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A TCA MANAGEMENT PAPER

FLOOD INSURANCE:

WHAT LENDERS MUST KNOW

INTRODUCTION

What apparently was the original Congressional attempt to control flooding – or at least to mitigate the damage floods cause – was the Flood Control Act of 1936. Generally, that legislation simply spurred the construction of more dams and levees, a strategy that ultimately was no match for Mother Nature, the nation's hurricane-prone communities, and farms and communities along interior waterways.

The National Flood Insurance Act was passed in 1968, the result of continued flooding along the Mississippi River. The goal then was threefold:

- Ultimately reduce federal expenditures for flood-related disaster control.
- Reduce flood damages through better state and local floodplain management.
- Better indemnify individuals for flood losses.

A key part of the '68 legislation required local communities to adopt, and enforce, floodplain management regulations to be eligible for the National Flood Insurance Program. The Flood Disaster Protection Act of 1973 added requirements, including mandatory insurance on all grants and loans on buildings in SFHAs (Special Flood Hazard Areas). In the mid-1990s, reform legislation increased compliance by mortgage lenders; increased the amount of coverage; and required FEMA to update its flood hazard map inventory at least every five years.

Based on the most recent count, flood hazard maps exist for more than 19,000 communities, and FEMA flood hazard maps are used an estimated 15 million times per year.

One could argue that more than 70 years of federal attention to flood issues should make flood insurance requirements almost routine for lenders, but flood insurance can be a quagmire confusing rules and requirements. At TCA, we know lenders struggle with flood coverage requirements: The dozens of flood compliance reviews we conduct each year for client lenders invariably turn up issues that raise examiner hackles.

To help, we have condensed a near flood of what we believe is useful flood coverage-flood insurance information into this White Paper. Based in part upon written material we already have distributed to TCA client institutions, this White Paper is being made available to the financial industry as a service from TCA.

We also are making the TCA staff available for limited phone discussions about flood issues to readers of this White Paper, at 800-934-REGS (800-934-7347). Lenders can call that same number to schedule a TCA flood program compliance review as well.

A 'Flood' of Flood Coverage Information

Flood insurance rules and regulations are among those compliance issues which seem to be constantly evolving. The requirements aren't new – we should be able to comply by now, right? But lenders do stumble, sometimes because new staff has come aboard and needs training; sometimes because "routine" compliance doesn't get the oversight and follow-up it should; sometimes because compliance rules keep changing.

We know. TCA's compliance reviews for client banking institutions often uncover flood compliance issues that, otherwise undiscovered and unrepaired, could lead to embarrassing and costly penalties when examiners inevitably find errors. What follows, therefore, is a summary of information based upon TCA staff experience. . .our reading of changing compliance rules. . .and continuing flood-related research we do.

This "flood" of compliance information will, we believe, be helpful to financial institutions as they administer their flood compliance programs.

Keep in mind that the TCA professionals are available to answer questions readers of the White Paper might have. Simply call us at 800-934-REGS (800-934-7347) or email TCA at info@tcaregs.com.

You can count on TCA to help.

What is a 'designated loan'?

A loan secured by a building or mobile home which is located or to be located in a special flood hazard area, in which flood insurance is available under the Act.

What are the Loan TRIP Wires triggering the need for flood insurance?

Remember **MIRE**

If the lender **M**akes, **I**ncreases, **R**enews or **E**xtends a designated loan, the lender must comply with the flood rules – including force placement, if necessary.

Don't forget modified or foreclosed loans need flood insurance, too. Restructured or modified loans that are designated loans are subject to mandatory purchase regulations if the lender increases the amount of loan, or extends or renews term of original loan. For instance, in a "work out" situation, if any past due fees are added to the principal, flood insurance is necessary for designated loans.

The amount of flood insurance required is the lesser of:

- Outstanding principal balance of the loan (or loans).
- Maximum amount of insurance available under the NFIP, which is the lesser of the maximum limit available for the type of structure.
- The insurable value of the structure.

The mystery is when to use Replacement Cost Value or Actual Cost Value.

Lenders first must determine whether they have a designated loan that is a residential or non-residential building.

