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DEPARTMENT OF HOMELAND SECURITY

Federal Emergency Management Agency

44 CFR Part 62

Docket ID FEMA-2017-0025

RIN 1660-AA90

National Flood Insurance Program (NFIP); Revisions to Methodology for Payments to Write Your Own (WYO) Companies

AGENCY: Federal Emergency Management Agency, DHS.

ACTION: Advance Notice of Proposed Rulemaking.

SUMMARY: As directed by the Biggert-Waters Flood Insurance Reform Act of 2012, the Federal Emergency Management Agency (FEMA) intends to modify the way it pays private insurance companies participating in the Write Your Own (WYO) Program. FEMA seeks comment regarding possible approaches to incorporating actual flood insurance expense data into the payment methodology that FEMA uses to determine the amount of payments to WYO companies.

DATES: Comments must be submitted by [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: You may submit comments, identified by Docket ID FEMA-2017-0025, by one of the following methods:

Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.

Mail/Hand Delivery/Courier: Regulatory Affairs Division, Office of Chief Counsel, Federal Emergency Management Agency, 8NE, 500 C Street, SW, Washington, DC 20472.

FOR FURTHER INFORMATION CONTACT. Sarah Ice, Federal Insurance and Mitigation Administration, FEMA, 400 C St. SW, Washington, D.C. 20472 (mail); (202) 320-5577 (phone); or sarah.devaney-ice@fema.dhs.gov (email).

SUPPLEMENTARY INFORMATION:

I. Public Participation

We encourage you to participate in this rulemaking by submitting comments and related materials. We will consider all comments and material received during the comment period.

If you submit a comment, identify the agency name and the docket ID for this rulemaking, indicate the specific section of this document to which each comment applies, and give the reason for each comment. You may submit your comments and material by electronic means, mail, or delivery to the address under the ADDRESSES section. Please submit your comments and material by only one means.

Regardless of the method used for submitting comments or material, all submissions will be posted, without change, to the Federal e-Rulemaking Portal at http://www.regulations.gov, and will include any personal information you provide. Therefore, submitting this information makes it public. You may wish to read the Privacy and Security Notice that is available via a link on the homepage of www.regulations.gov.

Viewing comments and documents: For access to the docket to read background documents or comments received, go to the Federal e-Rulemaking Portal at http://www.regulations.gov. The public may also inspect background documents and submitted comments at FEMA, Office of Chief Counsel, 500 C Street, SW., Washington, DC 20472-3100.

II. Glossary of Terms, Abbreviations, and Frequently Used Acronyms

To aid the reader, the following glossary (Table 1) defines technical terms most commonly used throughout this notice.

Table 1 - Glossary of Frequently Used Technical Terms

Term	Definition
Allocated Loss Adjustment Expense (ALAE)	A loss adjustment expense that is assignable or allocable to a specific claim, usually adjuster fees.
Credibility	(1) An actuarial term describing the degree of accuracy in forecasting future events based on statistical reporting of past events. (2) The weight assigned or assignable to observed data in contrast to that assigned to an external or broader-based set of data. Credibility is used to provide a measure of the relative predictive value of the data being reviewed. Weights can be determined through detailed formulas or by judgment. The weight assigned should generally increase with the number of exposure bases in the observed data and should decrease with higher levels of variability in the observed data.

General Expenses	An insurer's marketing, operating, and administrative expenses. Does not include loss adjustment expenses.
Incurred Loss	Sustained losses, paid or not, during a specified time period. Incurred losses are typically found by combining losses paid during the period plus unpaid losses sustained during the time period minus outstanding losses at the beginning of the period incurred in the previous period.
Loss Adjustment Expense (LAE)	The cost of investigating and adjusting a loss.
Net Written Premium	Written premium less deductions for reinsurance premiums and any commissions resulting from the purchase of reinsurance.
Paid Losses	Losses and allocated loss adjustment expenses (ALAE) paid to policyholders during a financial reporting period.
Ratio	Percent. For example, the percentage of ratio 2:4 is 50%. (2:4 can be written as 2/4; 2 divided by 4 equals .5, or 50%).
Special Allocated Loss Adjustment Expense (SALAE)	A loss adjustment expense assignable or allocable to a specific claim that is not covered as ALAE because the expense is not applicable in a standard claim. For example, an insurance company may need to hire an engineer to determine if flooding caused a covered loss or an expert to determine the extent of damage to a large piece of machinery. SALAE also includes litigation costs associated with a

	specific claim.
Unallocated Loss Adjustment Expense (ULAE)	All external, internal, and administrative claims handling expenses, including determination of coverage, that are not included in allocated or special allocated loss adjustment expenses.
Written Premium	The premium registered on the books of an insurer or a reinsurer at the time a policy is issued and paid for. This also includes any changes to that premium due to cancellations or mid-term endorsements.

To further aid the reader, the following table (Table 2) provides abbreviations and acronyms frequently used in this notice.

