

A STATEMENT

OF

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BEFORE
THE

COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON HOUSING AND INSURANCE
U.S. HOUSE
WASHINGTON, DC

**“THE NATIONAL FLOOD INSURANCE PROGRAM: OVERSIGHT OF
SUPERSTORM SANDY CLAIMS**

Submitted
By

Federal Emergency Management Agency
500 C Street, S.W.
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June 2, 2015

Introduction

Chairman Luetkemeyer, Ranking Member Cleaver, and Members of the Committee, I am Brad Kieserman, Deputy Associate Administrator for Federal Insurance in the Department of Homeland Security's (DHS) Federal Emergency Management Agency (FEMA). I am grateful for the opportunity to be here today.

Why does America need a National Flood Insurance Program? Floods remain the number one natural disaster in the United States causing an average of four billion dollars a year in insurance claims between 2003 and 2012. Millions of Americans are physically and financially vulnerable to floods. Floodplains exist throughout America—many of them in places that are economically important to our Nation. Moreover, floodplains are not the only places in America that flood. People outside of mapped high-risk flood areas file nearly 25 percent of all National Flood Insurance Program (NFIP) flood insurance claims and receive one-third of Federal disaster assistance for flooding. Yet, standard home insurance policies do not cover damage caused by rising water, and private companies that provide flood insurance are rare. That's because many private insurance companies stopped offering coverage for flooding following massive and expensive floods that plagued communities along the Mississippi River in the 1920s. In the decades that followed, Congress recognized the need to create a method for handling widespread flood damage when it occurs, passing flood insurance legislation in the 1950s and commissioning reports and studies in the 1960s. Congress created the NFIP in 1968 and its business model has remained largely unchanged since the early 1990s. The NFIP is still this Nation's first line of defense against flood damage for over 5.3 million policyholders living and working in millions of dwellings and small businesses in over 20,000 American towns and cities with \$1.3 trillion of insurance coverage in force.

What we learned from Hurricane Sandy is that if the NFIP is going to remain as the first line of defense against flood damage for millions of policyholders, then we must change the way we deliver the Program.

There is a great book written on organizational change titled, "Our Iceberg is Melting,"—the authors use a fable about a penguin colony in Antarctica that lived on the same iceberg for many years. When one curious bird discovers signs that the iceberg is melting, few of the other penguins want to listen to him. They are fine the way things are and do not want to change. But, once a small group of penguins came to understand that their iceberg actually was melting, they created a sense of urgency to help others see the need for change and the importance of acting immediately.

Hurricane Sandy showed us in several ways why the 47-year old NFIP is the proverbial melting iceberg: its product is stale and not well understood by consumers; some of the vital services the Program delivers to disaster survivors have decreased in quality over time; the outdated business

model we use to deliver the Program makes increasingly little sense in the 21st Century; and many property owners required by law to purchase flood insurance fail to do so. For its policy holders, the NFIP is the first line of defense for the number one natural disaster threat to millions of people and small businesses in this country. However, if we are to prevent this iceberg from sinking into the ocean, as I think we must, then we need a new strategy to implement it and that is what I would like to talk about with you today.

What Happened in Sandy?

Over time, the NFIP became increasingly disconnected from its real customers—flood survivors. It may be difficult to see or hear the effects of that disconnect in an average loss year. However, a significant or catastrophic flood event like Sandy amplifies the Program’s shortcomings and lays out the need for reforms.

In 1983, FEMA began what we call the Write Your Own (WYO) Program intending to create a cooperative undertaking between the insurance industry and the Federal Government. The WYO Program allows participating property and casualty insurance companies to write and service the Standard Flood Insurance Policy (SFIP) in their own names. The companies receive an expense allowance for policies written and claims processed while the Federal Government retains responsibility for underwriting losses. The WYO allowance today has risen to 33 percent of every premium dollar paid by our policyholders. The WYO Program operates as part of the NFIP, and is subject to its rules and regulations. When it began in the 1980s, FEMA hoped the WYO Program would increase the NFIP policy base and the geographic distribution of policies; improve service to NFIP policyholders through the infusion of insurance industry knowledge; and provide the insurance industry with direct operating experience with flood insurance in the hopes of eventual privatization.

By the time Sandy struck in 2012, FEMA’s role in the NFIP had devolved to loosely coordinating a broad-reaching network of actors FEMA relied upon to implement the Program. FEMA was entrusting the WYO companies to manage the customer experience. FEMA had limited ability to manage the actual policyholder experience due to deference to WYOs. This relationship is largely memorialized in the equivalent of a contract called “the Arrangement,” which is a federal regulation with the force and effect of law. The policyholder relationship was further complicated by legacy information management technology that is incapable of providing transparency on critical data, and disparate connections to the policyholder..