Residential buildings are:	Non-Residential buildings are:
1-4 family dwelling	Small businesses, churches
Apartments with more than 4 units	Schools, farm buildings (including grain bins and silos)
Condominiums & cooperatives in which at least 75 percent of square footage is residential	Pool house, clubhouses, recreational, mercantile buildings
Hotels or motels where normal occupancy is six months or more	Industrial structures, warehouses, nursing homes
Rooming houses with more than four roomers	Hotels (rental less than six months)
Residential buildings with incidental non-residential occupancies of less than 25 percent (50 percent for single-family dwellings)	Mixed–use buildings with less than 75% residential square footage

Lenders are required to mandate flood insurance for buildings with limited utility or value if they comprise a designated loan. Lenders may consider carving out such buildings from the security it takes for the loan. Lenders should carefully analyze all risks of this option, *e.g.*, ability to market property in event of foreclosure.

Coverage limits can be found at http://www.fema.gov/library/viewRecord.do?id=2954

Key points to remember

- An NFIP policy will not cover an amount exceeding a building's insurable value (described later).
- Lenders are permitted to require more flood insurance coverage than the minimum required.
- A lender may not allow a borrower to use a high deductible to avoid mandatory purchase.

Exemptions:

- State-owned properties.
- Designated loan with a balance of $5K or less and a term of one year or less.

Construction loans

The lender has two options for construction loans:

- Require purchase of policy at time of consummation.
- Require flood insurance at time of specified drawdown of loan for actual construction.

At the time of a drawdown, lenders need to monitor for the actual start of construction. There is no 30-day waiting period with either option. Buildings are eligible for coverage prior to being walled and roofed; materials and supplies are also eligible for coverage and rates are based on construction draws.

Residential Condominiums

RCBAP – a Residential Condominium Building Association Policy – insures a residential condominium building owned by a condominium association. The maximum building coverage is the Replacement Cost Value of the building and its supporting structure or up to $250,000 per unit times the number of units, whichever is less.

If insured to at least 80 percent of its Replacement Cost Value at the time of loss or maximum limit, there is no coinsurance penalty (a reduction in the amount of the loss payment). RCBAP automatically requires Replacement Cost (RC) loss settlement for the building elements.

Revisions to RCBAP Documentation as of October 1, 2007 require the flood insurance declaration page to indicate the number of units in a structure and state the Replacement Cost Value amount.

<u>A Dwelling Policy Form</u> insures a single family dwelling unit in a condominium building or a non-condominium 1-4 family dwelling. A condominium unit in a townhouse, rowhouse, high-rise or low-rise building is considered to be a single family dwelling. The maximum coverage is $250,000 per unit and $100,000 content coverage.

<u>The General Property Form</u> covers other residential condo associations which have a residential occupancy rate of less than 75 percent and not eligible for RCBAP. The maximum coverage is $500,000 per building not per unit.

Replacement Cost coverage is not available under a General Property Form. Also the method to calculate the amount of insurance is Actual Cash Value coverage that includes a deduction for depreciation.

Home Equities, Lines of Credit, Subordinate Liens

Home equities, second mortgages and other junior liens are subject to mandatory purchase requirements for flood insurance. Determinations are required if there is a triggering MIRE event.

A lender must obtain coverage for the least of:

- Loan amount (including the first mortgage).
- Maximum flood insurance available under the NFIP using the insurable value of the building.

Lenders must ensure that borrower adds junior lien holder's name as mortgagee/loss payee to existing policy and they have the option to pull credit report to obtain balance of the 1st mortgage.

Other Security Interests

- A loan that finances inventory in a building in an SFHA where the building is not security for the loan is not a designated loan.
- A loan secured by both building and contents when building is in a SFHA requires flood insurance on both the building and its contents. Content insurance coverage is up to $500,000.
- If loan is secured by a building in a SFHA and by contents in another building, flood insurance is not required on the contents.
- The regulation applies even in circumstances involving "abundance of caution."

Event of Sale/Transfer of Designated Loans

- Lenders must notify the insurance provider/carrier in writing of the identity of the servicer of the loan and any change in servicer.
- Notice of change of servicer must be done within 60 days of change effective date.
- Change notices may be sent directly to the insurance provider by the mortgagee.
- In the event of merger/acquisition, the duty to provide notice falls to the successor institution if not provided by the acquired institution prior to effective date of merger/acquisition.

Escrow Requirements

Lenders must require an escrow for flood insurance premiums and fees if the lender makes escrow mandatory taxes, hazard insurance premiums or any other charges for residential improved real estate. The only exception is when escrows are voluntary.

