Revisiting 2015's New Flood Regulations

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The past few years have brought about a steady stream—if not quite a flood—of changes to the federal mandatory purchase of flood insurance requirements (mandatory purchase requirements). Most recently, on July 21, 2015, the federal banking agencies (Agencies) published a joint final regulation (Final Flood Rule) that implements certain provisions of the Homeowner Flood Insurance Affordability Act of 2014 (HFIAA) and the Biggert-Waters Flood Insurance Reform Act of 2012 (Biggert-Waters). This article analyzes the impact of the Final Flood Rule on lenders' and servicers' compliance with the mandatory purchase requirements.

OVERVIEW

The National Flood Insurance Act of 1968 (NFIA) created the National Flood Insurance Program (NFIP). The purpose of the NFIP was to provide affordable flood insurance coverage to some of America's most vulnerable properties, as flood disasters imposed increasing burdens on the nation's resources and the private flood insurance market did not offer adequate coverage at affordable prices. The NFIA and NFIP have been amended multiple times, including in 1973 when the Flood Disaster Protection Act of 1973 (FDPA) instituted the mandatory purchase requirements. Pursuant to the mandatory purchase requirements, federally regulated or insured lenders must require flood insurance on properties that are located in areas that have a high

risk of flood damage (Special Flood Hazard Areas or SFHAs). The FDPA has been amended multiple times, including by Biggert-Waters in 2012 and by HFIAA in 2014.

The Agencies, which are charged with implementing the mandatory purchase requirements, have on various occasions coordinated efforts to publish consistent flood insurance regulations and guidance. The most recent rulemaking effort resulted in the Final Flood Rule, which included issuance of an initial joint proposed rule in October 2013. The October 2013 proposal related to certain Biggert-Waters provisions, but before it was finalized, HFIAA amended some of the changes Biggert-Waters had made to the FDPA. As a result, the Agencies issued another joint proposed rule in October 2014.

Following publication of the two proposed rules, on July 21, 2015, the Agencies published the Final Flood Rule, which:

- Clarified the lender-placed flood insurance (LPI) requirements that became effective upon Biggert-Waters' enactment (July 6, 2012), as of October 1, 2015;
- Clarified HFIAA's detached structures exemption. Although HFIAA's detached structures exemption originally became effective on March 21, 2014, some lenders and servicers declined to recognize it pending the Agencies' issuance of further guidance. The Final Flood Rule's detached structures provisions became effective on October 1, 2015; and
- Implemented the escrow requirements from Biggert-Waters and HFIAA. These requirements are slated to become effective on January 1, 2016.

The Final Flood Rule generally applies to federally regulated and insured lenders, as well as servicers acting on their behalf. Thus, for the sake of simplicity in this article, we generally use the term "lender" to include both a lender and a servicer.

LENDER-PLACED INSURANCE

With respect to LPI, the Final Flood Rule (1) clarifies that a lender may charge a borrower for LPI beginning on the date on which the borrower's coverage lapsed or became insufficient; (2) requires a lender to cancel LPI and refund unearned premiums within 30 days of receipt of acceptable borrower-obtained flood insurance; and (3) requires a lender to accept as proof of insurance a declarations page that includes the flood policy number, insurance company or agent, and contact number.

INITIATING AND CHARGING FOR LPI

Under pre-existing requirements, when a lender learns that a borrower's flood insurance coverage has either lapsed or become insufficient, the lender must send to the borrower a letter—commonly referred to as the "45-day letter"—informing the borrower that he or she has 45 days to purchase adequate flood insurance. If the borrower does not do so, the lender is required to purchase insurance on the borrower's behalf, which is known as "lender-placing" or "force-placing" insurance.

The 45-day letter must be sent "upon making a determination" that the existing insurance coverage is inadequate or has expired—which includes, for example, receiving a notice of cancellation or expiration from the insurance provider, discovering a lapse as the result of an internal flood policy monitoring system, or learning that the property now requires flood insurance coverage because of a flood map change that placed it in an SFHA. Although a lender may send one or more notices prior to a policy's expiration date as a courtesy to the borrower, such notices are not a substitute for the 45-day letter (which must be sent after determining that coverage is inadequate or has expired).

