Flood Compliance Overview Manual

Summary: FDIC Compliance Exam Manual

The maximum civil penalty for a flood violation is $2,000 *per* violation. There is no annual cap for the amount of penalties that can be assessed. A history or continued practice of violations will trigger a mandatory civil money penalty. Those practices relate to:

- Escrow Requirements
- Notice Requirements
- Force-placement requirements

In addition, failure to comply with flood requirements can impact the safety and soundness of the bank's collateral.

Scope: 12 CFR 339.1; 12 CFR 339.3

Flood requirements apply to loans that are secured by structures in a special flood hazard area. This is important for a few reasons. First, the rule is collateral-driven and not purpose driven and therefore, covers both consumer and commercial loans. This rule relates to improved real estate or insurable mobile homes. Under FEMA, a structure is any building that has two walls and a roof and is at least 50% or more above ground. To be covered, a mobile home must be either:

1) Tied down;
2) Connected to utilities; or
3) Sit on a foundation.

Second, the rules apply when the structure is in a special flood hazard area (SFHA). Flood zones A or V are SFHAs. Remember! SFHA determinations are determined by the location of the structure. If even a corner of a structure is in an SFHA, the entire structure is treated as being in a flood hazard area. If part of the land taken as collateral for the loan is located in a flood hazard area, but the building itself is not in the flood hazard area, insurance is not required.

Structures that are not in a SFHA do not have to comply with the rules. *However*, the bank cannot know if a structure is in a SFHA without getting a flood determination. Thus, the bank should pull flood determinations on every loan secured by a structure and then determine whether the loan needs flood insurance and must abide by the rest of the requirements. There are also exemptions for any state-owned property covered under a policy of self-insurance satisfactory to the Director of FEMA, who publishes and periodically revises the list of states falling within this exemption. There is also an exemption for a loan with an original principal balance of $5,000 or less and a repayment term of one year or less. In addition, if a property is in a non-participating community, the determination must be made and the notice sent, but the purchase of flood insurance is not mandatory.

Detached Structures:12 CFR 339.4

Detached structures are also exempt from the flood requirements. A detached structure is a building that:

- Is a part of any residential property but
- Is detached from the primary residential structure of such property and
- Does not serve as a residence

A "structure that is a part of a residential property" is a structure used primarily for personal, family, or household purposes. Whether a structure "serve[s] as a residence" will be based on the lender's good faith determination that the

structure is intended for use or is actually used as a residence. Importantly, "detached" means that the structure is not joined by any structural connection to the primary residence.

MIRE

Flood requirements are triggered by MIRE events which means when a lender makes, increases, renews or extends a loan. The bank must make sure insurance policies are current and must require flood insurance when there is knowledge of deficiency. As a quick note, life of loan monitoring is not required but is a best practice for safety and soundness.

Determination: 12 CFR 339.6

The flood regulation requires that the Special Flood Hazard Determination be in file prior to closing. The determination does not have to be signed or given to the borrower. The bank may rely on an existing determination if it is:

- Not older than seven years
- The previous determination was on the SFHD form
- The flood zone has not changed
- It is the same property & same lender

Disputes

If the consumer disputes the flood zone, FEMA will do a final determination but the bank will need to close the loan with insurance in the event of a dispute. The FEMA maps, and not any outside opinions, set the requirements. If the bank wants to dispute, they can request a letter of map amendment or revision which "counts" as a map change.

Discrepancies

A common issue seen on the C/A hotline relates to lenders receiving a policy with a flood zone that doesn't match their determination. Lenders are no longer required to reconcile to reconcile discrepancies between the flood determination and the insurance policy. For NFIP policies issued under FEMA's Risk Rating 2.0 - Equity in Action (Risk Rating 2.0), premium rates are no longer determined by the flood zone in which the property is located. Moreover, the flood zone is no longer included on the declarations page for NFIP policies issued under Risk Rating 2.0. Flood insurance policies issued by a private insurer may still include the flood zone on the declarations page, however, the NFIP policies that have not been issued or renewed under Risk Rating 2.0 will include the flood zone on the declarations page. In these cases, lenders also need not reconcile any discrepancy. The flood zone determination is still necessary to determine if a property is located in an SFHA. If the SFHDF indicates that the building securing the loan is in an SFHA, the lender must require the appropriate amount of insurance coverage in accordance with the Act and Regulation.