This broad network that FEMA relies upon includes 82 private insurance companies responsible for over four million policies between themselves, a contractor who manages an additional one million policies FEMA sells and services directly, nine “vendors” that actually service nearly 60 percent of the WYO policies, nearly 245,000 agents who sell flood insurance policies, 422,000

real estate brokers and agents, 53,000 title examiners, almost 300,000 loan officers, over 300 adjuster companies with about 6,000 certified flood adjusters, and an unknown number of structural engineers who provide consultative services to the adjuster companies. And, the most important people involved in this complex relationship, in my opinion, are our 5.3 million policyholders.

FEMA currently governs this insurance network that affects nearly six million people across the country with 80 federal employees in Washington, D.C.—not even enough to dedicate one employee to oversee each WYO.

Over the years, FEMA has permitted greater amounts of autonomy for WYOs to conduct business without a commensurate increase in the amount of oversight the agency applies to these companies. Moreover, due to business model changes throughout the insurance industry, many WYOs have delegated much of the day-to-day work of Program delivery to vendors, contractors, and sub-contractors over whom they often exercise little or no oversight. Indeed, the litigation after Sandy revealed that FEMA and some WYOs are not properly overseeing the actions of their vendors and contractors, and, in some cases, permit these vendors to manage all aspects of claims handling with little to no supervision. FEMA has some limited contact with front line insurance agents and adjusters through training but little opportunity to influence those involved in home purchase and sales (realtors, loan officers, title examiners) or WYO-contracted engineers and forensic accountants the latter of whom are responsible for tracking billions of dollars in taxpayer funds that the NFIP pays out in flood claims

The current business model affords FEMA limited interaction with the people who directly interact with our customers and deliver our Program, even though FEMA funds all costs of the Program and remains ultimately accountable for paying insurance claims fairly. In this model, FEMA is often the last to know about serious issues in the delivery of the NFIP. FEMA receives information about policies, claims, and WYO performance at a comparatively slow pace in today's world—our information systems are antiquated, ad hoc, dependent on input from WYOs and others, and routinely 90 days behind real time. We do not have the most basic actionable data about customer experience available in any systemic way. Consequently, the NFIP has no consistent or reliable method to identify systemic problems, pre-emptively identify and address claims or appeals with similar adjustment issues, or recognize patterns from warning signs like policyholder complaints, congressional correspondence, appeals, and other data.

Where has this gotten us? Two years after Sandy, the WYO companies and FEMA are now the defendants in over 2,000 court cases in which our NFIP policyholders, primarily in New York and New Jersey, contest the disallowance of flood insurance claims.

The number of cases is not out of the ordinary. Typically one to two percent of flood insurance claims result in litigation, and there were more than 144,000 total claims filed following

Hurricane Sandy. The nature of the cases is, however, highly unusual. Plaintiffs' lawyers filed more than six separate class action complaints, including complaints under the Racketeer Influenced and Corrupt Organizations (RICO) Act, alleging multiple WYO companies, their contractors, and even their attorneys conspired or knowingly facilitated a process whereby flood insurance claims were denied or underpaid. The suits also allege that the WYO companies purposely avoided oversight by FEMA, and unreasonably increased the referrals of appeals to the adjuster or engineering company. There are two broad categories of cases: (1) the first group asserts irregularities and fraud in the provision of engineering services and alleges conspiracies between engineers, adjusters, WYO companies, FEMA, and others involved in claims handling; and (2) the second group asserts contract and extra-contractual violations related to claims processing software and systemic underpayments resulting from allegedly defective software that is used almost universally to adjust flood insurance claims.

Approximately 11 percent of claims in litigation involve allegations that engineering companies altered engineering reports used to establish whether a flood caused the damage claimed. Plaintiffs have presented evidence that: 1) engineering companies pressured field engineers to find that damage was not caused by flood, resulting in undervalued claims; 2) engineering companies changed field engineer reports in a peer review process without the field engineer's knowledge and then forwarded the reports to the WYO companies and FEMA's Direct Side Agent as the work of the engineer; 3) engineering companies cut and pasted signatures and license seals resulting in falsified reports being sent to the WYO company and FEMA; and 4) engineering companies employed unlicensed engineers.