Table 2 - Abbreviations and Acronyms

Term	Abbreviation/ Acronym
Allocated Loss Adjustment Expense	ALAE
Biggert-Waters Flood Insurance Reform Act of 2012	BW-12
Federal Emergency Management Agency	FEMA
Federal Insurance and Mitigation Administration	FIMA
Homeowner Flood Insurance Affordability Act of 2014	HFIAA
Loss Adjustment Expense	LAE
National Association of Insurance Commissioners	NAIC
National Flood Insurance Act of 1968	NFIA
National Flood Insurance Program	NFIP

Special Allocated Loss Adjustment Expense	SALAE
Unallocated Loss Adjustment Expense	ULAE
Write Your Own	WYO

III. Background

A. The National Flood Insurance Program (NFIP) and the Write Your Own (WYO) Program

The National Flood Insurance Act of 1968 (NFIA), as amended (42 U.S.C. 4001 *et seq*.), authorizes the Administrator of the Federal Emergency Management Agency (FEMA) to establish and carry out the NFIP to enable interested persons to purchase insurance against loss resulting from physical damage to, or loss of, real or personal property arising from flood in the United States. *See* 42 U.S.C. 4011(a). Congress intended the NFIP to be "a program of flood insurance with large-scale participation of the Federal Government and carried out to the maximum extent practicable by the private insurance industry." *See* 42 U.S.C. 4001(b). Under the NFIA, FEMA may carry out the NFIP through the facilities of the Federal government, using, for the purposes of providing flood insurance coverage, insurance companies and other insurers, insurance agents and brokers, and insurance adjustment organizations, as fiscal agents of the United States. *See* 42 U.S.C. 4071.

Pursuant to this authority, FEMA works closely with the insurance industry to facilitate the sale and servicing of flood insurance policies. A person can purchase an NFIP flood insurance policy, also known as the Standard Flood Insurance Policy (SFIP), either: (1) Directly from the Federal government through a direct servicing agent, or (2) from a private insurance company (referred to as a WYO company) through the WYO Program. The SFIP sets out the terms and conditions of insurance. FEMA establishes terms of insurance and rates, which are the same whether purchased directly from the NFIP or through the WYO Program.

FEMA enters into a standard Financial Assistance/Subsidy Arrangement (Arrangement) with the WYO companies, which addresses the terms and conditions for administering the NFIP policies, including compensation. FEMA publishes the annual Arrangement in the Federal Register. *See* 44 CFR 62.23(a). FEMA published the Fiscal Year 2019 Arrangement in March 2018, which became effective October 1, 2018. 83 FR 11772 (Mar. 16, 2018).

B. Legislative Mandate to Revise the WYO Compensation Methodology

Congress enacted the Biggert-Waters Flood Insurance Reform Act of 2012 (BW-12) (Title II, Subtitle A of Public Law 112-141, 126 Stat. 405) to extend the NFIP's authorities through September 30, 2017, and to adopt significant program reform. Section 100224 of BW-12 (42 U.S.C. 4081 note) directs FEMA, the Government Accountability Office (GAO), and WYO companies to take a series of actions designed to improve the oversight of compensation provided to WYO companies under the WYO program.

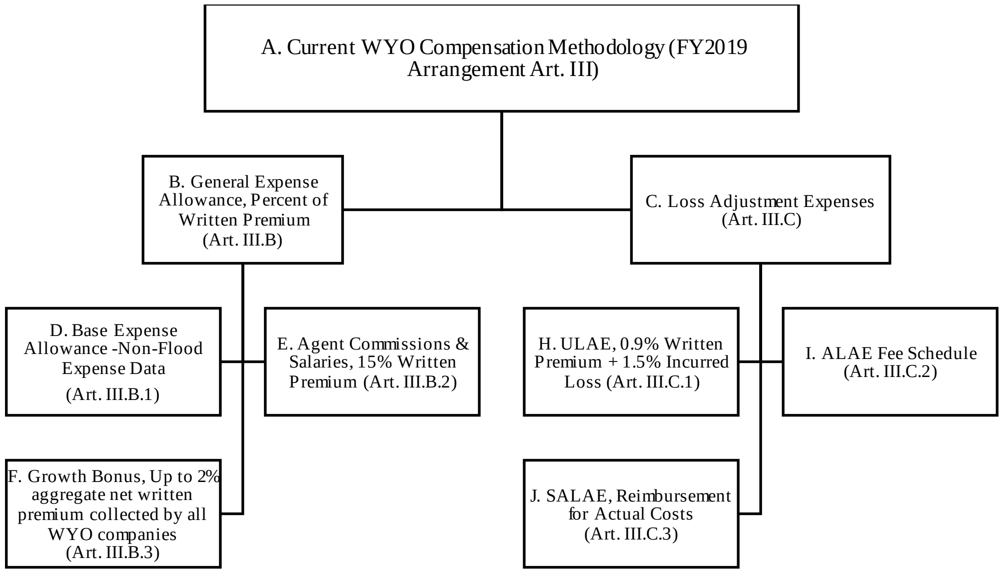
Subsection (b) directs FEMA to develop a methodology for determining the amount of reimbursements paid to WYO companies for selling, writing, and servicing NFIP policies and adjusting claims. FEMA must develop such methodology using "actual expense data for the flood insurance line." FEMA can derive the methodology from either: (1) flood insurance expense data provided by WYO companies; (2) flood insurance expense data collected by the National Association of Insurance Commissioners; or (3) a combination of previous two methods. This methodology is due 180 days following the enactment of BW-12.

Subsection (d) instructs FEMA to "issue a rule" adopting a revised WYO payment methodology. Such methodology must specify compensation in both catastrophic and non-catastrophic loss years and be structured to ensure reimbursements track the actual expenses of WYO companies as closely "as practicably possible." Based on the structure of section 100224, FEMA believes that Congress intended that the rule also align with the methodology FEMA is required to develop pursuant to subsection (b). FEMA intends to adopt a replacement WYO payment methodology via the notice-and-comment rulemaking process in order to comply with this direction.

