

# CONSUMER COMPLIANCE OUTLOOK®

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A FEDERAL RESERVE SYSTEM PUBLICATION WITH A FOCUS ON CONSUMER COMPLIANCE ISSUES



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## FLOOD INSURANCE COMPLIANCE REQUIREMENTS

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### INTRODUCTION

According to the Federal Emergency Management Agency (FEMA), “[F]loods are the most common and costly natural disaster in the United States.”<sup>1</sup> In 2011, homeowners throughout the country painfully learned this lesson as they endured devastating flooding that resulted in billions of dollars worth of damage to their properties. Hurricane Irene alone is estimated to have caused between \$7 and \$10 billion in losses, mostly from flooding.<sup>2</sup> These significant losses translate to a significant volume of flood insurance claims. For example, in 2005 Hurricane Katrina resulted in claim payments of \$16.2 billion from the National Flood Insurance Program (NFIP), ranking it as the most expensive flood since the NFIP’s inception in 1968.<sup>3</sup> These dramatic statistics provide a stark reminder to lenders about the importance of understanding and properly complying with federal flood insurance laws and regulations.

This article provides a brief history of the federal flood insurance statutes and regulations, an overview of flood insurance requirements, and a discussion of enforcement.

### THE NFIA AND ITS SUBSEQUENT AMENDMENTS

In response to increased flood damage, the escalating costs of disaster relief for taxpayers, and the unavailability of affordable flood insurance, Congress enacted the National Flood Insurance Act (NFIA) in 1968.<sup>4</sup> The NFIA established the NFIP to address the economic burdens of floods, encourage protective and preventative measures, and reduce the cost of flood insurance.<sup>5</sup> Property located in a flood area where the community participates in the NFIP is subject to the NFIA’s requirements. According to FEMA, “[a]lmost all

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<sup>1</sup> <http://1.usa.gov/facts-fema>

<sup>2</sup> Michael Cooper, “Hurricane Cost Seen as Ranking Among Top Ten,” *New York Times*, August 30, 2011.

<sup>3</sup> <http://1.usa.gov/facts-fema2>

<sup>4</sup> Public Law 90-448, 82 Stat. 572 (August 1, 1968). Codified, as amended, at 42 U.S.C. §4001 et seq.

<sup>5</sup> 42 U.S.C. §4001(a)

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of the nation's communities with serious flooding potential have joined the NFIP."<sup>6</sup>

Flood insurance compliance requirements for federally regulated financial institutions began in 1973, when Congress enacted the Flood Disaster Protection Act of 1973 (FDPA).<sup>7</sup> Section 102(b) of the FDPA amended the NFIA to require the federal banking agencies (agencies) to issue regulations directing lending institutions under their supervision not to make, increase, extend, or renew any loan secured by improved real estate or a mobile home located, or to be located, in a special flood hazard area (SFHA) where flood insurance is available under the NFIP, unless the building or mobile home and any personal property securing the loan are covered by flood insurance for the term of the loan.

Congress subsequently enacted the National Flood Insurance Reform Act of 1994 (NFIRA),<sup>8</sup> which made comprehensive changes to the NFIA and the FDPA. The changes include obligating lenders to escrow all premiums and fees for flood insurance required under the NFIA and its implementing regulations, applying flood insurance requirements to loans purchased by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), and directing the federal banking agencies to jointly issue uniform implementing regulations for common statutory and supervisory requirements for

the institutions they supervise.<sup>9</sup> In response to the last requirement, the agencies published substantially similar flood insurance regulations to implement the statutory requirements of the NFIA, the FDPA, and the NFIRA for the institutions they supervise.<sup>10</sup>

The agencies and the Farm Credit Administration (FCA) have provided additional guidance about flood insurance requirements for the institutions they supervise in the Interagency Questions and Answers Regarding Flood Insurance (Interagency Flood Q&As). In 2009, the agencies and the FCA, in coordination with FEMA, updated this guidance and included five new proposed Q&As.<sup>11</sup> In October 2011, the agencies and the FCA made two of the questions final, withdrew one, and sought additional comments on the other two questions regarding forced placement.<sup>12</sup>

### GENERAL COMPLIANCE REQUIREMENTS

#### *Flood Hazard Area Determination*

Before making a loan secured by a residential or non-residential building or mobile home, a federally regulated lending institution must determine whether the structure is located, or will be located, in an SFHA for which flood insurance is available under the NFIP.<sup>13</sup> This requirement applies even if a creditor takes a security interest simply out of an "abundance of caution." Question 41 of the Interagency Flood Q&As makes it clear that "if the lender takes a security inter-

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<sup>6</sup> National Flood Insurance Program, *Answers to Questions About the NFIP*, Q. 26, FEMA F-084 (March 2011). The list of participating communities is available at: <http://www.fema.gov/fema/csb.shtm>.

