OFFICE OF INSPECTOR GENERAL

National Flood Insurance Program's Management Letter for DHS' FY 2015 Financial Statements Audit (Redacted)

Homeland Security

June 9, 2016

OIG-16-101

DHS OIG HIGHLIGHTS

National Flood Insurance Program's Management Letter for DHS' FY 2015 Financial Statements Audit

June 9, 2016

Why We Did This Audit

The *Chief Financial Officers Act of 1990* (Public Law 101-576) and the *Department Of Homeland Security Financial Accountability Act* (Public Law 108-330) require us to conduct an annual audit of the Department of Homeland Security's (DHS) consolidated financial statements and internal control over financial reporting.

For Further Information:
Contact our Office of Public Affairs at (202) 254-4100, or email us at DHS-OIG.OfficePublicAffairs@oig.dhs.gov

What We Found

KPMG LLP, under contract with the DHS Office of Inspector General, audited the National Flood Insurance Program's financial statements and internal control over financial reporting for fiscal year (FY) 2015. The resulting management letter contains two observations related to internal controls and other operational matters for management's consideration. KPMG LLP noted internal control deficiencies and the need for improvement in system calculated premiums, and system calculated case loss reserves. These deficiencies are not considered significant and were not required to be reported in the *Independent Auditors' Report on DHS' FY 2015 Financial Statements and Internal Control over Financial Reporting,* dated November 13, 2015, included in the DHS FY 2015 *Agency Financial Report*. These observations are intended to improve internal control or result in other operating efficiencies.

FEMA Response

FEMA concurred with all of the recommendations and has begun implementing corrective actions.

OFFICE OF INSPECTOR GENERAL

Department of Homeland Security

Washington, DC 20528 / www.oig.dhs.gov

JUN 9 2016

MEMORANDUM FOR: Roy Wright
Associate Administrator
Federal Insurance Mitigation Administration
Federal Emergency Management Agency

FROM: Mark Bell Mark Bell
Assistant Inspector General for Audits

SUBJECT: *National Flood Insurance Program's Management Letter for DHS' FY 2015 Financial Statements Audit*

Attached for your action is our final report, *National Flood Insurance Program's Management Letter for DHS' FY 2015 Financial Statements Audit.* This report contains two observations related to internal control deficiencies that were not required to be reported in our *Independent Auditors' Report on DHS' FY 2015 Financial Statements and Internal Control over Financial Reporting*, dated November 13, 2015, which was included in the Department of Homeland Security's (DHS) fiscal year (FY) 2015 *Agency Financial Report.* We do not require management's response to the recommendations.

The independent public accounting firm KPMG LLP conducted the audit of DHS' FY 2015 financial statements and is responsible for the attached management letter and the conclusions expressed in it.

Consistent with our responsibility under the *Inspector General Act,* we will provide copies of our report to congressional committees with oversight and appropriation responsibility over the Department of Homeland Security. In a June 1, 2016, request, the Federal Emergency Management Agency's Office of Chief Financial Officer requested that we redact certain information from the report. Specifically, the flood insurance policy numbers and date of loss are considered Sensitive Personally Identifiable Information as defined in the Privacy Office's *Handbook for Safeguarding Sensitive Personally Identifiable Information at the Department of Homeland Security.* As a result, we have redacted the policy numbers and date of loss information from the report and will post a redacted version of the report on our website for public dissemination.

Please call me with any questions, or your staff may contact Maureen Duddy, Deputy Assistant Inspector General for Audits, at (617) 565-8723.

Attachment

KPMG LLP
1676 International Drive
McLean, VA 22102

December 15, 2015

Office of Inspector General and Chief Financial Officer,
U.S. Department of Homeland Security, and
Associate Administrator, Federal Insurance and Mitigation Administration,
U.S. Department of Homeland Security, Federal Emergency Management Agency
Washington, DC

Ladies and Gentlemen:

In planning and performing our audit of the consolidated financial statements of the U.S. Department of Homeland Security (DHS or Department), as of and for the year ended September 30, 2015, in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 15-02, *Audit Requirements for Federal Financial Statements*, we considered the Department's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the consolidated financial statements. In conjunction with our audit of the consolidated financial statements, we also performed an audit of internal control over financial reporting in accordance with attestation standards established by the American Institute of Certified Public Accountants.