C. Current WYO Payment Methodology

As set forth in the FY 2019 Arrangement, FEMA currently pays WYO companies for their expenses by authorizing companies to retain a portion of the premiums they collect on behalf of the NFIP. Article III of the Arrangement describes the methodology for calculating the amount WYO companies may keep as compensation. This includes the methodology for paying WYO companies for their marketing, operating, and administrative expenses (collectively referred to as general expenses) (Article III.B of the Arrangement) and the methodology for compensating WYO companies for their loss adjustment expenses (LAE) (Article III.C of the Arrangement). *Figure 1* illustrates this payment methodology.

Figure 1. Diagram of Current WYO Compensation Methodology



1. Marketing, Operating, and Administrative Expenses (General Expenses) (B in Figure 1)

Article III.B of the Arrangement authorizes WYO companies to retain a certain percentage of the written premiums they collect for the NFIP as compensation for their general expenses, including the costs of marketing, selling, and servicing policies.

FEMA calculates the Base WYO Expense Allowance Percentage (D in Figure 1) and then adds additional amounts, as described below. To determine the Base WYO Expense Allowance Percentage, FEMA begins with data from five non-flood insurance lines, namely Homeowners Multiple Peril, Fire, Allied Lines,[1] Farmowners Multiple Peril, and Commercial Multiple Peril (non-liability portion).[2] It uses these five insurance lines because (1) data on flood insurance expenses has only recently become widely available; (2) current reporting of flood insurance expenses has limited reliability; and (3) these non-flood lines are the most similar to flood insurance.[3] FEMA obtains data for these five insurance lines from A.M. Best Company's *Aggregates and Averages* publication.[4] Each of these five insurance lines has various expense categories. FEMA uses three expense categories that fit most closely with flood insurance expenses. These include "General Expenses," "Other Acquisition Expenses," and "Taxes, Licenses, and Fees." For each expense category, FEMA divides actual expenses by the written premium to come up with an expense ratio. For example, if the General Expenses are

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[1] "Allied Lines" are coverages which are generally included with property insurance, such as glass, tornado, windstorm and hail; sprinkler and water damage; explosion, riot, and civil commotion; growing crops; flood; rain; and damage from aircraft and vehicle. *See* http://www.naic.org/consumer_glossary.htm.

[2] The non-liability portion is the portion that deals with property insurance; the liability portion covers non-property based risks, such as civil liability for libel, slander, negligence, and unlawful employment practices. The property side is the side most akin to flood insurance and so FEMA uses that side for its calculation.

[3] As explained later in this notice, in December 2016, the Government Accountability Office (GAO) found that insurers were not consistently reporting flood insurance expense data to the National Association of Insurance Commissioners, resulting in underreporting of certain underwriting and loss expenses for their flood insurance lines. *See* GAO, *Flood Insurance: FEMA Needs to Address Data Quality and Consider Company Characteristics When Revising Its Compensation Methodology* (Jan. 9, 2017), at http://www.gao.gov/products/GAO-17-36.

[4] A.M. Best is an independent rating agency that focuses on the insurance industry. *See* http://www.ambest.com. A.M. Best obtains their data from financial statements submitted to the National Association of Insurance Commissioners (NAIC) by insurers in order to comply with State insurance regulator reporting requirements.

$50 and the written premiums are $5,000, FEMA divides $50 by $5,000 to come up with an expense ratio of 1%, meaning General Expenses equaled 1% of the written premium.

After FEMA calculates the expense ratio for each of the three expense categories, it adds them together to come up with the total expense ratio for each of the five insurance lines identified above. For example, if the expense ratio for General Expenses is 1%, for Other Acquisition Expenses is 5%, and for Taxes, Licenses, and Fees is 2%, FEMA then adds all three together (1 + 5 + 2) to come up with the total expense ratio for that insurance line (1 + 5 + 2=8%), which in this scenario is 8%. FEMA does this calculation for each of the five insurance lines. Once it has the total expense ratio for each of the five insurance lines, it weight averages them (using written premiums as weights) to determine the average expense ratio for all five lines of insurance combined. For example, if the expense ratios for each of the five insurance lines is: 2.6%, 9%, 11%, 13%, and 5%, and each line expressed as a portion of the total premiums of all five lines is: 25%, 25%, 25%, 15%, and 10%, respectively, FEMA multiplies each expense ratio by its portion of total premiums. FEMA then adds the products to get an annual weighted average expense ratio for the non-flood insurance lines of insurance of 8.1% $((2.6\times0.25)+(9\times0.25)+(11\times0.25)+(13\times0.15)+(5\times0.1)=8.1\%)$.

To account for variability from year to year, FEMA then takes the annual weighted average expense ratio that it calculated for each of the previous 4 years, plus the weighted average expense ratio for the current year and averages them. For example, if the current year expense ratio is 8.1%, the previous year 1 ratio is 6%, the previous year 2 ratio is 4%, the previous year 3 ratio is 8%, and the previous year 4 ratio is 3%, then FEMA would add these ratios together (8.1 + 6 + 4 + 8 +3 = 29.1%), and then divide

29.1% by 5 to get an average expense ratio of 5.82%. The Base WYO Expense Allowance Percentage would then be 5.82%.