<sup>7</sup> Pub. L. No. 93-234, 87 Stat. 975. (1973), available at: <http://1.usa.gov/fdpa73>

<sup>8</sup> Title V of the Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. 103-325 (September 23, 1994), available at: <http://1.usa.gov/1994-reform>

<sup>9</sup> See 42 U.S.C. §4012a(b)(3) (government-sponsored enterprises for housing), 42 U.S.C. §4012a(d)(1) (escrow of flood insurance payments), and 12 U.S.C. §4803(a)(3) (streamlining regulatory requirements).

<sup>10</sup> The agencies' flood insurance implementing regulations are codified at 12 C.F.R. §208.25 (Regulation H) for institutions supervised by the Board of Governors of the Federal Reserve System (Board); 12 C.F.R. part 172 for institutions supervised by the Office of the Comptroller of the Currency; 12 C.F.R. part 339 for institutions supervised by the Federal Deposit Insurance Corporation; and 12 C.F.R. part 760 for institutions supervised by the National Credit Union Administration. This article makes reference to the flood insurance requirements of the Board's implementing regulation, but the other agencies' regulations are substantially similar.

<sup>11</sup> 74 Fed. Reg. 35,914 (July 21, 2009), available at: <http://1.usa.gov/flood-2009>

<sup>12</sup> 76 Fed. Reg. 64,175 (October 17, 2011), available at: <http://1.usa.gov/flood-2011>

<sup>13</sup> "Regulated lending institution" is defined in the NFIA as "any bank, savings and loan association, credit union, farm credit bank, Federal land bank association, production credit association, or similar institution subject to the supervision of a Federal entity for lending regulation." 42 U.S.C. §4003(a)(10)

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est in improved real estate located in an SFHA, flood insurance is required.” Therefore, lenders must consider these requirements when determining if they will take a security interest in a property located in an SFHA.

Lenders must document the flood hazard determination using FEMA’s Standard Flood Hazard Determination Form (SFHDF) and retain a hard or electronic copy of the form throughout the term of the loan.<sup>14</sup> Making a flood determination as early as possible in the loan process is a good practice because it allows time for the borrower to obtain insurance if it is required and for the lender to meet all other obligations that such a determination may trigger.

Lenders often inquire whether they may rely on a prior flood hazard determination for the same property. Under Question 68 of the Interagency Flood Q&As, a lender may rely on its own prior determination when it is increasing, extending, or renewing a loan secured by the property if three conditions are satisfied: 1) the prior determination was made within seven years of the date of the transaction; 2) the SFHDF reflects the basis of the determination; and 3) FEMA has not revised or updated the map affecting the property since the original determination was made.<sup>15</sup> Lenders can determine when the last update was made to a flood map for a particular address from FEMA’s website.<sup>16</sup> A lender may not rely on a determination made by a different lender.<sup>17</sup>

### *Flood Hazard and Insurance Availability Notice*

If a lender determines that property securing the loan is or will be located in an SFHA, the lender must provide a notice to the borrower.<sup>18</sup> This borrower notification requirement applies regardless of whether the community participates in the NFIP. The notice must contain a warning that the property is or will be located in an SFHA; a description of the NFIA’s flood purchase requirements; a statement, where applicable, that flood insurance is available under the NFIP and from private insurers; and a statement on the availability of federal disaster relief assistance. Use of the sample notice form provided in Appendix A of Regulation H is not mandatory but provides lenders with a safe harbor if used.<sup>19</sup> If a lender chooses, it may use its own customized notice, but the notice must contain at least the minimum information required by the NFIA and its implementing regulations.<sup>20</sup> The lender must provide the notice to the borrower within a reasonable time before the transaction is completed.<sup>21</sup> A record (such as a signed copy of the notice or a certified mail receipt) of the borrower’s receipt of the notice must be retained for the term of the loan.<sup>22</sup> In a loan transaction involving multiple borrowers, the lender need only provide notice to one of the borrowers in the transaction.<sup>23</sup> If a mortgage servicer is used, the lender must provide notice to the servicer “as promptly as practicable” after the notice is furnished to the borrower and no later than when the lender transmits other loan data (such as information concerning hazard insurance and taxes) to the servicer.<sup>24</sup>