During our audit, we noted certain matters involving the Federal Emergency Management Agency's (FEMA) National Flood Insurance Program (NFIP) internal control and other operational matters that are presented for your consideration. These comments and recommendations, all of which have been discussed with the appropriate members of management of the named insurance companies (where applicable), FEMA's Office of the Chief Financial Officer (OCFO), FEMA's Federal Insurance and Mitigation Administration (FIMA), and communicated through a Notice of Finding and Recommendation, are intended to improve internal control or result in operating efficiencies. These observations and recommendations are summarized in Exhibit I of this letter and are not considered significant deficiencies or material weaknesses in internal control over financial reporting. Significant deficiencies and material weaknesses in internal control over financial reporting have been previously communicated to the DHS Office of Inspector General (OIG) and management in our *Independent Auditors' Report,* dated November 13, 2015, included in the fiscal year 2015 DHS *Agency Financial Report*.

Deficiencies related to FEMA information technology (IT) controls will be presented in a separate letter to the DHS OIG and the FEMA Chief Information Officer (CIO). In addition, certain other deficiencies related to FEMA's internal control exclusive of our IT findings will be presented in a separate letter to the DHS OIG and the FEMA Chief Financial Officer.

Our audit procedures are designed primarily to enable us to form opinions on the financial statements and on the effectiveness of internal control over financial reporting, and therefore may not bring to light all weaknesses in policies or procedures that may exist. We aim, however, to use our knowledge of the NFIP organization gained during our work to make comments and suggestions that we hope will be useful to you.

We would be pleased to discuss these comments and recommendations with you at any time.

The purpose of this letter is solely to describe comments and recommendations intended to improve internal control or result in other operating efficiencies. Accordingly, this letter is not suitable for any other purpose. FEMA's response to the deficiencies identified in our audit is included in Exhibit II. FEMA's response was not subjected to the auditing procedures applied in the audit of the consolidated financial statements, and accordingly, we express no opinion on it.

Very truly yours,

KPMG LLP

I. BACKGROUND

The Federal Insurance & Mitigation Administration (FIMA) of U.S. Department of Homeland Security Federal Emergency Management Agency (FEMA) manages the National Flood Insurance Program (NFIP). Private insurance companies and the Direct Servicing Agent (DSA) (NFIP insurers) administer the flood insurance policies issued through the NFIP. The NFIP insurers write NFIP policies, adjust flood claims, process and distribute claim payments to policyholders, and establish and maintain loss reserves. The NFIP has contracted with a third-party service provider to assist the NFIP in managing the program. The NFIP insurers submit NFIP data to the third-party service provider via the Transaction Record Reporting and Processing (TRRP) system. The service provider uses underwriting transactions (i.e., written premiums) data associated with flood policies to calculate the deferred revenue liability for the actual NFIP financial statements and the deferred revenue liability estimate for the year-end estimated NFIP financial statements, which is recorded in the year-end FEMA financial statements. The estimated financial statements are based on two months of actual data and one month of forecasted data, due to the timing of available data versus financial reporting deadlines. Once the actual data is available, FEMA compares the recorded estimated financial statements to the actual statements to determine whether any large or unusual differences exist to identify whether an on-top adjustment is necessary. The service provider's actuary uses the NFIP paid losses (i.e., claim payments) data for the current year and historical data to calculate the year-end actuarial liability for the NFIP financial statements, which is also recorded in the year-end FEMA financial statements. The case loss reserve data associated with flood claims may marginally and indirectly be used in this process, but is not separately disclosed in the NFIP financial statements. The consistency of this reserve from period to period is most important. Thus, the precision of the estimate to reflect actual events is dependent upon the accuracy and consistency of the underlying data submitted by the NFIP insurers on a monthly basis.

II. INTERNAL CONTROL DEFICIENCIES RELATED TO WRITTEN PREMIUMS

Observation (No formal NFR issued for deficiencies- verbal and written communication):

We selected six vendors or insurance companies at which to perform audit procedures over the operating effectiveness of controls related to written premiums for the periods October 1, 2014 through March 31, 2015; April 1, 2015 through June 30, 2015; and July 1, 2015 through August 31, 2015. For the six vendors/companies selected, we tested a sample of written premiums totaling 252 items covering the three testing periods identified above. During this testing, we noted the following internal control deficiency and error:

1. Based on our March 31, 2015 testwork, for one sample item, we noted there was a difference in the recalculation of the premium versus what is recorded in the population as of March 31, 2015. There was a system limitation in the calculation of premium amount due to a mid-term endorsement that caused an incorrect amount to be recorded as of March 31, 2015. The way in which the system calculated the premium amount did not prorate the endorsement amount for the applicable portion of the year, thus causing a difference in the premium.