FEMA then adds an additional 15 percentage points to pay WYO companies for commissions or salaries of insurance agents, brokers, or other entities producing qualified flood insurance applications and other related expenses (E in Figure 1). *See* Arrangement III.B.2. Prior to the Fiscal Year 2019 Arrangement, FEMA also added an additional 1 percentage point to the Base WYO Expense Allowance Percentage to account for the additional complexity associated with selling and servicing NFIP policies. *See* FY 2018 Arrangement, Art. III.B.1, 82 FR 17017, 17020 (Apr. 4, 2017); Arrangement, 44 CFR 62, App. A, Art. III.B ¶ 2 (Arrangement applicable prior to FY 2018).[5]

From 2009 to 2017, the percentages of written premium for each year (which include the Base WYO Expense Allowance Percentage, the extra 1 percentage point for years prior to FY 2019, and the 15 percentage points for agent commissions), were as follows:

Table 3. WYO Expense Allowance Percentage

Arrangement Year	Percent of Written Premium Paid to WYO for General Expenses
2009	29.8%
2010	30.0%
2011	30.2%

[5] *See* 81 FR 84483 (Nov. 23, 2016) (removing the Arrangement from regulation).

2012	30.4%
2013	30.7%
2014	30.7%
2015	30.8%
2016	30.9%
2017	30.9%
2018	30.9%
2019	30%[6]

In addition to these amounts, FEMA also provides for the possibility of a growth bonus. (F in Figure 1). *See* Arrangement III.B.3. The actual bonus varies by the extent a WYO company meets certain marketing goals. The total growth bonus paid to all WYO companies may not exceed 2 percent of aggregate written premium for all companies. Prior to the 2019 Arrangement, an individual company could not receive a growth bonus of more than 2 percent of such individual company's written premium. *See, e.g.* FY 2018 Arrangement, Art. III.B.3.

2. Loss Adjustment Expenses (LAE) (C in Figure 1)

LAE are expenses incurred in the course of adjusting insurance claims.[7] There are three categories of LAE in the Arrangement: (1) unallocated loss adjustment expenses (ULAE), (2) allocated loss adjustment expenses (ALAE), and (3) special allocated loss adjustment expenses (SALAE).

[6] Percentage reflects the FY 2019 Arrangement's one percent reduction in compensation for general expenses. The rate would have been 31 percent without FY19 Arrangement's 1 percent reduction.
[7] Adjusting an insurance claim is a determination of the amount payable by the insurer to the insured on a claim under an insurance policy.

ULAE (H in Figure 1) are expenses a WYO company incurs while adjusting flood insurance claims but cannot attribute to a specific claim. Examples of ULAE include general overhead, adjuster supervision expenses, and catastrophic response resources, such as mobile claim response units. FEMA reimburses ULAE based on a "ULAE Schedule." Arrangement III.C.1. The Fiscal Year 2017 schedule provides for 0.9 percent of net written premium and 1.5 percent of incurred loss.[8] FEMA calculates incurred loss based on claims that have been reported to the WYO company. FEMA excludes any estimate by the WYO company for additional dollars the WYO company will pay on claims from flooding events that have already happened but have not yet been reported to the company. Further, in calculating incurred loss for those claims already reported to the company, FEMA includes both amounts already paid on those claims and the estimate by the company of amounts remaining to be paid on those claims.

ALAE (I in Figure 1) are adjustment expenses attributable to specific claims, such as fees to adjusters. FEMA pays for ALAE for adjuster expenses according to a fee schedule, but only after the claim has been closed. Arrangement III.C.2. The NFIP

[8] Prior to Hurricane Katrina, FEMA reimbursed ULAE based on 3.3 percent of incurred losses, as that was the number FEMA determined was required to maintain sufficient WYO company participation in the NFIP program. Katrina, however, revealed that in a high-severity localized event, a payment of 3.3 percent of incurred losses resulted in significant overpayments to WYO companies. For this reason, FEMA removed the percentage from the Arrangement and instead communicated it on an annual basis. *See* 73 FR 18182, 18184-5 (April 3, 2008). Following this change FEMA altered its ULAE reimbursement method to decrease variations between low and high-payout years. Accordingly, it decreased its payment of incurred losses to 1.5 percent, and began reimbursing 1 percent of net written premiums, eventually reaching today's level at .9 percent of net written premiums. (The net written premium percentage was designed to cover expenses that are more fixed; as such, it is more static and thus avoids overcompensation during disaster years.)

published the current ALAE fee schedule in 2017. *See* NFIP Claims Manual, Appendix A.[9] The schedule provides for a range of flat rate fees varying according to the disposition of a claim and the amount of the gross paid loss.[10] The ALAE schedule is reproduced in part below:

Table 4. ALAE Fee Schedule	
Claim Range	**Fee**
Erroneous Assignment	$95.00
Claim Withdrawn	$95.00
Closed Without Payment (CWOP)	$395.00
.01 - $1,000.00	$525.00
$1,000.01 - $5,000.00	$800.00
$5,000.01 - $10,000.00	$1,035.00
$10,000.01 - $15,000.00	$1,175.00
$15,000.01 - $25,000.00	$1,275.00
$25,000.01 - $35,000.00	$1,475.00
$35,000.01 - $50,000.00	$1,750.00
$50,000.01 - $100,000.00	3.4% but not less than $1,750
$100,000.01 - $250,000.00	2.6% but not less than $4,250
$250,000.01 - $1,000,000.00	2.4% but not less than $7,800
$1,000,000.01 and up	2.2 % but not less than $24,000

The current ULAE and ALAE schedules have resulted in payments equal to 6.7 percent of the total losses paid (the amount actually paid for claims) during the last 5 years for which data is available. However, annual paid losses and the annual amount of

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[9] https://www.fema.gov/media-library-data/1535556801689-ef2b1232f884cc6e4396a8cc7e7526b3/Appendix_A_Adjuster_Fee_Schedule.pdf.