Through the Final Flood Rule, the Agencies clarified the following:

- The date of lapse of the borrower's policy is either the expiration date as provided by the policy or the date that the policy is cancelled; and
- The borrower may be charged for LPI beginning as early as the date on which the borrower's policy lapsed or did not provide sufficient coverage—that is, a lender need not wait until the end of the 45-day period to either begin LPI coverage or charge the borrower for such coverage. However, if the borrower obtains a flood insurance policy that overlaps with the LPI policy, the lender must refund any premiums paid by the borrower for this overlap period. This much-needed clarification resolves what has been a hotly contested issue. ▷

For example, if a borrower does not renew a flood insurance policy that expires on June 30 and the lender learns of the expiration, the lender must provide the 45-day letter and may also obtain LPI as early as July 1. The lender may then choose when to bill the borrower for the LPI, either (1) upon placement of the LPI, or (2) at a later date, such as, for example, when the 45-day period expires. If the borrower does not obtain a flood insurance policy and the lender has not obtained LPI by August 14, which is the end of the 45-day period, then the lender is required to obtain LPI on August 15. On the other hand, if the lender obtains LPI on July 1 and if, on July 15, the borrower renews his or her flood insurance policy effective from July 1 and provides sufficient evidence to the lender, then the lender must refund any premiums paid by the borrower for the LPI coverage between July 1 and July 15.

This example also raises a practical consideration: while the lender may charge a borrower for LPI as soon as a lapse in coverage occurs, it may be advisable to wait until the expiration of the 45-day period to charge for the coverage because, if the borrower obtains his or her own insurance during the 45-day period, the lender would have to undertake the administrative burden of refunding premiums for the overlapping coverage.

The Agencies also clarified that if a lender, despite its monitoring efforts, discovers a policy with insufficient coverage—for example, due to a re-mapping—the lender may charge back to the date of insufficient coverage if it has purchased an LPI policy that was effective as of the date of insufficient coverage. However, if the lender purchases a new policy that does not cover the period of insufficiency, then the lender may not charge back to the date of the lapse. Stated another way, a borrower may only be charged for coverage that was actually in place. Generally, though, from a safety and soundness perspective, lenders should attempt to ensure that there are no breaks in flood insurance coverage—that is, there should be continuous coverage on the property.

TERMINATING LPI

Prior to Biggert-Waters, there were no express requirements regarding when a lender needed to cancel LPI, but Biggert-Waters changed that. Lenders are now required to cancel LPI and refund unearned or overlapping premiums and fees within 30 days of receipt of acceptable borrower-obtained flood insurance.

The 30-day clock to provide a refund does not begin until the borrower's policy is actually "in effect." If the borrower's policy is subject to a 30-day waiting period, it is not "in effect" until the waiting period has expired. Furthermore, lenders must refund all premiums for periods of overlapping coverage regardless of when the borrower provides proof of insurance. This means that, even if a borrower delays providing evidence of coverage, lenders are still responsible for refunding any overlapping LPI coverage.

DETERMINING WHETHER LPI SHOULD BE TERMINATED

Under Biggert-Waters, a lender must accept a declarations page as proof of borrower-purchased coverage as long as the declarations page includes the policy number, insurance company or agent, and contact number. However, in the Preamble to the Final Flood Rule, the Agencies confirm that a lender can, subject to safe and sound banking practices, accept alternative evidence of insurance. Thus, as a practical matter, lenders still have some leeway to determine whether additional types of proof of insurance are acceptable.

The lender is also responsible for making all necessary inquiries into the adequacy of the borrower's insurance policy, and must do so within 30 days of receiving the borrower's confirmation of existing flood insurance. If the lender determines that the coverage amount—or any other terms and conditions of the policy—fail to meet any applicable requirements, the lender should notify the borrower and request that the borrower obtain an adequate flood insurance policy.

