

Federal Reserve Bank of San Francisco
101 Market Street, San Francisco, California 94105

October 23, 2006

**BANKING SUPERVISION AND REGULATION:
FLOOD INSURANCE UPDATE**

To State Member Banks, U.S. Branches
and Agencies of Foreign Banks,
and Others Concerned,
in the Twelfth Federal Reserve District

Flood Insurance Update

Violations of the flood insurance provisions of Regulation H are increasingly observed during routine consumer compliance examinations. Ensuring that borrowers obtain the level of insurance required by law is not only an important consumer protection; it reduces the level of legal and financial risk to which lenders may be exposed. Currently, a pattern or practice of violations expose lenders to civil money penalties of up to \$125,000 per calendar year. Legislation pending in both the U.S. House of Representatives (House) and U.S. Senate (Senate), however, could substantially increase the level of penalties to which lenders may be subjected. This letter serves to alert management to common violations and provides recommendations for precautionary measures banks can take to avoid their occurrence.

Background

The National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973, as implemented by section 208.25 of Regulation H, require state member banks and foreign banking organizations to ensure that all designated loans are covered by flood insurance for the term of the loan. A designated loan is defined as any loan secured by a building or mobile home that is located or will be located in a Special Flood Hazard Area (SFHA) for which flood insurance is available. Failure to obtain adequate insurance at the time the loan is made is a violation of section 208.25(c)(1), which prohibits a bank from making, increasing, or extending a designated loan, unless it is covered by flood insurance for the term of the loan.

Common Violations

Calculating Coverage

Loans secured by property located in an SFHA must have sufficient coverage in order to comply with the rule. Our examinations reveal that banks have been originating loans without flood insurance, or more commonly, with an inadequate amount of insurance. In order to meet the requirements of the law, coverage must equal the lesser of:

- The outstanding principal balance of the loan
- The maximum coverage available under the Act
- Or, the value of the property securing the loan minus the value of the land

The maximum coverage available under the Act is \$250,000 for 1-4 family residential properties, and \$500,000 for commercial properties. In addition, contents coverage is available in the amount of \$100,000 for residential properties, and \$500,000 for commercial properties. Contents coverage is required if the contents of the building also secure the loan.¹

¹ Currently, the proposed legislation in both the House and the Senate would increase the maximum coverage.

Multiple Buildings Securing One Loan

Each building securing a loan must be covered up to the maximum coverage allowed under the National Flood Insurance Program (NFIP), as discussed above. Particularly with respect to commercial and agricultural loans, it is not uncommon for lenders to originate a loan secured by real property consisting of multiple buildings. In this event, each structure on the property must be separately insured.²

One Property Securing Multiple Loans

When one property secures multiple loans, lenders must ensure that the property has coverage equal to the lesser of the maximum coverage available under the Act or the combined outstanding balance of all loans. Violations often result when lenders originate home equity loans or lines of credit in a subordinate position to an existing loan, and require insurance only in the amount of the current loan rather than the combined balance of all loans. Similarly, violations often occur when lenders extend refinance loans to borrowers with existing home equity lines of credit, but do not account for the line of credit when determining the amount of required insurance.

Insurance Waivers and Blanket Policies

When making a loan secured by real property located in an SFHA, unless specifically exempted by section 208.25(d), insurance may not be waived for any reason.³ This is also the case where a lender carries a blanket insurance policy that provides coverage to the collateral securing its loans. Although such a policy may provide the lender with some degree of coverage in the event of flood damage to its collateral, it does not meet the requirements of the NFIP and therefore is not an acceptable substitute for the borrower obtaining individual coverage as required by the law.

Buildings Under Construction

Flood insurance is required for buildings in the course of construction. Recently, questions have arisen regarding the point at which a policy must be in place. Federal Emergency Management Agency (FEMA) guidance states that a policy must be in place by the time there is a walled and roofed structure, defined as two walls and a roof. Many banks elect to use the inspection process to ensure that insurance is in place at the appropriate time. However, this type of process can result in violations if inspections occur after the building meets the FEMA definition of a walled and roofed structure. Accordingly, in guidance on pages 25 and 26 of the current *Mandatory Purchase of Flood Insurance Guidelines*,⁴ FEMA states that the only practical way of implementing coverage in this scenario is to require the purchase of the policy at the time the development loan is made, to become effective once the construction period begins.

Maintaining Insurance for the Life of the Loan and Force Placement

Flood insurance must be maintained for the life of the loan. Lenders should implement a monitoring system designed to identify instances where borrowers fail to renew policies, allow policies to lapse, or reduce coverage to levels that do not meet regulatory requirements. Whenever it is determined that a loan lacks adequate coverage, lenders must provide the borrower(s) with a notice indicating that they must obtain appropriate coverage within 45 days of notification or it will be force placed by the lender on their behalf.

Ensuring Flood Compliance

Bank management should assess the risks inherent in their lending operations and develop methodologies to address those risks in a manner that is consistent with their current operations and business strategies. Within that context, banking organizations should:

² With certain exceptions, coverage of up to 10 percent of the liability limit is allowed for detached garages.

³ Section 208.25(d) provides exemptions for state-owned properties covered under a policy of self-insurance satisfactory to the director of FEMA and for property securing any loan with a principal balance of \$5,000 or less and a repayment term of one year or less.

⁴ The manual is available online at <http://www.fema.gov/business/nfip/mpurfi.shtm>.

- Review their policies and procedures addressing compliance with the flood insurance provisions of Regulation H
- Ensure that the policies and procedures require a flood insurance policy be in place at the time a loan secured by a building to be constructed in an SFHA is made
- Train all applicable lending and loan processing staff to ensure that they are aware of the requirements of the law
- Implement adequate internal controls to ensure compliance with the law
- Develop a “tickler system” to ensure that adequate flood insurance remains in place for the term of the loan

Management should also consider implementing or making use of other resources that aid staff in complying with the law. For example, examiners have observed that banks that provide employees with job aids such as calculation worksheets or checklists generally have fewer instances of non-compliance than those that do not. In addition, answers to many questions regarding flood insurance rules and requirements can be found on FEMA’s National Flood Insurance Program (NFIP) website at www.floodsmart.gov. Lenders and compliance staff should visit this site periodically to ensure that they are aware of the most recent guidance issued by FEMA.

Updated Standard Flood Hazard Determination Form

Pursuant to Regulation H, section 208.25(f)(1), lenders are required to use the standard flood hazard determination form developed by the Director of FEMA when determining whether a building offered as collateral for a loan is or will be located in an SFHA. FEMA has recently updated the standard flood hazard determination form. The new form, which should display an expiration date of October 31, 2008 in the upper right hand corner, is available on FEMA’s website at <http://www.fema.gov/business/nfip/sfhdform.shtml>. Banking organizations are encouraged to review their flood hazard determination forms, and those of any vendors with which they contract to perform determinations, to ensure they are using the most current version.

Additional Information

All circulars and documents are available on the internet through the Federal Reserve Bank of San Francisco’s website, at <http://www.frbsf.org/banking/letters>.

For additional information, please contact our Banking Supervision and Regulation Department at (415) 974-3028.

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