[10] "Gross Loss" is the agreed cost to repair before application of depreciation or the applicable deductible(s), but subject to policy limitations (such as those dollar amounts specified in Coverage B — Personal Property Special Limits and Coverage C — Other Coverages, Loss Avoidance Measures and Property Removed to Safety) and exclusions.

LAE payments that are incurred to service them vary widely in that period, as seen in the Table 5:

Table 5. Amount FEMA Paid for ALAE and ULAE ($ Thousands)[11]				
Arrangement Year	**A. Paid Loss**	**B. ALAE Paid**	**C. ULAE Paid**	**D. Payment for LAE/ Paid Loss Ratio (B+C)/A=D**
2013	$7,463,580	$295,439	$137,529	5.80%
2014	$741,729	$33,205	$37,803	9.57%
2015	$687,407	$28,116	$36,358	9.38%
2016	$1,864,887	$61,930	$73,571	7.27%
2017	$3,376,735	$107,296	$141,216	7.36%
5-Yr Total/ Avg	**$14,134,338**	**$525,986**	**$426,476**	**6.74%**

SALAE include specialized claims handling expenses attributable to a specific claim, such as for legal, surveying, or engineering support. Unlike ULAE and ALAE, FEMA does not use a schedule to reimburse SALAE, but rather pays for SALAE on a dollar-for-dollar reimbursement basis.[12]

SALAE represents a very small portion of the National Flood Insurance Program's expenses and overall claims process. In 2015, FEMA's internal data indicates that 8.10 percent of claims involved SALAE payments, which cost 0.47 percent of losses

[11] Data were based on annual end of year financial statements for the National Flood Insurance Program and expenses paid exclusively for the Write Your Own program. All amounts shown in this table track payments to the Arrangement Year (Oct 1 through Sep 30) in which they were made. This is in contrast to other methods of tracking payments *(see, e.g.*, Table 7) to the year the flood occurred.

[12] The basic SALAE guideline is WYO Bulletin W-10039 (April 1, 2010), available at https://bsa.nfipstat.fema.gov/wyobull/2010/w-10039.pdf.

incurred for that year. In 2016, 2.57 percent of claims involved SALAE payments, which cost 0.18 percent of losses incurred for that year. However, administering this small portion on a dollar-for-dollar reimbursement basis requires significant administrative oversight on the part of FEMA. FEMA program staff review each reimbursement request to ensure fair pricing and reasonable use of professional services. Specific for reimbursement of litigation of claims, FEMA employs several dedicated program and legal staff members to oversee reimbursement of WYO companies for their legal expenses.

D. Findings of Inadequacies in Current Methodology

Relevant to this discussion, the GAO has issued two reports outlining its concerns with FEMA's methodology for calculating the amount FEMA pays WYO companies. In August 2009, GAO issued a report entitled, "Flood Insurance: Opportunities Exist to Improve Oversight of the WYO Program" (2009 GAO Report).[13] In the report, GAO criticized the NFIP for not considering actual flood insurance expense information when it determines the amount it pays the WYO company for selling and servicing flood insurance policies and adjusting claims. 2009 GAO Report, 5-6. As part of the review, GAO examined the expense payments FEMA made to six WYO companies for their actual expenses for calendar years 2005 through 2007. *Id*. at 6. GAO found that the

[13] GAO-09-455 (Sept. 21, 2009), available at http://www.gao.gov/products/GAO-09-455.

payments exceeded the WYO companies' actual expenses by $327.1 million, or 16.5 percent of total payments made. *Id.*

However, the 2009 GAO report also found inconsistencies in the actual flood expenses data obtained by the National Association of Insurance Commissioners (NAIC). *Id.* at 5-6. GAO found that some companies reported their flood insurance expenses to NAIC after offsetting them with the payments they received from FEMA. *Id.* In other instances, it found that companies included payments made under service agreements with affiliated companies that may have included profit distributions that should not have been included. *Id.* Accordingly, GAO found that the consistency of WYO companies' reporting to NAIC needs to be improved in order for data on the companies' expenses to be fully utilized. *See id.* at 5-6.

In December 2016, GAO issued another report entitled, "Flood Insurance: FEMA Needs to Address Data Quality and Consider Company Characteristics When Revising Its Compensation Methodology" (2016 GAO Report).[14] In this report, GAO affirmed its 2009 recommendations and found that FEMA has yet to revise its WYO compensation methodology to reflect actual expenses, due in large part to a lack of quality data on actual expenses.

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[14] GAO-17-36 (Dec. 8, 2016), available at http://www.gao.gov/products/GAO-17-36.

E. WYO Expenses Reported to NAIC Compared to WYO Compensation

FEMA has examined the difference between payments made under the current methodology and the actual expenses reported by WYO companies to the NAIC between 2009 and 2013, the latest year data is available for either methodology.[15] The results appear in Table 6. FEMA found that the reimbursement rate for general expenses under the current methodology exceeded the actual flood expense ratio calculated using NAIC data.

[15] In order to control for non-credible data in some NAIC reports, FEMA only used data from participating WYO companies reporting expense ratios of 10 percent and above.