According to one Federal Magistrate Judge, one case "exposed reprehensible gamesmanship by a professional engineering company that unjustly frustrated efforts by two homeowners to get fair consideration of their claims," that he added was "concealed by design" and, "worse yet, evidence suggests that these unprincipled practices may be widespread."

FEMA is statutorily responsible for administering the NFIP and providing the necessary oversight of the WYOs to ensure everyone delivering the Program does so with integrity. Despite letters, appeals, and other data available at the time, FEMA did not promptly discover the use of unlicensed engineers or that the so-called "peer reviews" process utilized by some engineering firms may have allowed for the inappropriate manipulation of engineer findings and conclusions or the outright falsification of engineer reports. In addition, FEMA's execution of the administrative appeals process required by Federal regulations failed to uncover problems with the adjustment of claims

Against this backdrop, some NFIP policyholders have been compelled to incur additional expenses to have their claims fairly adjusted. These expenses include additional engineering costs, additional adjuster costs, and attorney fees.

What Are We Doing About the Sandy Allegations?

As you can see, Hurricane Sandy showed us in several ways that the NFIP iceberg is melting. Change management experts say that the first thing to do when you realize the iceberg is melting is to help others see the need for change and the importance of acting immediately. The next steps are to pull together a team to lead the change and to develop a vision and strategy to implement that change.

Following that approach, FEMA established a Task Force that I lead—now nearly 100 people strong including approximately 70 personnel from outside of the Federal Insurance and Mitigation Administration who bring a fresh perspective to the challenges facing the NFIP—to accomplish three discrete tasks: expeditiously resolve the litigation involving Hurricane Sandy claims; establish a process by which Sandy survivors who have not pursued litigation can promptly have their claims reviewed if they feel they were underpaid; and begin developing and executing options to reform administration of the NFIP.

With respect to the first task, FEMA initiated an unprecedented process in February 2015 to settle Hurricane Sandy claims as quickly as possible so policyholders could receive negotiated payments for their claims and not endure prolonged litigation. To expedite FEMA's ability to settle claims more quickly—particularly in the majority of these cases where a WYO, not FEMA, was the defendant—FEMA took the unprecedented step of informing the WYOs that FEMA would lead efforts to settle these cases. The Agency generally defers to the WYOs to take the lead in reaching settlement agreements. The Task Force then began reviewing hundreds of individual cases and developed a procedure to analyze plaintiffs' payment demands, review relevant case materials, verify coverage and payment information, and provide a fair settlement offer as a basis for final negotiation. Using this expedited settlement process, we aim to provide every Sandy NFIP policyholder in litigation as of February 2015 with a settlement offer by the end of August, at the latest. As of May 31, 2015, we have directed settlement offers in 25 percent of all cases in litigation and we expect to meet our goal of offers in every case by the end of August. We anticipate that many policyholders will accept those offers bringing their often-painful journeys to recovery from Sandy closer to conclusion. Because FEMA is required by law to pay for WYO legal costs, settlement also has the potential to save taxpayers millions of dollars in legal fees that would be otherwise necessary to defend protracted legal battles. In fact, in a letter filed in the U.S. District Court for the Eastern District of New York, one experienced insurance defense lawyer stated: "The current prediction of the cost of FEMA's legal bill from Hurricane Sandy is that the total defense fees from just this one event are likely to exceed the total defense costs incurred by the NFIP for all flood events for the 20 years that preceded Sandy, including Katrina." That's about \$145 million in today's dollars—expedited settlement can help avoid much of those costs.

As for the second task, our customers should not have to sue us to get every dollar they are due under their insurance policy. Like other types of insurance, the NFIP does not cover everything, but it is the first line of defense against a flood. While the payouts will not make someone whole, our top priority is to ensure policyholders get what they are due under the terms of their insurance policy. As the litigation developed and revealed more and more irregularities in the claims process, we felt it was imperative to give policyholders who wanted it an opportunity to have their claim reviewed. That's why, on May 18, 2015, FEMA opened the Hurricane Sandy Claims Review process and began mailing letters to approximately 142,000 NFIP policyholders. Establishing this review is just one step in the plan to ensure we are administering a program that is survivor-centric and helps policyholders recover from flooding in a fair, transparent, and expeditious way. As of May 26, 2015, 796 people contacted FEMA by phone or email to request a review, and 530 of those reviews are actively in progress. We believe we can conclude most reviews within 90 days of the policyholder requesting the review.