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<sup>14</sup> 12 C.F.R. §208.25(f)(2)

<sup>15</sup> Interagency Flood Q&A 68

<sup>16</sup> <http://bit.ly/flood-map>

<sup>17</sup> Interagency Flood Q&A 37

<sup>18</sup> §208.25(i)

<sup>19</sup> §208.25(i)(5). The form is in Appendix A of Regulation H, which is available at: <http://1.usa.gov/flood-form>.

<sup>20</sup> Interagency Flood Q&A 80

<sup>21</sup> §208.25(i)(2)

<sup>22</sup> §208.25(i)(3)

<sup>23</sup> Interagency Flood Q&A 73. The bank is permitted to furnish multiple borrowers with notices if it so chooses.

### Amount of Coverage

The required amount of flood insurance for a loan secured by property located in a flood hazard area is the lesser of: (1) the loan's outstanding principal balance; or (2) the maximum amount of coverage available under the NFIA for the particular type of property serving as collateral.<sup>25</sup> The maximum coverage obtainable under the NFIA is the lesser of: (1) the greatest amount of coverage available under the NFIP for the property type securing the loan (i.e., residential, nonresidential); or (2) the overall property value securing the loan minus the value of the land on which it is located (e.g., the property's "insurable value").<sup>26</sup> The maximum coverage caps in an NFIP participating community are \$250,000 for a residential building and \$500,000 for a nonresidential building.<sup>27</sup>

### Insurable Value

Because an NFIP policy will not pay a claim in excess of a property's insurable value, it is important that this value be determined correctly. A miscalculation could cause the lender to inadvertently require the borrower to purchase too much or too little flood insurance, resulting in a violation. For example, if the value of the land is not excluded when determining the insurable value of a home or building, the borrower will purchase coverage exceeding the amount the NFIP will pay for a covered loss.<sup>28</sup>

To provide greater clarity about insurable value, the agencies issued a proposed definition in their revisions to the Interagency Flood Q&As in 2008 that linked the definition of insurable value to replacement cost value (RCV). However, some commenters expressed concern that the proposed definition could overstate the value in certain circumstances. In particular, for certain nonresidential properties, the NFIP pays only actual cash value, which FEMA defines as the cost to replace an

item at the time of loss less depreciation. Actual cash value would be less than RCV so if a creditor required insurance based on RCV for these types of properties, the borrower would be overinsured.

In response to this concern, the agencies and the FCA revised the final definition of insurable value in October 2011. Interagency Flood Q&A 9 clarifies that RCV should *not* be used as a proxy for insurable value for properties whose insurance loss payout would ordinarily be based on actual cash value:

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, in determining the amount of flood insurance required, to consider the extent of recovery allowed under the NFIP policy for the type of property being insured.*<sup>29</sup>

The guidance further states that when this occurs, lenders may choose from any reasonable approach to calculate insurable value, as long as it can be supported. The guidance provides examples of permissible methods, including appraisal based on a cost-value (not market-value) approach, a construction-cost calculation, and the insurable value used in a hazard insurance policy.<sup>30</sup>

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<sup>24</sup> §208.25(i)(2). Notice to the servicer may be made electronically or may take the form of a copy of the notice to the borrower. A copy of the notice must also be retained by the lender for the duration of the loan. See also Interagency Flood Q&A 75.

<sup>25</sup> §208.25(c)(1)

<sup>26</sup> Interagency Flood Q&A 8

<sup>27</sup> Interagency Flood Q&A 8. In participating communities that are under the emergency program phase, the coverage caps are \$35,000 for residential dwellings and \$100,000 for nonresidential structures.