Table 6. General Expenses: Reported Flood Insurance Expenses Ratio (i.e., Reported General Expenses as Percentage of Reported Written Premium) vs. Current Methodology[16]

Arrangement Year	A. NAIC Reported General Expenses	B. NAIC Reported Written Premium	C. NAIC Reported General Expenses as Percentage of Reported Written Premium A/B=C	Table 3. Percent of Written Premium Paid to WYO for General Expenses
2013	697,027,000	2,937,809,000	23.7%	30.7%
2014	719,039,000	2,911,660,000	24.7%	30.7%
2015	684,714,000	2,756,173,000	24.8%	30.8%
2016	723,487,000	2,759,584,000	26.2%	30.9%
2017	746,587,000	2,744,213,000	27.2%	30.9%
5-Yr Total/ Avg	**3,570,854,000**	**14,109,439,000**	**25.3%**	**30.8%**

FEMA also analyzed LAE and found similar results, i.e., the reimbursement rate under the current methodology exceeded the actual flood expense ratio using NAIC data. Both the actual expense data from the NAIC and the amounts FEMA pays under the current methodology show variation from year to year; some years have lower LAE/loss ratios while other years have higher ratios. However, as seen in Table 7, the NAIC actual expense data indicates consistently lower ratios (i.e., lower LAE relative to paid loss)

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[16] These reported figures for flood insurance expense data are the latest available as of November 2018. FEMA notes that the future differences between NAIC reported expenses and the corresponding WYO Expense Allowances will be slightly different than the historical difference shown here because of the FY19 Arrangement's 1 percent reduction in compensation for general expenses.

(column C of Table 7) than what FEMA pays under the current LAE methodology (last column of Table 7, which lists data from Table 5).

Table 7. Loss Adjustment Expenses (LAE) as a Percent of Paid Losses: Reported by NAIC vs. Paid Under Current Methodology (in $ Thousands)

Calendar Year/Arrangement Year[1]	A. NAIC Reported Paid Loss	B. NAIC Reported LAE Paid [2]	C. NAIC Reported LAE as Percentage of NAIC Reported Paid Loss (B÷A=C)	D. From Table 5 Payment for LAE/ Paid Loss Ratio[3]
2013	$6,393,676	$334,276	5.23%	5.80%
2014	$588,622	$61,435	10.44%	9.57%
2015	$829,042	$65,192	7.86%	9.38%
2016	$3,091,250	$141,377	4.57%	7.27%
2017	$7,189,144	$347,127	4.83%	7.36%
5-Yr Average	**$3,618,347**	**$189,882**	**5.25%**	**6.74%**

[1] Both "Calendar Year" and "Arrangement Year" are presented in one column for user ease. Although there is a calendar year and an arrangement year for each year of data, FEMA's definitions of the two differ. Specifically, here the calendar year represents January 1 through December 31. The arrangement year represents the time frame (generally the 365 days) covered in the standard Financial Assistance/Subsidy Arrangement with private sector property insurers, also known as Write Your Own (WYO) companies, to sell NFIP flood insurance policies under their own names and adjust and pay claims arising under the Standard Flood Insurance Policy (SFIP). *See* 42 U.S.C. 4081(a)

[2] In column B, the LAE values listed are the sum of both ULAE and ALAE for each year. SALAE is not included in the values.

[3] In column D, the values include only payments made for ULAE and ALAE for each arrangement year. SALAE is not included in the values, as reported in Table 5.

IV. <u>Possible Methodologies</u>

FEMA is considering three possible methodologies for calculating payments to WYO companies. The three methodologies only address payments for general and loss adjustment expenses incurred by WYO companies. FEMA is considering additional regulatory actions to address the possibility of additional non-expense related payments, such as for profit or performance-based incentives.

FEMA presents these possible methodologies in order to solicit comments from the public. FEMA intends to use these comments to inform the publication of a notice of proposed rulemaking that will propose a new WYO payment methodology in the future.

A. <u>Credibility Weighting Methodology: Incorporating Actual Expense Data into Current Methodology</u>

FEMA is considering a payment approach that uses credibility weighting procedures[17] to incorporate actual flood expense data into FEMA's current methodology (described in section III.C of this ANPRM). Credibility weighting combines two or more values. In this case, the values would be the expense compensation ratios under the current methodology and those yielded by flood insurance expense data. However, a weight is applied to each value to introduce a greater influence of one over the other in the final result. The weights are based on actuarial opinion of the quality, robustness, and

[17] The Actuarial Standard Board defines "credibility procedure" as: "A process that involves the following: (a) the evaluation of subject experience for potential use in setting assumptions without reference to other data; or (b) the identification of relevant experience and the selection and implementation of a method for blending the relevant experience with the subject experience." Actuarial Standards Board, Actuarial Standard of Practice No. 25: Credibility Procedures, 2 (Dec. 2013), available at http://www.actuarialstandardsboard.org/wp-content/uploads/2014/02/asop025_174.pdf. "Subject experience" means "[a] specific set of data drawn from the experience under consideration for the purpose of predicting the parameter under study." *Id.* "Relevant experience" means "[s]ets of data, that include data other than the subject experience, that, in the actuary's judgment, are predictive of the parameter under study (including but not limited to loss ratios, claims, mortality, payment patterns, persistency, or expenses). Relevant experience may include subject experience as a subset." *Id.*

representative nature of the available data, and can differ from year to year. How these factors are considered will vary based on the specific procedure or procedures used to incorporate credibility. Such procedures include Bayesian credibility procedures, empirical credibility procedures, and classical credibility procedures.[18]

Credibility weighting procedures allow FEMA to incorporate flood expense data in WYO compensation, while adjusting the impact of such data to account for its shortcomings. As data from the NAIC becomes a more credible indicator of actual flood expenses, this methodology will allow FEMA to give it greater weight. Under this approach, FEMA would steadily increase usage of actual flood expense data over time, as that data increases in credibility, while continuing to draw from the non-flood insurance expense data currently in use in the near term.