Here's a quick overview of the review process: first, it is the decision of each policyholder whether they want their claim reviewed. Many policyholders may have received everything they felt their flood insurance provider owed them. For those who think the NFIP may owe them more, we will provide a highly qualified, NFIP-certified adjuster to serve as a caseworker for the insured and guide them through the review process. An engineer not associated with firms currently under investigation will review claims with engineering reports. The caseworker will make a recommendation about a supplemental payment after a thorough review of the claim file and any new information provided. If the policyholder does not agree with the recommendation, the policyholder will have the opportunity to obtain an additional review of the file by a neutral third party, who may be a retired judge or an attorney with insurance expertise. This neutral party will make a recommendation to FEMA. FEMA will give substantial weight to the neutral party's recommendation. If the results of the review support additional payment, FEMA will direct the insurance company or its Direct Side Agent to issue payment to the policyholder. Policyholders do not need a lawyer to participate in this process and FEMA will not pay any legal fees incurred by those who request a review.

In both litigation and the Claims Review processes, we are making supplemental insurance payments outside the normal sequence of delivery for disaster assistance. That means that some people may receive insurance payments for exactly the same item or purpose they previously received a Federal disaster loan or disaster grant (which they often received because the NFIP did not cover some or all of their loss). Federal law prohibits Federal agencies from providing disaster assistance for damages or losses covered by insurance—this is called a “duplication of benefits.” When that happens, the policyholder may have to repay the other disaster assistance to the original source. As a service to policyholders, when they enter the litigation or review process, FEMA coordinates with affected third parties like U.S. Department of Housing and Urban Development (HUD) and U.S. Small Business Administration (SBA) to identify potential

duplication of benefits. By identifying potential duplication of benefits early in the process and connecting policyholders with appropriate third party interests, FEMA aims to eliminate any uncertainty for the policyholder.

Reforming the NFIP

I think by now it is clear that the NFIP's "iceberg is melting." If the NFIP is going to continue to be the first line of defense against flood damage for millions of policyholders, then we must change the way we deliver the Program. I believe we must make substantial progress settling litigation and reviewing claims to recover the public trust necessary to undertake credible reform.

To complete its third and arguably most vital task of developing options to reform administration of the NFIP, the Task Force established a dedicated Reform Branch to concentrate solely on organizational change: near-term, mid-term, and long-term. We are seeking input and ideas from the full spectrum of NFIP stakeholders and interests.

While the executive branch has considerable latitude to reform administration the Program, and the judicial branch will continue to interpret the Program via its decisions, especially in the Sandy litigation, FEMA will continue to focus on reform efforts. Some of the boldest and most promising reform ideas we have heard may require legislative action and we look forward to working with our partners in Congress to improve the Program.

Some reforms simply cannot wait, and we are not going to wait to make the NFIP more survivor-centric. For example, we've already begun overhauling the NFIP's claims and appeals process, and we are moving now to align the management of litigation in a way that puts the policyholder first. FEMA is engaging with our customers, nonprofit organizations, advocacy groups, community officials, insurance companies, and Congressional staff, among others, to gain insight into the claims process and how we can improve it in the near term and in the long term. We are also increasing the training for adjusters and agents so that we can all do a better job of helping policyholders understand their coverage and its limits. As part of this effort, FEMA is working with a variety of experts to gather insight and help bring the existing process into alignment with FEMA's survivor-centric mission and approach. We will make more business process changes in the near future even as we evaluate the potential for more sweeping reform. That is why we are also undertaking a forensic accounting of how the NFIP reimburses WYOs so that we can make better decisions about future business models.

As we think about future business models and transforming the NFIP, I believe the guiding principle for every person and entity delivering the Program should be putting the policyholder first by helping people receive the assistance to which they are entitled when they most need our help. The NFIP is a government program meant to protect our citizens and foster recovery from

flood loss: it is not a private business, an insurance company, or a regulator. Our policy holders should not be surprised at the time of loss about what is and is not covered, nor should they be systemically subjected to anything but the best in customer service every time they interact with any part of the NFIP.

Conclusion

As I stated throughout this testimony, FEMA's priority is the policyholder, and ensuring they get every dollar the NFIP owes them under their policy. All that we are doing, and have been doing since Sandy helped us understand the breadth and depth of the challenges facing the Program, is aimed at that singular objective. We all have seen the signs the NFIP iceberg is melting. Still, some private sector actors involved in delivering the Program are fine with the way things are and do not want to change. It is our role, now, to help everyone understand that the iceberg is actually melting and create the sense of urgency to help others see the need for change and the importance of acting immediately. We appreciate the Committee's oversight role in this regard and look forward to our continued partnership and assistance. We are committed to getting this right.