



Flood Insurance Regulations Update

October 23, 2014

As most lenders know, the Biggert-Waters Flood Insurance Reform Act of 2012 (Biggert-Waters) made numerous changes to the mandatory purchase of flood insurance requirements. To implement some of these changes, the FDIC, FRB, OCC, NCUA and FCA (collectively, "Agencies") issued a proposed rule in October 2013. 78 FR 65107. Following that, Congress passed the Homeowner Flood Insurance Affordability Act of 2014 (HFIAA), which made additional changes to some of these same provisions. In response, the Agencies have put together another proposed rule (Upcoming Proposal) to implement HFIAA's changes. As of the posting of this Update, only the FDIC's board has voted to issue this proposal. It may be accessed on the FDIC's website at: www.fdic.gov/news/board/2014/2014-10-21_notice_sum_c_fr.pdf. The other agencies are expected to issue the proposal soon.

This Update summarizes the state of affairs of the more significant flood insurance requirements that are relevant to regulated lending institutions, including proposed amendments under the Upcoming Proposal.

Detached Structure

Current Rule. Lenders must require flood insurance on each structure that secures a loan and is situated in a Special Flood Hazard Area which is located in a participating community. For residential buildings with one to four units that are covered under an NFIP Standard Flood Insurance Policy (Dwelling Form), up to 10% of the dwelling's coverage may be allocated to its detached garage (so long as that detached garage is not used or held for use for residential, business or farming purposes).

Biggert-Waters; October 2013 Proposal. Neither addressed detached structures.

HFIAA. Provided a new exemption to the mandatory flood insurance purchase requirements for a structure that is part of a residential property but is detached from the primary residential structure and does not serve as a residence. In a letter dated June 30, 2014 to the American Bankers Association, the federal banking agencies made clear that the exemption became effective upon the enactment of HFIAA, which was March 21, 2014.

Upcoming Proposal. The Agencies propose to revise the flood insurance regulations to incorporate HFIAA’s detached structure exemption by adding an exemption for “[a]ny structure 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.”

Unfortunately, the Agencies do not define the terms “structure,” “residential property,” “primary residential structure” or “residence” for purposes of this exemption. Instead, the Agencies are requesting comment on:

- “[W]hether this exception should be clarified. For instance, there may be some ambiguity as to when such structures serve as a ‘residence,’ but may not meet certain State or local definition of ‘residence,’ or when a detached structure that was not initially a residence becomes a residence.”
- “[W]hether or how the Agencies should define ‘residential property.’ For example, the term ‘residential’ may refer not only to the type of property securing the loan, but also to the purpose of the loan. Thus, the Agencies could clarify that the exemption is only available if the detached structure does not secure a loan that is an extension of credit for a primarily business, commercial or agricultural purpose.”

Comments must be received on or before 60 days after the Upcoming Proposal is published in the Federal Register. Again, at the time this Update was posted, the Upcoming Proposal had not yet been published.

On the plus side, the Agencies did explain the purpose of this exemption, which provides some guidance as to the applicability of this exemption. According to the Agencies, this exemption is to “address an area of concern for borrowers and lenders by excluding relatively low-value structures, for example, detached sheds and garages, from the mandatory flood insurance coverage if they secure a designated loan.” However, the Agencies go on to state that they understand that not all detached structures are of low value, but instead may be of relatively high value. The Agencies give the example of a detached greenhouse. With regard to high-value detached structures, “[w]hile the statute does not require flood insurance for such structures, as a matter of safety and soundness, lenders may nevertheless require flood insurance on these detached structures.” From this we can surmise that a non-residential shed, garage or greenhouse that is part of a residential property but is detached from the primary residential structure on the property is exempt from the mandatory purchase of flood insurance requirements.

Escrow Requirements

Current Rule. A lender is required to escrow flood insurance premiums on residential improved real estate when the lender requires the escrowing of funds to cover other property expenses, such as property taxes or premiums for hazard or fire insurance, in connection with the loan.

Biggert-Waters. A lender will be required to escrow flood insurance premiums on residential improved real estate or a mobile home regardless of whether the lender requires the escrowing of other property expenses. Biggert-Waters included an exception for small institutions. Originally, the new escrow requirements were to be effective July 6, 2014.

October 2013 Proposal. Included the new escrow requirements and proposed exceptions for non-consumer credit, if another lender establishes an escrow account or if a common interest community has purchased the insurance.

HFIAA. Pushed the effective date back to January 1, 2016—the new escrow requirement will apply to the origination, refinance, increase, renewal or extension of a loan on or after January 1, 2016, provided that the loan is secured by residential improved real estate or a mobile home). In addition, HFIAA also mandated that the federal banking agencies adopt regulations that will require regulated lending institutions to provide borrowers with the option of escrowing flood insurance premiums and fees for loans that are outstanding as of January 1, 2016. HFIAA also created several exceptions to the new escrow requirements. Some of these exceptions were the same as the October 2013 Proposal's exceptions.

Upcoming Proposal. The Agencies propose to revise the flood insurance regulations to incorporate HFIAA's provisions requiring the escrow of flood insurance premiums and fees. Furthermore, the Agencies considered comments concerning the escrow provisions that were not addressed in the October 2013 Proposal or HFIAA.

– *New Escrow Requirement.* Under the Upcoming Proposal, the general rule for the new escrow requirements remains the same—regulated lending institutions, or their servicers, would be required to escrow all premiums and fees for flood insurance required for loans secured by residential improved real estate or a mobile home unless the loan or the lending institution qualifies for one of the statutory exceptions.