1. General Expenses

For general expenses, FEMA would credibility weight two sources of expense data: the actual flood insurance expense ratio and the non-flood insurance expense ratio. FEMA would obtain this data from A.M. Best Company's Aggregates and Averages publication, as FEMA does under its current methodology. The actual flood insurance expense ratio would cover the "General Expenses," "Other Acquisition Expenses," "Taxes, Licenses, and Fees," and "Agent Commission" expense categories incurred by

[18] *See* Actuarial Standards Board, Actuarial Standard of Practice No. 25: Credibility Procedures, 5-6 (Dec. 2013), available at http://www.actuarialstandardsboard.org/wp-content/uploads/2014/02/asop025_174.pdf.

insurance companies, averaged over the previous five years for which reliable and complete data are available. FEMA projects that, based on data reported by WYO companies to the NAIC for FY 2013 through FY 2017, this would yield an expense ratio of 25.3 percent of written premium (i.e., actual expenses are 25.3 percent of the written premiums) before credibility weighting.[19]

The non-flood insurance industry expense ratio would be the expense ratios for the five non-flood property/casualty insurance lines used in the current methodology. The ratios would cover the "General Expenses," "Other Acquisition Expenses," and "Taxes, Licenses, and Fees" expense categories, averaged over the previous five years, then adding the static 15 percent agent commission percentage of the current general expense scheme (discussed in section III.C.1. of this ANPRM). FEMA expects this would yield an expense ratio of 30 percent of written premium before credibility weighting.[20]

Based on the current NAIC actual flood expense data, FEMA estimates that the credibility-weighted general expense ratio for FY 2019 would be approximately 28.8 percent of written premium (based on preliminary estimates that assume an initial credibility weighting of only 25 percent for the self-reported NAIC data). This would

[19] 25.3 percent is estimated based on a 5-year average of NAIC-reported data of WYO companies who reported expenses within the 10 percent and above range. FEMA limited analysis of NAIC data to this specific range because it deemed WYO-reported expenses below 10 percent to be less than credible, based on number of firms reporting and general experience with the WYO program and the NFIP.

[20] 30 percent is based on data from FY 2014 through FY 2016 (which were factored into the WYO compensation rates between FY 2017 and FY 2019).

represent approximately a $36.63 million decrease in general expense payments to WYO companies in FY 2019, as compared to the current compensation baseline in 2019. As the flood expense data collected by the NAIC becomes more credible, this approach would assign greater weight to the flood insurance expense ratio.

2. LAE

As noted above, FEMA currently reimburses ULAE and ALAE using different methods. It reimburses ULAE based on 0.9 percent of written premium and 1.5 percent of incurred loss, and ALAE according to a schedule based on a range of flat-rate fees. Under the credibility weighting approach, FEMA would no longer reimburse ULAE and ALAE separately using these different methods. Instead, FEMA would use one new fee schedule (modeled after the current ALAE schedule) to determine reimbursements for both. Because FEMA would use the same reimbursement schedule for both, it would no longer need to differentiate between ULAE and ALAE; as such, this new fee schedule would depict the overall LAE payment rate. FEMA's reimbursement for SALAE would remain unchanged because FEMA currently pays for SALAE on a dollar-for-dollar reimbursement basis, and would continue to do so.

FEMA would revise this LAE fee schedule annually to minimize the difference from year to year between actual LAE that WYO companies incur as reported by NAIC and what FEMA pays to cover those incurred expenses. FEMA would minimize this difference by adjusting the previous annual LAE fee schedule by applying a certain calculated percentage. FEMA would calculate this percentage by credibility weighting (1) the payment amounts that FEMA would have made if the most recent LAE fee schedule had been in place during recent years and (2) the payment amounts that FEMA would have paid under the current LAE fee schedule, revised to yield the actual reported LAE expenses for the same period. In essence, FEMA would incorporate actual reported expenses incurred by WYO companies by regularly examining the validity of the current LAE fee schedule and revising that LAE fee schedule using historical LAE payment experience.

Using this approach, FEMA's preliminary calculations indicate that LAE under the unified fee schedule in FY 2019 would result in a payment rate of 7.63 percent of paid losses (the dollar amount of claims paid by the NFIP), which is a reduction of 0.66 percentage points from the FY 2019 compensation rate of 8.29 percent under the current LAE compensation methodology.[21] This would represent an approximately $20.28 million decrease in LAE payments to WYO companies in the first year. Over time, the LAE payment rate would better align with the year-to-year LAE expenses because FEMA would likely assign an increasing credibility to the NAIC flood expense data and each year's experience would inform and improve the next year's rates. FEMA expects an increase in credibility because of FEMA's ongoing collaboration with the NAIC to improve data quality and the NAIC's issuance of guidance on the proper accounting of reimbursements to Write Your Own companies. FEMA has also improved its monitoring

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[21] As a reference point, the average historical compensation rate for ALAE and ULAE from 2013-2017 was 6.74 percent of total paid losses.

of WYO expenses related to litigation, *see* WYO Bulletin W-16045 (July 19, 2016), engineering inspections, *see* WYO Bulletins W-15010 (Mar. 9, 2015), and overall expense reporting, *see* WYO Bulletin W-16048 (Aug. 4, 2016). *See, e.g.*, N.C. Gen. Stat. § 58-2-180 (willful misstatement of information in certain financial or other statements); Va. Code Ann. § 38.2-2027 (withholding of certain information and giving false or misleading information to the Commissioner of Insurance, statistical rating agencies, or any other insurer).