A lender is not in violation of the regulation if there is a discrepancy between the flood zone on the SFHDF and the flood zone associated with a flood insurance policy.

Notices

SFHA Notice: 12 CFR 339.9

A notice must be provided when borrower must obtain insurance. The notice must include information about obtaining flood insurance and the escrow language. Receipt of the notice must be acknowledged in writing. The notice must be sent within a reasonable time before closing. There is no regulatory definition of "reasonable time" but 10 days is the industry and regulator standard. The bank cannot close the loan without adequate flood insurance coverage. Be aware that the FEMA Flood Manual was updated in October of 2018 and indicates that acceptable proof of insurance is a copy of the declarations page.

Notice of Servicer Identity: 12 CFR 339.10

When a loan covered by the Flood regulation is made, the lender must notify FEMA of the identity of the loan servicer. This notice is given to the insurance provider. The notice must be in writing. In addition, if the servicer changes during the life of the loan, the lender must give notice within 60 days of the effective date of the change. When servicing rights are transferred, the duty to provide the notice will transfer to the new servicer.

Minimum Amount of Flood Insurance: 12 CFR 339.3

The minimum flood requirement can be broken down into the following statement– the lesser of the insurable value of the property, the principal loan balance or the NFIP maximum amount. Insurable value is the overall value of the property without the land. There are two ways to determine insurable value depending on property type – replacement cost value and actual cost value. The principal loan balance is the outstanding principal balance at the time the loan is made, increased, renewed or extended. The NFIP maximum amount refers to the maximum amount of coverage that will be extended by the National Flood Insurance Program. For residential one-to-four family homes, that amount is $250,000. For multifamily homes with five or more units, that amount is $500,000 and for commercial buildings amount is $500,000.

When determining the least amount of flood insurance required, the bank is to pick the lowest of all three categories. So, for a single-family home with a replacement cost value of $200,000, a principal loan balance of $250,000 and the NFIP maximum of $250,000, the replacement cost value is the lesser of the three. Therefore, the minimum amount of flood coverage required is $200,000.

Content Coverage

Contents coverage is required when the contents of a building secure the loan, in addition to the building when the building is in a SFHA. Content Coverage is based on the Actual Cost Value (ACV). The property must be insured in order for the contents to be eligible. The NFIP Maximum for personal property is $100,000 and is $500,000 for commercial property.

Condominiums

For condominium, when the borrower is purchasing an individual condo unit, the bank should see if the building association has a master policy called a Residential Condominium Building Association Policy. The RCBAP is special because it covers the shared areas of the building, as well as, the individual units. If there is some other type of building coverage, like a policy that just covers the shared areas and exterior walls, that's not RCBAP and the bank has to require individual unit coverage from the borrower.

If there is RCBAP coverage you first ensure that the policy covers 100 percent of the RCV of the building or the total number of units times $250,000, whichever is less. If policy doesn't have that amount, the bank may have to require the borrower to get a policy to make up the deficiency. If there is no RCBAP coverage or the policy doesn't have enough coverage, the bank will look at the replacement cost value of the building and divide by the number of units, the NFIP maximum of $250,000 per unit or the loan amount to determine the required amount of coverage.
For a commercial condominium, the maximum amount of coverage is $500,000 for the building and $500,000 for the common contents. Remember the NFIP maximum of $500,000 for multifamily buildings only applies to non-condominiums so the bank needs to consider the number of units if the borrower is buying the whole building. In addition, when looking at personal contents in a condo, it's just like a regular house and set at $100,000.

Force Placement: 12 CFR 339.7

A lender is required to force-place flood insurance if at any time during the term of the loan insurance is inadequate or does not exist. A lender must begin force-placement procedures immediately upon discovery of the deficiency – force placement is not limited to renewals, extensions, etc. If the lender gets any notice of inadequate coverage during the life of the loan, the lender must start force-placement procedures. Those procedures start with the 45-day notification requirements. Bank must notify the borrower that the borrower should obtain flood insurance, at the borrower's

expense, in an amount at least equal to the amount required, for the remaining term of the loan. The rule clarifies that a lender has the authority to charge a borrower for the cost of flood insurance commencing on the date on which the borrower's coverage lapsed or became insufficient

Within 30 days of receipt of proof of flood insurance, the lender must:

- Notify the bank's flood insurer to terminate the insurance;
- Refund all premiums paid by the borrower for the force-placed flood insurance during the overlap period; and
- Refund any fees related to the force-placed flood insurance during that period.