Escrows for condominiums are not required if the condo unit is adequately covered by a RCBAP and dues to the condo association include the RCBAP premium. Escrows would be required if the RCBAP coverage is inadequate and the unit is covered by a dwelling form policy where the lender requires escrow of hazard insurance or taxes.

The following are revised and updated "Interagency Questions and Answers" regarding flood insurance. The guidance finalizes two Q&As that were previously proposed; NFIP requested additional comments on three proposed Q&A updates.

Question #9 (finalized). What is the "Insurable Value" of a building?

Replacement Cost Value is:

- Cost to repair or replace a building using material of similar kind and quality.
- No deduction for depreciation.
- Land value is excluded.
- Market value is excluded, too.

Actual Cost Value is:

- Cost to replace an insured item of property at time of lossless the value of its physical depreciation based on age, wear and tear.

It can be viewed as Replacement Cost less depreciation.

The insurable value of a building is the same as the overall value of a property minus the land on which the property is located. FEMA's Mandatory Purchase of Flood Insurance Guidelines state that the insurable value of a building is the same as 100 percent Replacement Cost Value (RCV) of the insured building, which is defined as "the cost to replace property with the same kind of material and construction without deduction for depreciation."

However, FEMA's guidelines also provide that lenders should avoid creating a situation in which the insured pays for more coverage than the NFIP would pay in the event of a loss. Strictly linking insurable value to RCV is not practical in all cases. In cases involving certain residential or condominium properties, insurance policies should be written to, and the insurance loss payout usually would be the equivalent of, RCV. However, in cases involving nonresidential properties, and even some residential properties, where the insurance loss payout would normally be based on actual cash value, which is RCV less physical depreciation, insurance policies written at RCV may require an insured to pay for coverage that exceeds the amount the NFIP would pay in the event of a loss.

Therefore, it is reasonable for lenders determining the amount of flood insurance to consider the extent of recovery allowed under the NFIP policy for the type of property being insured. This allows the lender to assist the borrower in avoiding situations in which the insured pays for coverage that exceeds the amount the NFIP will pay in the event of a loss. For example, insurance on a barn not used for farming. Lenders need to be equally mindful of avoiding situations in which, as a result of insuring at a level below RCV, they underinsure property.

In calculating the amount of insurance to require, the lender and borrower (either by themselves or in consultation with the flood insurance provider or other appropriate professional) may choose from a variety of approaches or methods to establish the insurable value.

For instance, they may use an appraisal based on a cost-value (not market-value) approach, a construction-cost calculation, and insurable value used in a hazard insurance policy. Insurable value for flood insurance purposes may differ from the coverage provided by the hazard insurance and that adjustments may be necessary) For example, most hazard policies do not cover foundations or any other reasonable approach, so long as it can be supported.

Question #10. Are there alternative methods approaches to determining the insurable value of a building? <u>This question has been withdrawn due to the finalized answer of question #9</u>.

Question #61 (finalized with minor clarifications). When must the lender have flood insurance in place if the borrower has not obtained adequate insurance within the 45-day notice period?

The Agencies decline to set an arbitrary number of days after the end of the 45-day notice period as a safe harbor. The Agencies believe that the lender should have policies and procedures in place to allow force placement of insurance when the 45-day notice period expires.

FEMA said the Agencies recognize that the process of force placing flood insurance may not always occur immediately on the 46th day. As long as the lender can provide a reasonable explanation for the brief delay, the Agencies would consider the force placement time frame satisfied.

Question #60 (revised and proposed for comments). When should a lender send the force placement notice to the borrower?

On July 21, 2009, the Agencies proposed Q&A 60 to address the permissibility of a lender's acceleration of the 45-day notice period for force placement by sending notice to the borrower before the borrower's flood insurance coverage expires. The proposed answer stated that although a lender or servicer could send an advance notice, the Act and Regulation do not allow a lender or servicer to shorten the 45-day notice period.

A majority of the commenters viewed the proposed question and answer as thwarting the flood insurance program's primary purpose of ensuring continuous flood insurance coverage during the life of the loan and the Agencies agree.

The Agencies have sought to reconcile the statue's requirement that a lender send the borrower notice of inadequate or lapsed flood insurance with the purpose of the statute to ensure continuous coverage. The Agencies are, therefore, proposing revisions to Q&A 60 to clarify when a lender is required to send a force placement notice.

