul style="list-style-type: none"> <li>-- Incorporates insurance industry; maximizes the number of companies and agents selling flood insurance and the number of claims adjusters.</li> <li>-- Offers presence in all states and territories.</li> <li>-- Has increased participation in the program since 1983 by 3.7 million policies.</li> </ul>	<ul style="list-style-type: none"> <li>-- Insurers are compensated per a schedule of fees rather than under a competitively awarded contract.</li> <li>-- FEMA has not consistently been able to oversee the large number of WYO companies.</li> <li>-- WYOs typically resort to using vendors to conform to the terms of the program, and FEMA does not have direct oversight of these vendors.</li> </ul>
<b>Alternative 1: FEMA contracts with one or more insurance companies</b>	<ul style="list-style-type: none"> <li>-- Incorporates competition, potentially leading to lower costs.</li> <li>-- Incorporates insurance industry.</li> <li>-- Makes oversight easier because fewer companies are involved.</li> </ul>	<ul style="list-style-type: none"> <li>-- A competitive process may or may not reduce the price per policy.</li> <li>-- Insurance companies may not want to be federal contractors.</li> <li>-- It minimizes the number of insurance companies by reducing the number of agents, limiting choice for consumers.</li> <li>-- Insurers may not offer presence in all states and territories.</li> </ul>
<b>Alternative 2: FEMA contracts with one vendor</b>	<ul style="list-style-type: none"> <li>-- Incorporates competition, potentially leading to lower costs.</li> <li>-- Makes oversight easier, with one company to oversee.</li> <li>-- Improves administrative efficiency because flood vendors service most flood policies for the WYOs.</li> </ul>	<ul style="list-style-type: none"> <li>-- The insurance industry is not directly involved.</li> <li>-- The sales network is restricted to independent agents.</li> <li>-- 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.</li> <li>-- Independent agents may prefer to sell through insurance companies that they have a relationship with rather than through a vendor.</li> </ul>
<b>Alternative 3: FEMA contracts with multiple vendors and maintains the WYO network</b>	<ul style="list-style-type: none"> <li>-- Incorporates competition, potentially leading to lower costs.</li> <li>-- Incorporates insurance industry; maintains the current network of insurance companies and their sales force.</li> <li>-- Removes the need to pay WYOs for servicing and claims-related expenses.</li> <li>-- Makes oversight easier because FEMA has a contractual relationship with significantly fewer companies.</li> </ul>	<ul style="list-style-type: none"> <li>-- A competitive process may or may not reduce the price per policy.</li> <li>-- The direct relationship between the insurance industry and FEMA is severed, so FEMA might be less likely to incorporate insurance industry input.</li> <li>-- Participating insurance companies would be required to use a vendor, even if they did not currently use one.</li> </ul>

Figure 2. Reproduced from p. 69 of the August 2009 GAO document entitled “Report to the Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate.”

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



Source: GAO.