

*After interagency
Q&As from the regulators,
some clarity,
but vexing issues and
unanswered questions
remain*

Atwash

To the uninitiated, flood insurance compliance seems like a simple concept: see whether a building securing a loan sits in a high-risk flood area; if it does, get insurance. Nothing to it. But we all know there is a lot more to it, and over the years the regulatory agencies and FEMA have issued guidelines, booklets, and questions and answers to address the many details. We're getting closer, but we're not there yet. The regulators' latest Interagency Questions and Answers Regarding Flood Insurance (published in the *Federal Register* on July 21, 2009) finalized many previously proposed Q&As but proposed more still.

The good news is that a few issues, such as dealing with construction loans, making junior lien loans, and dealing with flood zone discrepancies, have been clarified to a great degree. But we're still searching for definitive guidance on what constitutes "insurable value" when determining how much coverage to obtain. These are the topics we'll cover here.

in Flood Issues

Construction Loans

Construction loans have troubled lenders for a long time. When should the determination be made? If the building (when constructed) will be located in a special flood hazard area (SFHA), when should the insurance policy be purchased and when should coverage begin? The natural temptation in these situations is to put off worrying about flood insurance until there is actually something to insure—i.e., a building, or at least part of a building.

While there are options regarding how insurance must be purchased if required, most of your normal flood responsibilities remain the same. The determination must be performed prior to origination; it can't wait until sometime later during the construction process (such as when there is something there to insure). If the building will be located in a SFHA, then the borrower must be given notice prior to origination, as well.

However, there is flexibility in how and when to have the policy in place and when exactly coverage begins. Buildings in the course of construction are eligible for coverage under a flood insurance policy. But when does this "course of construction" begin? FEMA's *Flood Insurance Manual* describes the "start of construction" as when the first placement of permanent construction of a building on site, such as the

pouring of a slab or footing, the installation of piles, the construction of columns, or any work beyond the stage of excavation, occurs.

What about materials or supplies intended for use in the building's construction that are on site but are not yet part of the building? They are also eligible for coverage, provided they "are contained in an enclosed building on the premises or adjacent to the premises."¹

The lender has two choices when procuring the policy:

1. Treat the loan as you would any other: require the policy to be in place when the construction loan is originated, even though the policy will not be effective until the "start of construction."
2. Defer the purchase of the policy until the time construction begins, meaning when the foundation has been poured or an elevation certificate has been issued. If the building will have its lowest floor below the base flood elevation, the purchase must occur by the time the building has been walled and roofed.

In any case, you must ensure that insurance is in place before disbursing funds to pay for construction (except for pouring the slab, preliminary site work, or purchasing building materials). As the Q&A states, you must also "have adequate internal controls in place at origination to

ensure that the borrower obtains flood insurance no later than when the foundation slab has been poured and/or an elevation certificate has been issued.”²

Junior Lienholders

Let’s say your bank is making a loan secured by a junior lien on the property. Does that relieve you of any of the normal flood responsibilities? It depends (thanks for the clarity); you may be able to rely on a previous determination done on the property, but if insurance is required, you have an extra step to consider.

■ **Reliance on a previous determination.** In cases where you’re making a junior lien loan on a property where you also hold the first mortgage, does it make sense to obtain a new determination when you have already done one on that same property? No, and the Q&As clarify that as long as “the same lender made the first mortgage, then a new determination may not be necessary.”³ That “may” means that the previous determination must meet regulatory requirements (is not more than seven years old, was recorded on the standard form, and no map changes have occurred in the interim).

This holds true no matter the type of junior lien loan. Before this latest set of Q&As, this applied only to second mortgages or home equity loans, but now reliance is permitted “whether the subordinate lien loan is a home equity loan or some other type of junior lien loan.”⁴ Making another loan on the same property is “the functional equivalent of increasing the amount of the original loan,”⁵ according to the regulators.

The one catch is that the lender making the junior lien loan must also be the one that made the first mortgage (the “same lender” rule). If another lender made the first mortgage, you must obtain a new determination because you’re making a new loan, even if you have a copy of the previous determination and it meets all of the regulatory requirements. To borrow from an appraisal rule, no read-dressed flood determinations.

■ **How much insurance must be obtained?** The answer depends on what the first lienholder did, meaning how much coverage exists. The lender making the junior lien loan must determine how much insurance the first lender obtained in connection with that loan. This seems to run counter to the requirement that you need not obtain insurance for an amount greater than the loan amount, but the technically accurate way to state this requirement is that coverage need not exceed “the combined total outstanding principal balance of the first and second loan”⁶ (if less than the insurable value of the building or maximum available under the act).

You might think that if you obtain enough insurance to cover your loan amount, you’ve complied with the requirement even if the first lienholder didn’t obtain adequate coverage. But what happens if there is a flood? The policy

pays out according to lien position; in other words, the first lienholder gets paid first, then you do (if there is enough left over).