The lender is required to accept the insurance declarations page as proof of borrower-paid insurance that requires cancellation of the lender-paid insurance. The declarations page must include:

- The policy number;
- Identity of the borrower-paid insurer; and
- Contact information for that company or agent.

Escrow: 12 CFR 339.5

The flood escrow rule was effective in 2016 and relates to loans secured by residential real estate. Flood escrow is confusing because there were different requirements prior to January 2016. However, for any loan secured by property in a flood zone that is made, increased, renewed or extended after January 1, 2016, the bank needs to escrow unless an exception applies. It's important to note that it's not just limited to loan originations, it's required for all MIRE events.

So, let's talk about the exceptions. First, if the loan purpose, not the use of the collateral but the loan purpose, is primarily for business, commercial or agricultural purposes, it's exempt. If the loan is a subordinate lien and there's already flood coverage, it's exempt. If the property is covered by an HOA or condo association or a cooperative policy, it's not required. Flood escrow is also not required on HELOCS, non-performing loans and short-term loans of less than 12 months.

Importantly, there is a small lender exception. A small lender is one that has total assets of less than $1 billion in either of the last two calendar years and was not required to nor had a consistent policy to escrow loans prior to July 6, 2012. If the bank is a small lender, regardless of the loan purpose or the flood coverage requirements, the bank does not have to comply with a flood escrow requirement. There are often questions as to whether flood escrow requires the bank to escrow all loan fees. The answer is no. Flood escrow requirements relate to flood insurance only and doesn't require the bank to escrow hazard insurance and taxes.

NFIP Reauthorization: NFIP

The NFIP reauthorization decision has multiple times since September 2017. As such, it's important for the bank to have a plan for if the NFIP fails to reauthorize. The bank can keep up to date with this issue by simply following the NFIP reauthorization.

Private Flood Insurance: Final Rule

On February 20, 2019, the Federal Register published a long-awaited Final Rule on private flood insurance from five federal agencies: OCC, FRB, FDIC, FCA, and NCUA (the Agencies). Generally, the Final Rule implements the private flood insurance requirements originally enacted in the Biggert-Waters Flood Insurance Reform Act of 2012 (Biggert-Waters). Some of the key takeaways of the Final Rule are that it:

1. Implements the Biggert-Waters requirement that institutions accept private flood insurance policies that meet specific criteria;
2. Defines "private flood insurance" for purposes of determining whether acceptance is required;
3. Allows institutions to rely on an insurer's written assurance ("compliance aid") in the private policy that the specific criteria have been met;
4. Clarifies that institutions may accept private policies that do not meet the specific criteria, under certain circumstances; and
5. Permits institutions to accept flood insurance plans provided by mutual aid societies in certain cases.

"Private Flood Insurance" Defined

The 2016 Proposed Rule defined "private flood insurance" consistent with the definition in Biggert-Waters, and the Final Rule for the most part adopted the same definition, which includes the following generalized conditions that a private flood insurance policy must have:

1. Is issued by an insurer or surplus lines insurer that's licensed by the insurance regulator in the state where the property is located;
2. Provides flood insurance coverage that is "at least as broad" as that under an NFIP standard flood insurance policy (SFIP), specifically considering deductibles, exclusions, and conditions;
3. Includes a requirement for the insurer to give 45-day written notice before cancellation or non-renewal;
4. Includes information about the availability of flood insurance coverage under the NFIP;
5. Includes a mortgage interest clause similar to the clause in an SFIP;
6. Includes a one-year statute of limitations provision; and
7. Contains cancellation provisions that are as restrictive as the provisions in an SFIP.