DETACHED STRUCTURES EXEMPTION

The Final Flood Rule also clarifies a HFIAA provision that created a new exemption from the mandatory purchase requirements for certain detached structures. Specifically, flood insurance is no longer required on any structure that (1) is part of a residential property, (2) is detached from the primary residential structure, and (3) does not serve as a residence.

Previously, every building—even a low-value detached structure—located in an SFHA was required to be insured, despite the fact that insuring some of these structures imposed considerable costs on borrowers with only minimal or no benefit. To address this situation, HFIAA created an exemption from the mandatory purchase requirements for certain types

of structures that typically would not be considered in the lender's underwriting of the loan. While this was certainly a welcome change, HFIAA's language left much to be desired with regard to the scope of the exemption because none of the key terms were defined.

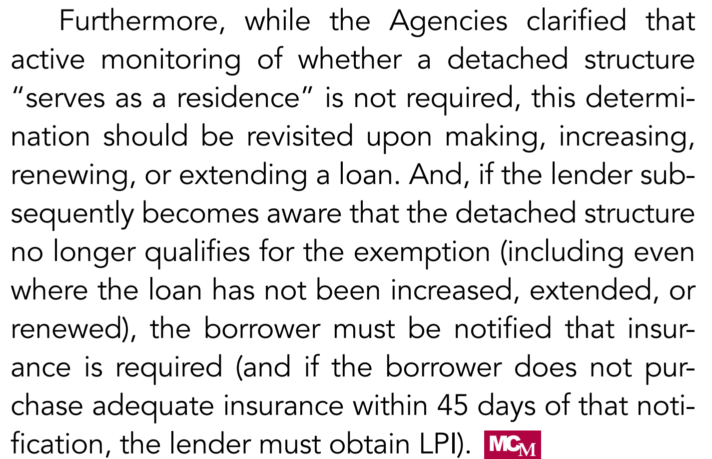
The Final Flood Rule clarifies the detached structures exemption by providing definitions of certain key terms, including "part of a residential property," "detached," and "serve as a residence."

"Part of a residential property." The exemption applies to a structure that is part of a residential property. A structure is part of a residential property if the structure—both the primary structure and the detached structure—is used primarily for personal, family, or household purposes, and not used primarily for agricultural, commercial, industrial, or other business purposes. This means that the exemption applies regardless of the purpose of the loan (e.g., consumer, business, commercial, or agricultural), as long as the loan is secured by a residence. Furthermore, "residential property" is not defined by whether a building is single- or multi-family or owner- or renter-occupied, and thus includes single-family dwellings, two- to four-family dwellings, multi-family dwellings containing five or more residential units, and mixed-use buildings—so long as the building is used primarily for residential purposes.

"Detached." A structure is detached if it is not joined to the primary residential structure by a structural connection, i.e., it stands alone.

"Serves as a residence." To qualify for the exemption, the detached structure must not serve as a residence, which is ultimately based on the lender's good faith determination of the structure's intended use. Here, the Agencies declined to adopt a bright line test and instead gave lenders significant discretion to determine which structures require coverage. As a rule of thumb, if the structure includes sleeping, bathroom, and kitchen facilities, then it will likely be considered a residence. But a structure need not have all of these features to be considered a residence. And, while no single question is dispositive as to whether a detached structure serves as a residence, lenders might consider and document some of the following considerations:

- Has the borrower indicated that the structure will be used as a residence?
- Does the structure have bathroom, kitchen, and sleeping facilities?
- Is the structure traditionally used as a residence (e.g., guest house)?
- Is the structure traditionally used for some purpose other than a residence (e.g., green house, horse barn, tool shed)?



Furthermore, while the Agencies clarified that active monitoring of whether a detached structure "serves as a residence" is not required, this determination should be revisited upon making, increasing, renewing, or extending a loan. And, if the lender subsequently becomes aware that the detached structure no longer qualifies for the exemption (including even where the loan has not been increased, extended, or renewed), the borrower must be notified that insurance is required (and if the borrower does not purchase adequate insurance within 45 days of that notification, the lender must obtain LPI). MCM

Check back in next month's issue for an exhaustive breakdown of the Final Flood Rule's escrow provisions and a wrap-up of everything you need to know.

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