<sup>28</sup> Interagency Flood Q&A 8

<sup>29</sup> Interagency Flood Q&A 9, 76 Fed. Reg. 64, 175, 64.182 (Oct. 17, 2011) (emphasis added)

<sup>30</sup> Interagency Flood Q&A 9

### ***Escrowing Flood Insurance Premiums and Fees***

If a creditor requires escrow accounts for loans secured by residential real estate or mobile homes, the creditor must also require the escrow of all premiums and fees for flood insurance required under the NFIA and its implementing regulations.<sup>31</sup> Section 208.25(e) authorizes state member banks, or servicers acting as their agents, to deposit the funds earmarked for flood insurance premiums and fees into the escrow fund on the borrower's behalf. The bank or its servicer is then required to make payments for the borrower's flood insurance premiums from the escrow account as they become due.<sup>32</sup>

### ***Forced Placement of Flood Insurance***

The Interagency Flood Q&As provide detailed guidance on the requirements for forced placement of flood insurance. If at any time during the term of the loan a lender or its servicer determines that the collateral has less flood coverage than is required by the agencies' implementing regulations, it must notify the borrower to obtain the required insurance. The notice should state that if the borrower does not obtain the insurance within 45 days, the lender will purchase the insurance on behalf of the borrower and may charge the borrower for the cost of premiums and fees to obtain the coverage, which are likely to be more expensive than if the borrower purchases it.<sup>33</sup> If the borrower has not purchased the necessary flood insurance 45 days after the notice was sent, the lender must purchase insurance on the borrower's behalf.<sup>34</sup> A servicer or lender may add the premium and fee charges to the principal amount of the loan.<sup>35</sup> A lender may comply with the forced-placement requirement by purchasing an NFIP Standard Flood Insurance Policy in the amount

required by the implementing regulations.<sup>36</sup> Appendix A of FEMA's September 2007 *Mandatory Purchase of Flood Insurance Guidelines* sets out the Mortgage Portfolio Protection Program (MPPP) Guidelines and Requirements, including forced-placement procedures and examples of notification letters to be used in connection with the MPPP. Lenders seeking further assistance with implementing forced-placement procedures should consult FEMA's MPPP.<sup>37</sup>

The agencies and the FCA recently provided guidance on when forced-placement insurance must become effective. In October 2011, the agencies issued final Interagency Flood Q&A 61, which states that if a borrower fails to obtain insurance within 45 days after notification, the agencies expect the lender to have insurance in effect on the 46th day. If there is a brief delay, for example, because of batch processing, the agencies expect the lender to provide a reasonable explanation for the delay.<sup>38</sup>

One concern for lenders is their exposure during the 45-day notice period. If a borrower has a policy and fails to renew, the NFIP provides a 30-day grace period to receive the premium, so lenders are covered for the first 30 days. The NFIP will honor a claim for a loss during the grace period as long as the full renewal premium is paid by the end of the 30-day period.<sup>39</sup> However, if the premium is not paid after 30 days, the policy lapses, and the lender has exposure until a policy is obtained. Some lenders rely on blanket insurance (also known as gap insurance) to cover this risk. Interagency Flood Q&A 64 provides that a lender may use blanket or gap insurance to protect itself during the 45-day interim period before a forced-placed in-

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<sup>31</sup> Section 208.25(e)

<sup>32</sup> Funds escrowed in connection with designated loans remain subject to the escrow requirements of Regulation X, 24 C.F.R. §3500.17.

<sup>33</sup> Interagency Flood Q&A 57. See also proposed Q&A 57. 76 Fed. Reg. 64,175, 64,182 (Oct. 17, 2011).

<sup>34</sup> §208.25(g)

<sup>35</sup> Interagency Flood Q&A 57

<sup>36</sup> Interagency Flood Q&A 63. Additionally, a private flood insurance policy may be an adequate substitute for NFIP insurance if it meets the criteria set forth by FEMA in its *Mandatory Purchase of Flood Insurance Guidelines*.

<sup>37</sup> <http://1.usa.gov/fema-mppp>

<sup>38</sup> Interagency Flood Q&A 61. 76 Fed. Reg. 64,175, 64,181 (October 17, 2011)

<sup>39</sup> Section H of Appendix A(1) to 44 C.F.R. Part 61.

insurance policy becomes effective. However, the lender is still required to force place the required coverage in a timely manner and cannot rely on a blanket or gap policy as a substitute for an NFIP policy.

Lenders frequently inquire whether they may charge a borrower for the cost of forced-placed insurance obtained during the 45-day notification period. In the October 2011 guidance, the agencies proposed for comment Interagency Flood Q&A 62 to address this issue. The proposed question permits lenders to charge a borrower for the forced-placed insurance obtained during the 45-day period if the borrower provided the lender authority to do this as a contractual condition of making the loan. The comment period for this question closed on December 1, 2011. A final question and answer will be issued in the future.