The 2016 Proposed Rule clarified that a policy is "at least as broad as" the coverage provided under an SFIP if several conditions are met. One of these was that the policy must cover both the mortgagor(s) and the mortgagee(s) as loss payees, but in another positive change, the Final Rule removed this requirement, leaving only the following conditions:

(1) Defines "flood" to include the same events defined as a "flood" in an SFIP;
(2) Contains the same coverage and provisions in an SFIP, including:
    - building property coverage;
    - personal property coverage;
    - other coverages; and
    - the increased cost of compliance;
(3) Has deductibles that are not higher than the NFIP maximum for the same type of property, and includes non-applicability provisions that are similar to those in an SFIP;
(4) Provides coverage for direct physical loss caused by a flood and may exclude other types of loss that are included in an SFIP; and
(5) Does not contain any other conditions that provide less coverage than would be provided in an SFIP.

Required Acceptance and Compliance Aid

The Final Rule *requires* institutions to accept any "private flood insurance" that meets the definition above. Luckily, the Final Rule not only adopted the "Compliance Aid" that was originally set out in the Proposed Rules, but it also streamlined it so that it's easier for institutions to meet. The 2016 Proposed Rule would have required that the insurer write a summary detailing how the policy meets the private flood insurance definition, *and* that the institution verify the accuracy of that summary.

Under the Final Rule, the institution can determine that a policy meets the definition (without the need for a summary or review) as long as the policy or an endorsement contains the following sentence: "This policy meets the definition of private flood insurance contained in 42 U.S.C. 4012a(b)(7) and the corresponding regulation." It's important to note, however, that the Final Rule does not allow the institution to refuse a policy simply because it does not contain this statement. If that's the case, the institution is required to make its own determination regarding whether the policy meets the definition set out above.

Discretionary Acceptance

The Final Rule maintains the option for institutions to accept certain flood insurance policies issued by private insurers, even if the policy doesn't meet the definition of "private flood insurance." Another positive change is that the Final Rule removed some of these conditions for discretionary acceptance that were required in the 2016 Proposed Rule. The Final Rule now only contains the following requirements:

(1) The policy meets the minimum coverage requirement;
(2) The policy is issued by a licensed insurer;
(3) The policy covers both the mortgagor and mortgagee as loss payees; and
(4) The policy provides sufficient protection for a designated loan, consistent with general safety and soundness principles.

Mutual Aid Society

Like the Proposed Rules, the Final Rule also allows institutions to choose whether to accept certain plans providing flood coverage issued by "mutual aid societies." Specifically, the 2016 Proposed Rule defined "mutual aid society" as an organization that meets the following three criteria:

(1) The members must share a common religious, charitable, educational, or fraternal bond;
(2) The organization must cover losses caused by damage to members' property pursuant to an agreement, including damage caused by flooding, in accordance with this common bond; and
(3) The organization must have a demonstrated history of fulfilling the terms of agreements to cover losses to members' property caused by flooding.

The Agencies received a variety of concerns about the third prong, but the Final Rule made clear that they believe the requirement is necessary for safety and soundness, and that institutions should be able to obtain sufficient information about an organization's history in covering members' losses; for example, through the institution's own experiences with the mutual aid society, or documentation provided by the mutual aid society that it covered previous losses.

Like in the 2016 Proposed Rule, the institution may accept a plan issued by a mutual aid society if:

1. The institution's regulator has determined that the plan qualifies as flood insurance for purposes of the Act;
2. The plan meets the minimum coverage requirements;
3. The plan covers both the mortgagor(s) and the mortgagee(s) as loss payees; and
4. The plan provides sufficient protection for a designated loan, consistent with general safety and soundness principles, and the institution documents this in writing.

As you might notice, these conditions are almost the same as those for discretionary acceptance. Note that also like the discretionary acceptance provisions, institutions are not required to accept a plan from a mutual aid society, assuming the plan does not otherwise meet the definition of private flood insurance.

Record Retention: 12 CFR 339.3

Copies of completed SFHD forms, in either hard copy or electronic form, are required to be retained for as long as the bank owns the loan. Additionally, records of receipt of notices to the borrower and the servicer are required to be retained for as long as the bank owns the loan.