So, for now, the answer to question #60 is:

To ensure that adequate flood insurance coverage is maintained throughout the term of the loan, a lender or its servicer must notify a borrower whenever flood insurance on the collateral has expired or is less that the amount required for the property.

The lender must send notice upon making a determination that the flood insurance coverage is inadequate or has expired, such as upon receipt of the notice of cancellation or expiration from the insurance provider or as a result of an internal flood policy monitoring system. Notice is also required when a lender learns that a property requires flood insurance because it is in an SFHA as a result of a flood map change.

To avoid the expiration of insurance, the Agencies recommend that the lender also advise the borrower when flood insurance on the collateral is about to expire.

Question #62 (revised and proposed for comments). When may a lender or its servicer charge a borrower for the cost of insurance that covers collateral during the 45-day notice period?

The Agencies received several comments and as a general rule, the revised proposed question and answer would allow a lender or its servicer to charge a borrower for insurance coverage for any part of the 45-day notice period in which no adequate borrower-purchased flood insurance coverage is in effect. However, the lender or its servicer needs express authority to charge the borrower for such coverage as a contractual condition of the loan being made.

Any policy that is obtained by a lender or its servicer, the premium of which is charged to the borrower pursuant to a contractual right, should be equivalent in coverage and exclusions to an NFIP policy and cover the interest of both the borrower and the lender. The Agencies also encourage institutions to explain their force-placement policies to borrowers (including their policy on charging for force-placement coverage for the 45-day period and the timing of that charge) and encourage lenders and servicers to escrow flood insurance premiums.

Question #57 (previously finalized, now revised as proposed). What is the requirement for the force placement of flood insurance under the Act and Regulation?

The Agencies are proposing revisions to previously finalized question and answer 57 as a result of the proposed revisions to questions and answers 60 and 62. The Act and Regulation require a lender to force place flood insurance, if all of the following circumstances occur:

- The lender determines at any time during the life of the loan that the property securing the loan is located in an SFHA.
- Flood insurance under the ACT is available for improved property securing the loan.
- The lender determines that flood insurance coverage is inadequate or does not exist.
- After required notice, the borrower fails to purchase the appropriate amount of coverage with 45 days.

FEMA developed the Mortgage Portfolio Protection Program (MPPP) to assist lenders in connection with force-placement procedures. FEMA published these procedures in the Federal Register on August 29, 1995 (60 FR44881). Appendix A of FEMA's September 2007 Mandatory Purchase of Flood Insurance Guidelines sets out the MPPP Guidelines and Requirements, including force-placement procedures and examples of notification letters to be used in connection with the MPPP.

Private Flood Insurance

A private insurance policy may be an adequate substitute for NFIP insurance if it meets the criteria set forth by FEMA.

- Requires the insurer to meet individual state department of insurance rules.
- Have surplus Lines recognized by state department of insurance.
- Include a 45-Day Cancellation/Non-Renewal Notice.
- Be as broad as the NFIP policy.
- Contain similar NFIP mortgage interest clause.
- Have the same legal recourse as NFIP if claim is denied.

The Standard Flood Hazard Determination Form (SFHDF) is required to be used. The SFHDF may not be used as a substitute for the borrower notification form. The SFHDF may be reused when increasing, extending, renewing or purchasing a loan. It cannot be reused when making a new loan.

Exceptions: Refinancing or assumption by same lender who obtained original determination and multiple loans to the same borrower only if the SFHDF is less than seven years old and no new or revised maps have been issued.

Notice to Borrower - When a bank makes, increases, extends or renews a loan secured by a building or mobile home located or to be located in a special flood hazard area, the bank shall mail or deliver a written notice to the borrower and servicer in all cases whether or not flood insurance is available under the Act for the collateral securing the loan.

Notice must be provided a "reasonable" time prior to closing. The old rule was 10 days.

- If multiple borrowers, notice can provided to any one of the borrowers and they can sign.
- If placement of manufactured home is unknown, lender notice to borrower should be made as soon as practicable after determination that the manufactured home will be located in a SFHA.

- Records of receipt provided by the borrower must be maintained for the time that the lender owns the loan.
- Unlike the re-use of the SFHDF, the lender must provide a new notice to the borrower, even if a new determination is not required.
- Neither the regulation nor the preamble addresses waiving the requirement to provide the notice to the borrower.

