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FLOOD DISASTER PROTECTION ACT: ENSURING ADHERENCE, CUTTING THROUGH COMPLEXITIES

By Janice DiMaria

Topics: *Janice DiMaria* *Flood Insurance* *Quality Assurance*

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With impending expiration of the National Flood Insurance Program and potential changes to flood policy, it is timely for lenders and/or servicers to strengthen their due diligence processes. Let's discuss the basic elements and some of the underlying complexities facing lenders along with

recommended practices that promote sustainable adherence to regulatory requirements.

Janice DiMaria

While lending institutions are very familiar with the basics, adhering to requirements can be more challenging than it appears and not always fully understood by the lender. Likewise, there is a high expectation to have strong quality assurance and control functions in place supported by seasoned personnel with proficiency in flood-related areas.

Flood Disaster Protection Act Basics

Since enacted in 1973 the FDPA has changed and expanded, but the fundamental requirements remain constant addressing the following key principles:

--Determination: The determination of flood applicability for certain loans as defined by the regulation and the ordering method for obtaining the property's flood zone.
--Notification: Notifying the borrower that the property(s) is located or "to be located" in a special flood hazard area, the availability of flood Insurance and insurance purchase requirements.
--Coverage: Regulatory purchase requirements as defined by 12 CFR 22.3.
-- Evidence of Coverage: Acceptable proof of coverage and guidelines for private policies.

Complying with FDPA begins with defining the type of loan requiring flood insurance. Specifically, this applies to any loan secured by improved real estate or a mobile home affixed to a property located in a special flood hazard area in which flood insurance is available, also referred to as a "designated loan." No matter the size of the lending institution all are required to ensure the purchase of flood insurance for designated loans with few exceptions.

Determination. Each time the lender makes, increases, renews or extends a designated loan a determination must be made to identify the property's flood zone status. The lender must consider any residential or commercial loan that meets this criterion. Included are loans where real estate collateral is taken as abundance of caution or collateral is cross-collateralization/cross guaranty or part of a syndication. The latter is particularly important as proper due diligence is expected for syndicated loans regardless of whether the lender is the lead or agent institution.

To ensure proper flood due diligence is achieved the lender should have robust systems in place to identify all loans subject to mandatory flood requirements.

Designation of the flood zone status is made by the Federal Emergency Management Agency and requires the lender and/or servicer to use FEMA's standard form. In order to request a flood zone designation from FEMA the lender needs an accurate property address. For residential real estate loans obtaining the address can usually be accomplished by reviewing the appraisal or applicable loan documents. For new construction and commercial loans acquiring the address can be more challenging as the legal address may only be readily available. The lender should have processes in place to address this situation and include other sources to acquire required information.

Separately, a review should be performed to identify all flood-eligible buildings on the property and to provide this information when ordering the determination. The added information enhances the determination results and is particularly vital in cases where the property is partially located in a special flood hazard area. Gathering this information can be more complex for commercial loans depending upon the number of properties securing the loan. In cases where multiple structures exist on the property, obtaining information and location of all eligible structures will require coordination on the part of loan officer, operations and the borrower.

Relying on an appraisal may not be sufficient as it may not provide information on all buildings that may be subject to required flood insurance. For loans where contents have been taken as collateral, similar information and accounting of all eligible structure(s) will be needed to confirm whether contents are located in the building in a special flood hazard area.

Notification. The regulatory notification requirements for lending institutions under 12 CFR 22 are clear in specifying that the lender must notify the borrower if the property securing the loan is located (or partially located) in a special flood hazard area and whether federal disaster assistance is available. The notice must include mandatory language and requires that a written notice be delivered or mailed to the borrower within a "reasonable" period before completion of the transaction.

In addition, a record of the notice must be retained by the lender for the time that they own the loan. While not required, a best practice is to maintain records indicating delivery and/or notice acknowledgement by the borrower to show that timely notification was achieved.

Coverage. The minimum amount of required flood insurance as defined in the regulation represents the lesser of the unpaid principal balance of the "designated loan," the insurable value of the collateral or the maximum coverage available for the particular property type under the National Flood Insurance Program. The maximum amount of insurance under the NFIP represents $250,000 for residential properties (single and two- to four-family units) and $500,000 for all non-residential structures including commercial properties. Program amounts available for personal property/contents differ under NFIP representing up to $100,000 for residential and $500,000 for commercial.