Enforcement: 12 USC 5113

Potential negligence liability if lender does not comply with the act the borrower's property is damaged or destroyed in the flood, Administrative enforcement, Regulatory authorities must examine for compliance with the flood insurance laws during each exam that is required either annual or every 18 months

In May 2022, the Agencies (OCC, FRB, FDIC, etc.) released an updated version of their Question-and-Answer guidance regarding flood insurance rules. The updates included reorganization, revisions, and additions to the prior Q&A guidance regarding flood insurance rules.

This manual offers a brief history of the flood rules; an overview of the applicability, sufficiency, escrow, and timeline requirements under the flood rules; a discussion of the updates to the Interagency Q&As; insight into frequently asked questions (FAQs), and a short exam to test your understanding of the 2022 Q&A updates.

Interagency Q&A

Background

Since 1997, the Interagency Q&A have provided banks with guidance on a variety of technical flood insurance-related compliance issues.

In 2009, the Agencies comprehensively revised and reorganized the initial 1997 Interagency Q&A, and in 2011, the Agencies further finalized two additional Q&A that were proposed in 2009, and re-proposed three Q&As that were never finalized.

Considering the significant changes in the laws, the Agencies proposed new and revised Interagency Q&A in July 2020 and published them in March 2021.

The Agencies have now consolidated these into one set of Interagency Q&A consisting of 144 questions and answers.

In May 2022, the Agencies (OCC, FRB, FDIC, etc.) released an updated version of their Question-and-Answer guidance regarding flood insurance rules. The updates included reorganization, revisions, and additions to the prior Q&A guidance regarding flood insurance rules. These include key topics such as:

- Escrow of flood insurance premiums;
- The detached structure exemption;
- Force placement procedures; and
- Acceptance of flood insurance policies issued by private insurers.

Flood Compliance Overview

FAQ: Questions

Question 1:

When does the flood regulation require that the Special Flood Hazard Determination be filed?

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Question 2:

Does a lender need to take a security interest in the primary residential structure for detached structures to be eligible for the exemption?

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Question 3:

The bank is making a loan that is secured by real property which contains a home and a detached garage that is part of the residence. The home is not in a flood zone, **but** the garage is in a flood zone. The garage does not serve as a residence and is primarily used for personal purposes. Can the bank use the detached structure exemption in this case?

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Question 4:

The bank agreed to extend a loan to a borrower for what we thought was vacant land, initially. The appraisal came back, however, and we discovered that there was a shed on the property. Does this fall under the detached structure exemption? The officer initially exempted the shed from flood insurance, but I am under the impression that it had to be tied to real property in order the for exemption to apply. Am I correct in thinking this?

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Question 5:

Is the bank required to implement force placed insurance? If so, when?

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Flood Compliance Overview

FAQ: Answers

Answer 1:

The flood regulation requires that the Special Flood Hazard Determination be in file prior to closing. The determination does not have to be signed or given to the borrower. The bank may rely on an existing determination if it is:

- Not older than seven years
- The previous determination was on the SFHD form
- The flood zone has not changed
- It is the same property & same lender

Answer 2:

No, but the lender needs to evaluate the uses of detached structures to determine if they are eligible.

Answer 3:

Yes. This is because the garage meets all the criteria for the exemption. It is part of the residence but detached. It is used for personal purposes, rather than commercial, agricultural, or other business-type purpose, and it does not serve as a residence, itself. Therefore, it is exempt under the detached structure exemption. The house does not have to be in a flood zone for the bank to utilize this exemption.

Answer 4:

Yes - the shed has to be detached from a residential dwelling. It can't just be detached. So, it does not fall under the exemption. Flood insurance is required.

Answer 5:

A lender is required to force-place flood insurance if at any time during the term of the loan insurance is inadequate or does not exist. A lender must begin force-placement procedures immediately upon discovery of the deficiency – force placement is not limited to renewals, extensions, etc. If the lender gets any notice of inadequate coverage during the life of the loan, the lender must start force-placement procedures. Those procedures start with the 45-day notification requirements. Bank must notify the borrower that the borrower should obtain flood insurance, at the borrower's expense, in an amount at least equal to the amount required, for the remaining term of the loan. The rule clarifies that a lender has the authority to charge a borrower for the cost of flood insurance commencing on the date on which the borrower's coverage lapsed or became insufficient

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