Flood Zone Discrepancies

There are three types of zone discrepancies:

Grandfather rating rule, allows a property owner to lock in a previous flood zone and/or lock in a previous Base Flood Elevation. Grandfathering also refers to getting a Standard Rated Policy at a non-flood zone rate if a policy is purchased BEFORE the effective date of a NEW map, moving a property from a non-flood zone INTO a flood zone.

Lenders must document the use of the grandfather rule. As of 10/01/2009, insurance agencies need to indicate if the property has been grandfathered.

> Procedures Relating to Flood Zone Discrepancies
> April 16, 2008
> Page 2
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> Effective May 1, 2008, WYO companies and the NFIP Servicing Agent are hereby directed to use the most hazardous flood zone for rating when presented with two different flood zones, unless the building qualifies for the "grandfathering rule." If the policyholder wants to dispute the high-risk flood zone determination, procedures are available, including the Letter of Determination Review (LODR) and the Letter of Map Amendment. These are cited in the Code of Federal Regulations, (CFR) at 44 CFR 65.17, Review of Determination. More detailed information concerning the LODR process is available from the FEMA website http://www.fema.gov/plan/prevent/fhm/fq_proc.shtm#fldproc81.

Too Close to Call, when the edge of the property comes right to the edge of the flood zone and the determination is too close to call.

Purposeful manipulation such as obtaining two initial flood determinations and picking the one that says the property is not in a flood while the other determinations say it is. If any discrepancy happens the lender needs to document the actions taken to resolve discrepancies to avoid possible violations.

Failure to comply has mandatory penalties, which are not to exceed $350 per violation, with a ceiling of $100,000 during a calendar year. Regulators will look for a pattern or practice of committing violations – including a failure to place insurance; escrow the flood insurance premium; force place insurance and/or provide notice requirements.

In addition to this White Paper, there are a variety of flood coverage related resources for lenders:

Helpful Resources:

National Flood Insurance Program Home page www.fema.gov/business/nfip

Federal Register- Interagency Q & As Regarding Flood Insurance (July 2009)
http://edocket.access.gpo.gov/2009/pdf/E9-17129.pdf

Federal Register- Interagency Q & As Regarding Flood Insurance (October 2011)
http://www.gpo.gov/fdsys/pkg/FR-2011-10-17/pdf/2011-26749.pdf

Mandatory Purchase of Flood Insurance Guidelines http://www.fema.gov/library/viewRecord.do?id=2954

And, of course, TCA. 800-934-7347.

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About TCA, the Thomas Compliance Associates, Inc.

TCA's arsenal of bank compliance risk solutions includes an unmatched array of people and service-related weapons, all intended to help banks effectively and cost-efficiently meet today's compliance challenges.

Our company was born in 1991 to provide high quality compliance consulting and related assistance to the nation's banking industry. Today, more than 21 years later, TCA continues to be among the best and most responsive when it comes to helping banks navigate their increasingly complicated compliance environment.

TCA's ability to help banks adapt to compliance demands ushered in as part of the regulatory (and political) reaction to the excesses that saddled banking with the 2008-09-01 Great Recession has drawn more than 300 institutions to the TCA compliance family.

For example, many TCA clients benefit from our **Visiting Compliance Manager** program, a unique, short-term service that connects banks with a specific TCA professional who will help solve a short-term compliance problem. Other clients utilize our **Virtual Compliance Manager** service – a secure virtual system that allows us to remotely conduct the same, meticulous compliance reviews our staff conducts in person, but at a lower cost.

In the final analysis, however, it is the TCA people who make the positive difference. Our staff includes several professionals who hold such special, industry-recognized designations as the CRCM (Certificated Regulatory Compliance Manager). . .CISSP (Certified Information Systems Security Professional) and the less common but equally important Certified Fraud Examiner designation.

In addition, TCA staff includes a former bank CFO. . .former bank attorneys. . .and former compliance managers and examiners.

TCA client banks also benefit from founder Tom Thomas' role as a director of Park Ridge (IL) Community Bank, where he is a member of the Board's Audit Committee. The insights Mr. Thomas gains as a director are part of TCA's approach to compliance management.

Aware. Experienced. Professional. TCA, the best compliance solutions in banking.

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