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Flood Insurance for Lenders: ABCs of Flood Insurance Compliance

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Presented by:
Katherine J. Henry & Heather Howell Wright

Importance of Flood Insurance
Billions in Losses

- Between 1980 and 2013, the United States suffered more than $260 billion in flood losses

- These losses create significant flood insurance claims
  - Hurricane Katrina: $16.3 billion
  - Superstorm Sandy: $8 billion

Importance of Flood Insurance Compliance for Lenders and Servicers

- Lending institutions may not “make, increase, extend, or renew” loans secured by real property in special flood hazard areas without complying with flood insurance statutes and regulations

- Keys for lenders and servicers
  - Ensure compliance
  - Protect assets

- Operating in uncertain environment because current flood insurance program sunsets on September 30, 2017

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Governing Federal Regulations

- National Flood Insurance Act of 1968 (NFIA)
- Flood Disaster Protection Act of 1973 (FDPA)
- National Flood Insurance Reform Act of 1994 (NFIRA)
- Biggert-Waters Flood Insurance Reform Act of 2012
- Homeowners Flood Insurance Affordability Act of 2014 (HFIAA)

National Flood Insurance Act of 1968 (NFIA)

- Federal response to increased flood damage, costs of disaster relief, and lack of flood insurance
- Makes federally-subsidized flood insurance available in special flood hazard areas (SFHA) in participating communities
- Administered by Federal Insurance and Mitigation Administration (FIMA) (a department of FEMA)
- Insurance available through
  - Direct Program agents
  - Write Your Own Program (WYO) from private insurers
  - Private insurers using their own paper

Flood Disaster Protection Act of 1973 (FDPA)

- First implemented flood insurance requirements for federally-regulated financial institutions
- FDPA and implementing regulations govern lending institutions that “make, increase, extend, or renew” loans secured by real property in special flood hazard areas
- Required agencies to promulgate regulations requiring lending institutions not to “make, increase, extend, or renew” loans secured by real property in special flood hazard areas unless covered by flood insurance

National Flood Insurance Reform Act of 1994 (NFIRA)

- Increased the focus on lender compliance
- Required lenders to escrow premiums and fees for flood insurance if the lender also required escrow for taxes and other property insurance
- Applied flood insurance requirements to any loans purchased by Fannie Mae or Freddie Mac

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Biggert-Waters Flood Insurance Reform Act of 2012

- Designed to ensure NFIP's fiscal stability by:
  - Phasing out subsidized rates
  - Phasing out grandfathered rates
  - Implementing full-risk pricing for all policies
- Increased monetary penalties and removed statutory caps for lender non-compliance
- Required lenders to refund premiums where force-placed flood insurance overlaps with borrower's flood insurance
- Required lenders to accept private flood insurance
- Established a sunset of September 30, 2017

Homeowners Flood Insurance Affordability Act of 2014 (HFIAA)

- Biggert-Waters’ full-pricing requirement resulted in unaffordable premiums affecting real estate market

- Limits amount of rate increase in a single year

- Permits lenders not to require flood insurance on detached residential structures not part of residence

Future of the NFIP

- Sunset of September 30, 2017

- Legislative efforts to reauthorize NFIP

  - HR 1422: Flood Insurance Market Parity and Modernization

  - HR 2246: The Taxpayer Exposure Mitigation Act

  - HR 2847: 21st Century Flood Reform Act

  - HR 1558: Repeatedly Flooded Communities Preparation Act

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Future of the NFIP

- Current Lobbying activities
  - Mortgage Bankers Association
  - National Association of Realtors

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Compliance Basics – A of the ABCs

- Special Flood Hazard Area (SFHA)
  - Before making a loan, lender must determine whether structure currently in or will be in a SFHA
  - Referred to as a “designated loan”
  - Lender must document this determination using FEMA’s Standard Flood Hazard Determination Form

- Notice to borrower
  - Lender must advise the property is in SFHA
  - Must provide a description of NFIP requirements and availability
  - Lender must retain a record of the notice
  - Regulatory agencies provide a model notice form

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Compliance Basics – A of the ABCs

- Escrow Requirements
  - If the lender requires escrow accounts for loans secured by real property, then must also escrow premiums for flood insurance
  - Limited escrow exceptions under 2015 rule-making
    - Small lender – financial institution with assets less than $1 billion
    - Non-performing loans – 90 days or more past due
    - Loans with terms of 12 months or less

Compliance Basics – B of the ABCs

- Required Coverage Limits
  - Loan's outstanding principal balance
  - Maximum coverage available
    - $250,000 for residential
    - $500,000 for commercial – including multi-family
- Calculating Coverage Limits = Lesser of
    - Maximum amount of coverage available under NFIP

      OR
    - Overall property value minus value of land

Compliance Basics – B of the ABCs

- Insurable value – not market value
  - NFIP will not pay claim in excess of insurable value
- Lender miscalculation
  - Require borrower to purchase too much: subject lender to penalty for violation
  - Require borrower to purchase too little: subject lender to risk of loss

Compliance Basics – B of the ABCs

- Forced Placement
  - At any time when lender or servicer determines collateral has no flood insurance or insufficient flood insurance
  - Must notify borrower
  - If borrower does not purchase within 45 days, lender must purchase on borrower's behalf
  - Regulators expect force-placement on the 46th day
  - Refund under the Biggert-Waters Act
- Escrow – Biggert Waters rule-making

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Compliance Basics – B of the ABCs

- Modifications and Work-Outs
  – NFIP requirements for lenders apply whenever a lender “makes increases, extends, or renews” a loan secured by real property located in a SFHA
- Residential Modifications
- Commercial Workouts

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Compliance Basics – B of the ABCs

- Construction Loans
  - NFIP does not apply to loans only secured by unimproved land
  - Once construction begins, loan is subject to NFIP
  - Lender options
    - May require flood insurance purchase at time of origination
    - Defer purchase of flood insurance until foundation poured

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Enforcement – C of the ABCs

- Regulated lender demonstrating "pattern or practice" of noncompliance is subject to monetary penalties
  - Not requiring flood insurance
  - Not escrowing when required
  - Not force-placing within required time limits
  - Not providing notice that property is in SFHA

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Enforcement – C of the ABCs

- What constitutes a “pattern or practice”: not defined in National Flood Insurance Act

- Factors considered
  - Failure resulted from cause within lender’s control
  - Failure resulted from policy or practice
  - Repeated failure over period of time
  - Percentage of failures related to transactions

Compliance – Next Steps

- Uncertainty about NFIP's future
- Lenders and servicers should prepare for possible changes
  - Implement systems and processes to ensure appropriate flood coverage in place before loan closing
  - Maintain records of notice to borrower
  - Redundant valuation tools to ensure accuracy of insurable value
  - Implement monitoring processes to track revisions in flood maps, insurance renewal, property valuation

For Updates on Flood Insurance

www.financialservicesperspectives.com

www.itpaystobecovered.com

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Questions?