B. Methodology Based Completely on Flood Expense Data

FEMA is also considering a methodology that uses solely actual flood insurance expense data, meaning it would no longer use industry expense ratios as part of the calculation. Under this approach, FEMA would use reported flood expense data to determine reasonable flood expense payment ratios by dividing previous years' general expenses by the associated written premium. Setting payment rates entirely on publicly available expense data collected from the NAIC would likely be the simplest approach for FEMA to administer, but would depend entirely on the credibility of flood expense data obtained from the NAIC. While the credibility of this data continues to improve, it is not likely fully credible at this time. *See* GAO-17-36 (Dec. 8, 2016). Any approach that depends entirely on the use of flood expense data would, at least in the short term, suffer from the same deficiencies as the current methodology, in that it would not be an accurate representation of the actual expenses incurred by WYO companies in carrying out their obligations under the WYO Program.

Over the long term, this approach could result in payments that closely align with the actual reported flood expenses. However, relying solely on flood expense data would very likely result in wide gaps in what FEMA would pay year-to-year. This is because unlike expenses for non-flood lines, which tend to be evenly distributed and thus relatively stable, flooding tends to occur all at one time. Because flooding is not an evenly distributed hazard, it is difficult to insure. FEMA could continue its practice of averaging expense data over 5 years in order to smooth sudden changes in expenses. Tailoring payments to WYO companies to their actual expenses in the long term, therefore, would place the methodology solely on a self-reported basis, which is not immune from manipulation and other potential irregularities. FEMA would be required to rely entirely on data provided by the NAIC, regardless of its credibility, which, as noted above, GAO identified as a source of concern.

Based on the current NAIC actual flood expense data, FEMA projects that the general expense ratio for FY 2019 would be approximately 25.3 percent of written premium (based on preliminary estimates that average the most recent three years of expense ratios based on self-reported NAIC data). This would represent approximately a $146.51 million decrease in general expense payments to WYO companies in FY 2019.

In addition, using this approach, FEMA's preliminary calculations indicate that LAE under the unified fee schedule in FY 2019 would result in a payment rate of 5.67

percent of paid losses (the dollar amount of claims paid by the NFIP), which is a reduction of 2.62 percentage points from the FY 2019 compensation rate of 8.29 percent under the current LAE compensation methodology in FY 2019.[22] This would have represented an approximately $81.11 million decrease in LAE payments to WYO companies in FY 2018.

C. Methodology Based on Invoices

In a third possible methodology, FEMA would pay WYO companies on a direct, invoice-supported, dollar-for-dollar reimbursement basis, similar to how FEMA currently pays for SALAE. This approach would be based on the actual expenditures of WYO companies and would allow FEMA to collect detailed expenditure data. This would give FEMA more monitoring and control over WYO expenditures while ensuring that payments directly reflect an individual WYO company's incurred expenses. It would also avoid the consequences associated with the year-to-year variability of expenses discussed above. However, this approach would likely create significant administrative burdens for the NFIP and WYO companies. FEMA employs several legal and program staff members in order to oversee current SALAE reimbursements, and an expansion of direct reimbursements to cover all loss adjustment expenses would entail expanded cost burdens, given the volume of losses and the number of claims against which

[22] As a reference point, the average historical compensation rate for ALAE and ULAE from 2013-2017 was 6.74 percent of total paid losses.

compensation would be tied. The timely processing of each claim's related expenses from each WYO company would not be possible given current staff and administrative capacity of FEMA and as a result, expansion of the reimbursement concept would likely require hiring numerous new staff members. Without such an increase in FEMA processing staff, a direct reimbursement methodology for all LAE expenses would result in reimbursement delays and disruption to both the policyholders and WYO companies. WYO companies would likely incur significant additional administrative expenses.

V. Public Comment

FEMA seeks public comment on all aspects of a revised WYO payment methodology, with particular interest in better understanding the implication of the three methodologies described above. FEMA will use the received comments to inform future rulemaking on the subject. Comments accompanied by supporting data and analysis of the issues addressed in those comments would provide the greatest assistance to FEMA. Additionally, FEMA would derive particular benefit from commenters addressing one or more of the following questions:

1. What are the limitations with the current WYO expense compensation methodology that you believe FEMA needs to address in the revised methodology?
2. What recommendations do you have for improving the current WYO expense compensation methodology?
3. What credibility weighting procedures should FEMA consider using, if any?
4. Do the five non-flood property/casualty lines of insurance act as a good approximation of flood insurance general expenses in the credibility

weighting-based approach? If FEMA continues to use non-flood property/casualty lines of insurance, what lines should FEMA consider adding or subtracting from this list?

5. Should FEMA merge payments for ULAE into the existing ALAE fee schedule so that ULAE payments are better tailored to the severity of a flood event?
6. Does NAIC flood expense data accurately reflect the actual expenses incurred by WYO companies? What are the challenges of ensuring accurate data are provided to the NAIC and how can they best be overcome?
7. What, if any, alternative data sources can provide WYO company expense data that are more accurate than what the NAIC captures?
8. What, if any, additional costs would WYO companies incur if required to submit all NFIP-related expenses for reimbursement as they are incurred (i.e., the third alternative referenced above)?
9. Does the structure of the current ALAE fee schedule adequately take into account the differences in incurred expenses between catastrophic and non-catastrophic loss years?
10. What changes to the current methodology would allow FEMA to better distinguish between catastrophic and non-catastrophic years in paying out LAE?
11. What individual characteristics of WYO companies could be used to better tailor a payment methodology to the actual expenses of individual companies?

12. What additional data may help FEMA better understand actual expenses of WYO companies?

Authority: 42 U.S.C. 4081 note.

Pete Gaynor,

Acting Administrator,

Federal Emergency Management Agency.

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