Company	Sample No.	Policy #	Premium Receipt Date	Premium Amount per Population	Premium Amount per KPMG	(Under)/Over Statement
Nationwide Mutual Fire Ins.	19	[redacted]	[redacted]	$14,908	$16,538	$(1,630)

Recommendations:

We recommend that the Federal Insurance and Mitigation Administration:

1. Follow-up with the insurance company identified above to determine if appropriate corrective action has been implemented to address the exceptions identified.
2. Provide increased oversight to insurance companies participating in the NFIP to ensure they process and review underwriting files in accordance with the NFIP guidelines.

III. INTERNAL CONTROL DEFICIENCIES RELATED TO PAID CLAIMS

A. Internal Control Deficiencies and Errors Identified over Claims' Case Loss Reserves

Observation (NFR FEMA 15-19):

We selected five vendors or insurance companies at which to perform audit procedures over the operating effectiveness of controls related to the establishment and closure of case loss reserves for the periods October 1, 2014 through March 31, 2015; April 1, 2015 through June 30, 2015; and July 1, 2015 through August 31, 2015. For the five vendors/companies selected, we tested a sample of paid claims totaling 210 items covering the three testing periods identified above. We also performed substantive audit procedures over the completeness and accuracy of case loss reserves reported as of February 28, 2015 and August 31, 2015 for all insurance companies participating in the NFIP through a sample of 130 case loss reserve balances. During this testing, we noted the following internal control deficiencies and errors:

1. The insurance company's IT system improperly calculated the case loss reserve balance. The Increase Cost of Compliance (ICC) reserves were improperly closed based on the system's limitations to process several transactions in the order in which they occur during the course of one day. The system limitation caused the case reserve balance to be understated as of February 28, 2015.

Company	Sample No.	Policy No.	Month of Loss	Reserve Amount per Sample	Reserve Amount per KPMG	(Under)/Over Statement
Selective Insurance Co.	#11	[redacted]	[redacted]	$23,130	$38,130	$(15,000)

2. In three instances, the policies and associated claims were cancelled and re-written as new policies with the associated claims and case reserves. At that time the case reserves were not properly closed. The error was identified and a TRRP reserve correction change was processed; however, the correction was not properly processed. Consequently, the case reserve balance remained open as of the dates listed below.

February 28, 2015:

Company	Sample No.	Policy No.	Month of Loss	Reserve Amount per Sample	Reserve Amount per KPMG	(Under)/Over Statement
Allstate Insurance Co.	#48	[redacted]	[redacted]	$8,700	$0	$8,700
Allstate Insurance Co.	#49	[redacted]	[redacted]	$26,300	$0	$26,300

June 30, 2015 Claims:

American Bankers Insurance Co.	#1	[redacted]	[redacted]	$0.47	$0	$0.47

3. In eight instances, the amount recorded for case reserves in the case reserve population was not properly updated as additional claim information was obtained, creating a net overstatement of $6,870 as of August 31, 2015.

Company	Sample No.	Policy No.	Month of Loss	Reserve Amount per Sample	Reserve Amount per KPMG	(Under)/Over Statement
Wright Flood	#9	[redacted]	[redacted]	$12,000	$16,000	$(4,000)
Fire Insurance Exchange	#25	[redacted]	[redacted]	$10,300	$7,500	$2,800
Nationwide Mutual Fire Insurance	#26	[redacted]	[redacted]	$104,631.29	$101,015.34	$3,615.95
American Bankers Insurance	#29	[redacted]	[redacted]	$84,912.52	$94,912.52	$(10,000)
National Lloyds Insurance	#35	[redacted]	[redacted]	$21,500	$4,500	$17,000
Hartford Fire Insurance Company	#36	[redacted]	[redacted]	$10,000	$2,169.23	$7,830.77

Nationwide Mutual Fire Insurance	#39	[redacted]	[redacted]	$135,691.29	$140,068.02	$(4,376.73)
Nationwide Mutual Fire Insurance	#40	[redacted]	[redacted]	$100,363.49	$106,363.49	$(6,000)

Cause:

Condition 1: WYO Companies or vendor IT systems were not properly monitored for errors created by IT system limitations, which prevented case loss reserves from being closed or properly updated based on the claim activity.

Condition 2: Management at NFIP insurers have not fully developed and implemented adequate policies and procedures to monitor open case loss reserves to ensure final claim payments properly reduce the related reserve to zero.

Condition 3: Management at the NFIP insurers did not update the open case loss reserve balance based on new information received or document in the claim file whether the reserve information was considered by the claims examiner.