## SPECIFIC COMPLIANCE REQUIREMENTS

### *Residential Condominiums*

Flood insurance is required for loans secured by an individual residential condominium unit, including a unit in a multi-story condominium complex, if the condominium is located in an SFHA where flood insurance is available under the NFIP. Loans secured by other condominium property are also covered, such as a loan to the condominium association or to a condominium developer.<sup>40</sup>

The NFIP offers a specific insurance policy for a residential condominium complex — defined as a building having 75 percent or more of its floor area in residential use — known as the Residential Condominium Building Association Policy (RCBAP).<sup>41</sup> This policy, which can only be purchased by condominium owners' associations, covers all individual units (including improvements) and common property. Content in the units can also be covered if content coverage is purchased.

The minimum amount of flood insurance for a loan secured by a condominium unit is the lesser of the outstanding principal balance of the loan or the maximum amount available under the NFIP, which is the lesser of:

- the maximum limit for a residential condominium unit; or
- the insurable value allocated to the unit, defined as 100 percent of the RCV of the entire condominium building divided by the number of units.<sup>42</sup>

To facilitate compliance, the Interagency Flood Q&As include a condominium loan example.<sup>43</sup> The example provides that a lender makes a \$300,000 loan secured by a residential condominium unit in a 50-unit condominium building that is located in an SFHA within a participating community, with a replacement cost of \$15 million and which is insured by an RCBAP with \$12.5 million of coverage.

In this example, additional flood insurance is not required because the RCBAP's \$250,000 per unit coverage ( $\$12.5 \text{ million} \div 50 = \$250,000$ ) satisfies the mandatory flood insurance requirement, which is the lesser of: 1) the outstanding principal balance (\$300,000); 2) the maximum coverage available under the NFIP (\$250,000); or 3) 100 percent of the insurable value ( $\$15 \text{ million} \div 50 = \$300,000$ ). Lenders may rely on the replacement cost value and number of units on the RCBAP declaration page when verifying compliance.<sup>44</sup>

If a lender determines that a borrower's unit is not covered by an RCBAP, or that the coverage under an RCBAP is below the minimum amount required by the NFIA, the lender must ensure that the borrower obtains sufficient coverage.<sup>45</sup> The lender should first request that the borrower ask the condominium association to obtain coverage or obtain additional cover-

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<sup>40</sup> Interagency Flood Q&A 26

<sup>41</sup> The FEMA flood manual, updated in October 2011, provides more specific details about the RCBAP, available at: <http://1.usa.gov/fema-condo>.

<sup>42</sup> Under the previous Interagency guidance released in 1997, lenders were permitted to use 80 percent of the building's RCV, divided by the number of units. The current regulatory guidance, however, requires that, effective September 21, 2009, lenders must use 100 percent of the condominium building's RCV when computing an individual unit's insurable value.

<sup>43</sup> Interagency Flood Q&A 28

<sup>44</sup> Effective October 1, 2007, FEMA requires agents to list the RCV on the declaration page along with the number of units. But a lender cannot rely on this information if it has reason to believe that the listed RCV clearly conflicts with other available information. In that case, the lender should notify the borrower of the potential conflict.

<sup>45</sup> Interagency Flood Q&A 28

age sufficient to meet the regulation's requirements. If the association fails to comply, the lender must require the borrower to purchase a FEMA dwelling policy for supplemental coverage or force place the policy if necessary.<sup>46</sup> When both the RCBAP and a dwelling policy cover the same unit, the RCBAP is considered primary insurance. The maximum amount of coverage for a residential condominium unit is \$250,000; therefore, when both an RCBAP and dwelling policy are in place, the policies are coordinated such that the maximum payout is capped at \$250,000.

THE LENDER MUST CALCULATE BOTH THE TOTAL PRINCIPAL BALANCE OF ALL OF THE OUTSTANDING LIENS ON THE PROPERTY AND THE TOTAL AMOUNT OF FLOOD INSURANCE ON THE OTHER SENIOR AND JUNIOR LIEN(S) SECURING THE PROPERTY.