What will change is the scope of this requirement. Under the October 2013 Proposal, this requirement applied to a covered loan “that is outstanding or entered into on or after July 6, 2014.” Under the Upcoming Proposal, the requirement will apply to loans that are “made, increased, extended, or renewed on or after January 1, 2016,” which is consistent with the flood insurance regulations’ triggering events. Said another way, under the Upcoming Proposal, the new escrow requirement does not automatically apply to loans that are outstanding on or after July 6, 2014. Instead, lenders must give borrowers the option to escrow flood insurance premiums and fees and notify the borrowers of such option for covered loans that are “outstanding on January 1, 2016.”

– *Small Institution Exception.* As stated above, Biggert-Waters included a small institution exception to the new escrow requirements and the Agencies included this exception in the October 2013 Proposal. Although this exception is substantially the same in the Upcoming Proposal, the Agencies made one big change by adding the word “any.” Under the Upcoming Proposal, the exception applies to an institution:

- That has total assets of less than \$1 billion as of December 31 of either of the two prior calendar years; and
- On or before July 6, 2012:
 - Was not required under Federal or State law to deposit taxes, insurance premiums, fees or any other charges in an escrow account for the entire term of **any** loan secured by residential improved real estate or a mobile home; and

- Did not have a policy of consistently and uniformly requiring the deposit of taxes, insurance premiums, fees or any other charges in an escrow account for **any** loans secured by residential improved real estate or a mobile home.

By adding the word “any,” the Agencies are clarifying that “the exception is unavailable if either statutory condition applies to any residential loans originated by the lender on or before July 6, 2012.” (Emphasis added.) With regard to the latter condition, the Agencies also are making clear that if “an institution had a policy of consistently and uniformly requiring the deposit of taxes, insurance premiums, fees or any other charges in an escrow account for even a portion of its portfolio of residential loans, such a lender would not be eligible for the exception.”

– *Additional Exceptions.* The Upcoming Proposal would also implement HFIAA’s additional exceptions as follows:

- Loans that are in a subordinate position to a senior lien secured by the same property for which flood insurance is being provided;
- Loans secured by residential improved real estate or a mobile home that is part of a condominium, cooperative or other project development, provided certain conditions are met;
- Loans that are extensions of credit primarily for a business, commercial or agricultural purpose;
- HELOCs;
- Nonperforming loans, which the Agencies will define as a loan that is 90 or more days past due; and
- Loans with terms not longer than 12 months.

Force-placement Provisions

Current Rule. If a lender or a servicer determines at any time during the term of a designated loan that the structure securing the loan is not covered by flood insurance, or that the amount of flood insurance is less than required by the regulation, the lender must notify the borrower to obtain the required insurance (or amount of insurance) at the borrower’s expense for the remaining loan term.

Biggert-Waters. Allows lenders to charge a borrower for premiums and fees incurred for force-placed coverage beginning on the date the flood insurance coverage lapsed. (However, it is still not clear whether this means that lenders merely may start charging on the date the borrower’s existing policy expires or whether lenders may actually force place immediately upon the lapse in flood insurance coverage.)

October 2013 Proposal. Although the force-placed insurance requirements in Biggert-Waters were effective upon enactment of Biggert-Waters, the Agencies addressed these new requirements in the October 2013 Proposal. For example, the Agencies requested comment as to whether institutions may force place on behalf of the borrower the day after the borrower’s policy expires. See 78 FR at 65118.

HFIAA. Left the force-placement provisions untouched.

Upcoming Proposal. Because HFIAA left these provisions untouched, the Agencies did not address them in the Upcoming Proposal. However, in the Supplementary Information to the Upcoming Proposal, the Agencies stated that regulations incorporating the force-placed insurance requirement will be included in a separate rulemaking.

Private Flood Insurance Policies

Current Rule. A private insurance policy may be an adequate substitute for NFIP insurance if it meets the criteria set forth in FEMA's (albeit, rescinded) *NFIP Mandatory Purchase of Flood Insurance Guidelines* (August 2008). Similarly, a private insurance policy may be used to supplement NFIP insurance for designated loans when the property is underinsured, provided that the policy meets the criteria set forth in FEMA's Guidelines.

Biggert-Waters. If a policy meets the definition of "private flood insurance," as defined in Biggert-Waters, then a lender must accept that policy to satisfy the mandatory purchase requirement.

October 2013 Proposal. Contained provisions to implement this requirement.

HFIAA. Left the private insurance policies provisions unchanged.

Upcoming Proposal. Because HFIAA left this requirement untouched, the Agencies did not address the private insurance policy provisions in Upcoming Proposal. However, in the Supplementary Information to the Upcoming Proposal, the Agencies stated that private flood insurance provisions will be included in a separate rulemaking.

In the Upcoming Proposal, the agencies did not propose a compliance date for the escrow and private flood insurance provisions. Instead, they stated that the compliance date for these provisions will be determined on the issuance of the final rule that implements them. Again, this update is just a summary of the new and proposed flood insurance requirements. For more detailed information, contact the firm or listen in on the upcoming BCG Monthly Telephone Briefing during which we will address these requirements for BCG members. At the moment, we have tentatively scheduled a presentation on the Upcoming Proposal as part of the November Monthly Telephone Briefing to be held on Friday, November 21, at 12:00 p.m. We will post information as to that Monthly Telephone Briefing in the near future.

For further information or questions regarding the Upcoming Proposal, BCG members and other clients are encouraged to email Robert K. Olsen (ROlsen@ablawyers.com) or Stephanie A. Shea (SShea@ablawyers.com) or call either one at 949-474-1944.