When determining the minimum amount of required insurance, the lender must consider the insurable value of the collateral as the NFIP coverage is limited to that value (defined as the value of the property minus the value of the land).

Determining the insurable value for flood insurance purposes is not always a simple task and becomes even more complex for commercial properties. To determine the insurable value we must first look at the property type (i.e., residential vs. commercial). Generally for residential properties the insurable value represents replacement cost defined by FEMA as the cost to replace property with similar materials and construction. For structures classified as non-residential including commercial, agricultural, mixed-use buildings, etc., insurable value represents the actual cash value which is the replacement cost minus physical depreciation.

Understanding the difference between valuations is critical to ensuring that an appropriate amount of insurable value is used when computing mandatory insurance requirements and corresponds to the amount expected to be paid out by the NFIP.

The bank and/or servicer will consider various methods and valuation sources to determine a building's insurable value including the recoverable cost value from the NFIP policy, an appraisal (based on cost value), a hazard insurance policy (with adjustments for foundation) or an alternate valuation tool. If using an alternate tool to arrive at a value, appropriate testing by the lender and/or servicer should be conducted to validate the accuracy of the acquired tool.

Obtaining the insurable value for contents can be challenging as there is no specific guidance in this area other than the value must be at actual cash value. Valuation sources specifically for contents may come from the insurance policy, an appraisal, financial information or other reliable sources.

When computing the insurable value lenders and/or servicers may review a combination of these sources for reasonableness or they may consult with the insurance provider. The bottom line is that the regulators expect that the approach taken is reasonable, fully supported and consistently applied.

Upon review and determination of the insurable value, a comparison is made to the NFIP amount and the unpaid principal balance to compute the required minimum coverage. The lender and/or servicer must consider in their allocation of insurable value not exceed applicable NFIP maximum amounts. This allocation occurs where there are multiple structures and/or contents.

In our experience organizations are particularly challenged in this area as they may lack full technical knowledge of the regulatory nuances.

The regulation clearly requires that sufficient coverage be maintained for the life of a "designated loan." It is therefore incumbent upon the lender and/or servicer to have effective processes in place to identify and track flood zone map changes, renewal or cancellation of insurance policies as well as methods to detect changes in servicer, collateral or property occupancy type (i.e., owner vs. non-owner occupancy). The latter is important for distinguishing NFIP payout method as Replacement Cost Value or Actual Cash Value, respectively.

When the lender and/or servicer "determines" during the life of a loan that the amount of insurance coverage is insufficient or has lapsed, a notification is sent to the borrower stating that they need to provide ample coverage. The regulation allows for the borrower to obtain required coverage within 45 days. FEMA provides further guidance under the Mortgage Portfolio Protection Program regarding notification timelines and content. If the borrower fails to produce evidence of adequate coverage within the required timeframe, the lender and/or servicer is required to purchase coverage on behalf of the borrower and may charge the borrower for incurred cost and fees. Where the borrower provides adequate confirmation of an existing policy, the regulation requires for timely and accurate termination of the lender-placed policy and applicable refund within 30 days of receipt of coverage.

Evidence of Coverage. Flood coverage may be purchased through the NFIP for "designated loans" or through private insurers. Most borrowers will purchase initially through NFIP, but private flood insurance may be purchased to supplement or used in place of an NFIP policy. This is more typical for commercial corporate real estate loans and larger residential transactions.

A copy of the declaration page is provided to the lender and/or servicer to evidence purchase of flood insurance. A review of the declaration page should be conducted for accuracy of pertinent information including insurance company name and agent, property address, flood zone, borrower name and name of mortgagee or loss payee along with a review of coverage adequacy and deductible amounts.

Insurance deductibles should be within NFIP minimums and maximums. The NFIP sets minimum deductibles based upon the coverage amount and flood policy rating and is applied separately for buildings and contents. The maximum deductible amounts increased with the Biggert-Waters Flood Insurance Reform Act of 2012 and the Homeowner Flood Insurance Affordability Act of 2014 to $10,000 for residential properties and $50,000 for commercial properties. The deductible cannot exceed these amounts for NFIP policies but may be higher for private policies.