#### *Nonresidential Condominium Associations*

For a nonresidential condominium building, a condominium association must purchase FEMA's general property policy. Both building and contents coverage are available separately, in amounts up to \$500,000 per nonresidential building.<sup>47</sup>

#### *Home Equity Loans and Lines of Credit*

A home equity loan (closed-end credit) or home equity line of credit (open-end credit) secured by a building or mobile home located in an SFHA community that participates in the NFIP is subject to the flood insurance

requirements, regardless of lien priority.<sup>48</sup> Therefore, when a lender makes, increases, extends, or renews a designated home equity loan or line of credit, it must ensure adequate flood insurance is in place taking into account the liens of other creditors on the property.

For home equity loans with multiple lienholders, the required minimum coverage is determined by the same formula used for single-lien designated loans, except that the outstanding principal balance of the designated home equity loan is calculated by adding together the principal balances of each existing loan. Therefore, when the outstanding principal balance of all loans is less than the property's insurable value, a lender making a home equity loan on a property with multiple liens cannot comply with the minimum coverage requirement by simply ensuring that flood coverage for the collateral is at least equal to the outstanding principal balance of its loan to the borrower. The lender must calculate both the total principal balance of all of the outstanding liens on the property and the total

amount of flood insurance on the other senior and junior lien(s) securing the property.<sup>49</sup> Interagency Flood Q&A 36 provides several examples to facilitate compliance. Lenders may obtain a borrower's current credit report to determine the current amounts owed other lienholders.<sup>50</sup>

For home equity lines of credit, a flood determination must be made before the consummation of the loan, but draws against an approved line of credit do not require additional determinations.<sup>51</sup> However, a borrower's request to increase the credit limit on the line

<sup>46</sup> Interagency Flood Q&A 30. While supplementing a borrower's RCBAP coverage with a dwelling policy of the statutorily required amount will satisfy the minimum purchase requirement, the lender and the borrower/unit-owner may still be subject to risk of loss. Specifically, the dwelling policy does not extend the RCBAP's maximum coverage limits. The dwelling policy may also not cover the individual unit-owner's share of the co-insurance penalty. Lenders are encouraged to inform borrowers of this risk.

<sup>47</sup> FEMA, *Mandatory Purchase of Flood Insurance Guidelines*, p. 50, available at: <http://1.usa.gov/flood-purchase>

<sup>48</sup> Interagency Flood Q&A 34

<sup>49</sup> Interagency Flood Q&A 34

<sup>50</sup> Interagency Flood Q&A 36

<sup>51</sup> Interagency Flood Q&A 35

of credit may trigger a new flood insurance determination depending on whether the requirements in Flood Q&A 68 for relying on a previous flood insurance determination are satisfied.

### **Construction Loans**

The Interagency Flood Q&As provide detailed guidance on the flood insurance requirements for construction loans in questions 19-23. If a loan is secured only by land that will later be developed into a buildable lot, flood insurance is not required because the insurance requirements apply only to a loan secured by a building or mobile home.<sup>52</sup> On the other hand, a loan secured by a building in the course of construction is subject to flood insurance requirements, even if the building is not yet walled and roofed, as long as the construction has not been halted for 90 days or longer and/or the lowest floor used for rating purposes is not below the base flood elevation (BFE).<sup>53</sup> When insurance is obtained for a building in the course of construction, materials or supplies used in construction or repair are not insurable unless they are in an enclosed building located on or adjacent to the premises.

The Interagency Flood Q&As offer two compliance options for a lender making a loan secured by a building to be constructed. A lender may require the borrower to acquire a flood insurance policy at the time of origination. Alternatively, a lender may allow a borrower to defer the purchase of flood insurance until either: (1) a foundation slab has been poured and/or an elevation certificate has been issued; or (2) the building is walled and roofed, provided the building to be constructed will have its lowest floor below the BFE.<sup>54</sup> But, before the lender disburses funds for construction (except for pouring the slab or preliminary site work), it must require the borrower to have flood insurance in place. A lender who elects to allow the borrower to defer the purchase of flood insurance until after origination must have adequate internal controls in place

to detect whether either of the above two mandatory purchase triggers has occurred. When any of these triggering conditions occur, the lender must require the borrower to purchase flood insurance or, if necessary, prepare to force place the insurance.<sup>55</sup>