Recommendations:

We recommend that the Federal Insurance and Mitigation Administration:

1. Follow up with the NIFP insurer identified to determine if appropriate corrective action has been implemented to address the exception identified.

2. Continue to monitor and address exceptions on the Monthly Loss and Reserves Report and ensure that all open reserves on closed claims are reduced to zero in a timely manner.

3. Develop a requirement for NFIP insurers to review case loss reserve transactions for accuracy prior to submission of the data to the third-party service provided.

U.S. Department of Homeland Security
Washington, DC 20472

FEMA

June 1, 2016

MEMORANDUM FOR: Mark Bell
Assistant Inspector General for Audits
Office of Inspector General

FROM: Roy E. Wright
Deputy Associate Administrator
Federal Insurance and Mitigation Administration

SUBJECT: National Flood Insurance Program's Management Letter for DHS' FY 2015 Financial Statements Audit – For Official Use Only
OIG Project No. 16-026-AUD-FEMA

Thank you for the opportunity to review and comment on this Final Report, "National Flood Insurance Program's Management Letter for DHS' FY 2015 Financial Statements Audit." This memorandum addresses our responses to the five recommendations contained in the report with which the Federal Emergency Management Agency (FEMA) concurred.

In the fall of 2015 FEMA's Federal Insurance and Mitigation Administration (FIMA) embarked on an effort to restructure its National Flood Insurance Program (NFIP) enterprise focusing on increased oversight of the NFIP Write Your Own (WYO) insurance company partners, improved program delivery, and improved customer experience for NFIP policyholders. In February 2016, FEMA implemented the new enterprise structure which resulted in the establishment of new branches including an Industry Management Branch with the primary focus on WYO oversight responsible for WYO account management.

Recommendations 1 and 2 relate to INTERNAL CONTROL DEFICIENCIES RELATED TO WRITTEN PREMIUMS.

Recommendation 1: Follow-up with the insurance company identified above to determine if appropriate corrective action has been implemented to address the exceptions identified.

Response: Concur. FEMA followed up with the identified insurer. The insurer took appropriate corrective action.

Recommendation 2: Provide increased oversight to insurance companies participating in the NFIP to ensure they process and review underwriting files in accordance with the NFIP guidelines.

Response: Concur. By December, 30, 2016, FEMA will evaluate the WYO Financial Control Plan review process and will make recommendations on the data needed to improve WYO company oversight. FEMA has assembled a team to look comprehensively at oversight to include improved ways to measure performance and provide oversight of underwriting, claims, financial, and litigation aspects of WYOs. This team will implement new processes, test those in pilots, and codify the new procedures by December 30, 2016.

Recommendation 3, 4 and 5 relate to INTERNAL CONTROL DEFICIENCIES RELATED TO PAID CLAIMS.

Recommendation 3: Follow up with the NFIP insurer identified to determine if appropriate corrective action has been implemented to address the exception identified.

Response: Concur. FEMA followed up with the identified insurer. The insurer took appropriate corrective action.

Recommendation 4: Continue to monitor and address exceptions on the Monthly Loss and Reserves Report and ensure that all open reserves on closed claims are reduced to zero in a timely manner.

Response: Concur. FEMA will monitor and address WYO company case reserve exceptions on closed claims. To bolster our WYO oversight, we are in the process of staffing our Industry Management Branch with a team of WYO Account Managers by the end of this fiscal year (September 30, 2016). Each WYO Account Manager will track, manage and monitor the financial components of the Transaction Record Reporting and Processing Plan (TRRP). The Account Managers will engage in continuous and ongoing dialogue with their assigned companies and monitor company performance in critical Program delivery areas, including case reserving.

Recommendation 5: Develop a requirement for NFIP insurers to review case loss reserve transactions for accuracy prior to submission of the data to the third-party service provided.

Response: Concur. Using the case loss reserve report, the Legacy System of Record will continue the monthly task of reporting to the WYO companies any open reserve appearing to be ready for closure or adjustment. The WYO companies must reply that the reserve was closed (zeroed out) or explain why it should not be closed. The WYO companies have been notified via FIMA bulletin (W-10100) of the requirement for established case reserve procedures and the importance of consistency. FEMA has informed the companies that reserve errors are critical errors for the WYO Operation Review audits. The FEMA Industry Relations Account Managers will regularly monitor and report on the case loss reserves of their designated WYO companies

Again, thank you for the opportunity to comment on this Final Report. Please direct any questions regarding this response to Gary McKeon, Director of FEMA's GAO/OIG Audit Liaison Office, at (202) 646-1308. We look forward to working with you in the future.

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