Comments from the regulators on this subject express their concern about the amount of the deductible in relation to the coverage and potential risk it may pose to the borrower and lender. Also, they are clear that the amount of the deductible must not equal or exceed the insurable value of the structure or contents so that it eliminates the required minimum coverage.

A flood policy issued by a private insurer brings added operational complexity for the lender and/or servicer as a comparative review of the policy to a standard flood insurance policy is required. Performing this review requires a specialized competency and understanding of private policies including FEMA's six-point criteria (i.e., licensure, surplus line recognition, 45-day cancellation/non-renewal notice, breadth of coverage, strength of mortgage interest clause and legal recourse) along with an assessment of the coverage, deductibles, exclusions, conditions and premiums. While the lending community awaits final rules from their prudential regulator regarding the acceptance of private insurance, lenders will continue to perform and document their reviews and accept private flood insurance on a "discretionary basis."

Key Takeaways and Recommended Practices

In the preceding section we covered the flood basics and underlying challenges. We also highlighted those processes that will improve execution of flood due diligence and regulatory adherence. The following are some key takeaways in fostering an environment of sustainable compliance.

--Evidence of strong quality assurance and control functions supported by effective test scripting and conducted by seasoned personnel with strong technical knowledge in respective areas.

--Loan systems that appropriately identify all "designated" loans including those where real estate collateral is taken as an abundance of caution or the lending structure and related entities are

cross-collateralized, guaranty or included in a participation/syndication.

--Ensure control systems are in place to test due diligence processes and ensure flood coverage is in place prior to completion of a transaction.

--Maintain records indicating delivery and/or notice acknowledgement by the borrower to show that timely notification was achieved.

--Processes and systems that appropriately identify contents as collateral at origination. Review and confirm location of collateral and define measures to determine insurable value.

--Processes that support the identification of all eligible buildings.

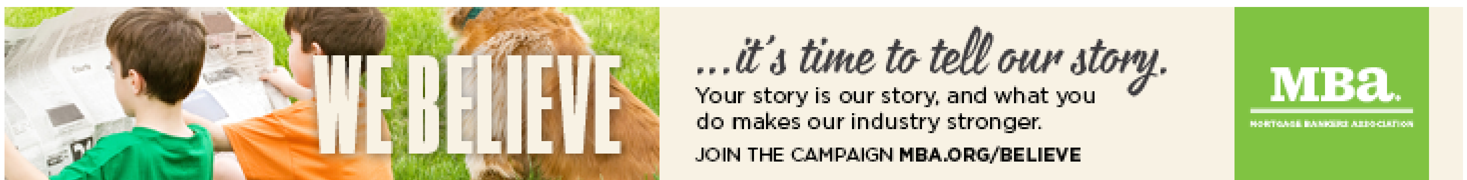
--Ensure proper testing is performed of alternate valuation tool(s) used in determining insurable value for accuracy.

--Test system or tools used to calculate insurance coverage requirements to ensure allocation of insurable value is appropriate, particularly when coverage involves multiple structures. Consider that the insurable value amount may not exceed applicable NFIP maximums for allocation purposes.

--Ensure proper monitoring processes are in place to detect flood related activities and events such as: insurance renewals, map changes, collateral changes (particularly for commercial loans), force placement activities and servicing transfers for the life of the loan.

--Encourage development of flood-related training programs that go beyond the basics, providing proficiency in areas of coverage adequacy, insurable value, multiple building and content coverage, private policy review, etc.

(Views expressed in this article do not necessarily reflect policy of the Mortgage Bankers Association, nor does it connote an endorsement of a specific company, product or service. MBA Insights welcomes your submissions. Inquiries can be sent to Mike Sorohan, editor at ***msorohan@mba.org****; or Michael Tucker, editorial manager, at* ***mtucker@mba.org****.*)



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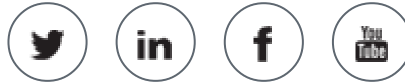

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