### **TRANSFER OR SALE OF SERVICING RIGHTS**

When a regulated lender originates a designated loan and later transfers or sells the servicing rights to a non-regulated party, but retains ownership of the loan, the regulated lender remains ultimately responsible for fulfilling the flood insurance compliance requirements. The regulated lender must take adequate steps to ensure that the loan servicer will comply with all flood insurance requirements. Such steps include notifying FEMA or its designee of the identity of the new servicer.<sup>56</sup>

### **ENFORCEMENT: CIVIL MONETARY PENALTIES**

Under the NFIA, a regulated lender demonstrating a “pattern or practice” of violating any of the following statutory requirements is subject to civil monetary penalties (CMPs): (1) purchasing flood insurance where available; (2) escrowing flood insurance premiums, when required; (3) force placing flood insurance after providing the requisite notice to the borrower; (4) providing notice of special flood hazards and the availability of federal disaster relief assistance; and (5) providing notice of the identity of the loan’s servicer and any change of that servicer to the regulatory entity.<sup>57</sup>

The NFIA does not define “pattern or practice.” In determining whether a financial institution has engaged in a pattern or practice of flood insurance violations, the following factors may be considered: the duration of noncompliance; significance of the number of violations; prior citations for noncompliance with flood insurance regulations; strength of the institution’s audit process at identifying and addressing flood compliance deficiencies; and the presence of effective flood

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<sup>52</sup> Interagency Flood Q&A 19

<sup>53</sup> Interagency Flood Q&A 21

<sup>54</sup> Interagency Flood Q&A 22

<sup>55</sup> Interagency Flood Q&A 22

<sup>56</sup> Interagency Flood Q&A 44. The issue of third-party servicing compliance obligations is also discussed in Interagency Flood Q&As 45-50.

<sup>57</sup> 42 U.S.C. 4012a(f). See also Interagency Flood Q&A 81.



insurance compliance policies and procedures and/or an employee training program. While “[i]solated, unrelated, or accidental occurrences” will not be deemed a pattern or practice, “repeated, intentional, regular, usual, deliberate, or institutionalized practices will almost always constitute a pattern or practice.”<sup>58</sup>

Banking regulators assess CMPs for violations when required by the statute. In addition to imposing a substantial financial penalty, CMPs can cause reputational damage to financial institutions because the CMP


orders are often reported by local media outlets and are tracked on websites.<sup>59</sup>

## CONCLUSION

Congress enacted the NFIA to reduce the costly burden of floods. In recent years, major flooding has caused devastating property losses, making the NFIA and its amendments even more crucial. It is important that financial institutions have a strong flood insurance compliance program. Specific issues and questions about consumer compliance matters should be raised with your primary regulator. ©

<sup>58</sup> Interagency Flood Q&A 82

<sup>59</sup> See, e.g., *Flood Penalties Watch*, available at <http://bit.ly/flood-cmp>.



# OUTLOOK

LIVE WEBINARS

The Federal Reserve System regularly conducts *Outlook Live* webinars on consumer compliance topics. All webinars are free of charge. The table below lists the 2011 archived presentations. You can view the webinars and download the presentation slides on the *Outlook Live* archive page: <http://bit.ly/Outlook-webinars>.

Date	Webinar	Description
12/15/11	<b>Consumer Compliance Hot Topics</b>	Discussion of significant 2011 compliance changes and a preview of changes expected in 2012.
11/02/11	<b>Fair Lending Issues and Hot Topics</b>	Discussion of several fair lending topics, including the activities of the Interagency Non-Discrimination Working Group of the Financial Fraud Enforcement Task Force.
10/04/11	<b>Real Estate Owned (REO) Disposition Risks and CRA Opportunities</b>	Discussion of financial, reputational, legal, and compliance risks associated with REO properties and potential CRA opportunities from alternative uses of these properties.
05/26/11	<b>Proposed Ability to Repay Standards for Mortgage Loans</b>	Discussion of the proposed final rule under Regulation Z to require creditors to determine a consumer's ability to repay a mortgage loan before making the loan.
04/06/11	<b>CRA and HUD Neighborhood Stabilization Program</b>	Discussion of new CRA opportunities under the Neighborhood Stabilization Program.
03/17/11	<b>Loan Originator Compensation</b>	Discussion of new regulatory requirements for loan originator compensation.
02/16/11	<b>Risk-Based Pricing (RBP) Notices</b>	Discussion of the new regulatory requirements for the RBP notices.