Say for example that you make a loan secured by a junior lien for \$50,000 on a property where the building is worth \$200,000. The first lienholder had previously made a \$100,000 loan but obtained only \$75,000 of flood insurance (this is the fact scenario in Example 1 of Q&A #36). In total, \$150,000 of insurance is required. If you obtain only \$50,000 of coverage, what happens if there is a flood loss? The first lienholder has claim to \$100,000 of the loss payment, even though it didn’t obtain that much on its own. That leaves you \$25,000 short (and in violation); thus you must obtain \$75,000 of coverage when you originate your loan. You must make up for the shortcomings of a senior lienholder.

■ **How do we determine how much coverage is currently in place?** The borrower’s credit report could be pulled to determine loan balance, but the guidance recommends working with the borrower and senior lienholder to determine how much coverage is ultimately needed. The borrower’s consent should be obtained to get loan balance and policy information from the senior lienholder.

But what if the first lender refuses to provide the information on some sort of privacy grounds? Let’s flip the situation: if you hold the first mortgage, can you provide loan balance and coverage information to a junior lienholder even without proof of the borrower’s consent? The answer is yes:

The Agencies have determined that the privacy provisions of the Gramm-Leach-Bliley Act, as implemented in the Agencies’ regulations, do not prohibit sharing of the loan and flood insurance information between two lenders with liens on the same property, even without the borrower’s consent.⁷

But what if, after trying your hardest, you just can’t get the necessary information? In this (we hope rare) case, which normally happens when renewing your loan, you can presume that the senior lienholder’s coverage amount continues to be sufficient, provided that it was sufficient when your loan was originally made. But be sure to document your efforts to obtain the information before relying on this presumption.

In any case, be sure to add your institution’s name to the existing flood policy as a mortgagee/loss payee.

Flood Zone Discrepancies

A persistent issue in flood insurance circles is how to deal with differences in the flood zone documented on the bank’s determination form and that noted on the flood insurance policy. The zone is used by the insurance company to rate the policy and determine the premium. The insurance

company or agent may choose to determine for itself what zone the building sits in, and this may differ from what the bank has. Unfortunately it is ultimately up to the lender to ensure that appropriate coverage is in place when required.

■ **Have a process.** As long as a lender has a “process in place to identify and resolve flood zone discrepancies,” and can “substantiate in its loan file a bona fide effort to resolve a discrepancy ... no violation will be cited.” But if the bank does nothing, and a “pattern or practice of unresolved discrepancies is found,”⁸ violations could be cited.

The process must determine (1) if there is a discrepancy; and (2) if there is, whether something should be done about it.

1. What exactly is a “discrepancy” worthy of doing something about? When a flood insurance policy is obtained, look at the zone designation and compare it to the determination form. If they are identical, you need go no further. If there is a difference, and your determination lists a high-risk zone (A or V, where flood insurance is required) and the policy lists a low- or moderate-risk zone (B, C, D, or X, where insurance is not required), you must work to resolve the discrepancy.

If the difference is between sub-zones, even though they’re different, you need not resolve that sort of discrepancy. For example, where the policy is rated to zone B and the lender’s determination lists zone A, that is a discrepancy worthy of further investigation; if the policy lists zone AH and the lender’s determination lists zone AE, that is not.

2. What do we need to do then? The easy answer here is to, as the Q&A requires, conduct a “bona fide effort” to investigate and resolve the discrepancy. Investigations normally turn up one of the following three reasons for the difference:

- a mistake
- a legitimate reason for the difference
- a legitimate difference of opinion

Mistake: Say the bank’s determination shows that the building sits in an AE zone, but the insurance policy is rated for a B zone. Further investigation is therefore warranted, beginning with rechecking your determination. If your determination provider verifies its original finding, check with the insurance company to have it recheck. If the insurance company also verifies its original finding, there is the option of submitting the determination to FEMA to confirm or review the lender’s original determination. But FEMA will do this only within the first 45 days after the lender notified the borrower that flood insurance was required.

Legitimate reason for the difference: Differing flood zones are acceptable in certain cases, specifically under the NFIP’s “grandfather rule.” This applies where a policy was issued before changes to the flood map affecting hazard ratings were made by FEMA. If the borrower built according to standards necessary or maintained continuous coverage

under a policy rated for a B zone despite a subsequent change to an AE zone, the policy can continue to be rated for the B zone.

The borrower may continue to pay the lower premium, but the lender should document the application of the rule in its files. Some good news here is that as of October 1, 2009, the declarations page of an NFIP policy will indicate if the policy is grandfathered. For older situations, a letter from the agent can document the grandfathered rating.

Legitimate difference of opinion: What if the grandfather rule doesn’t apply, or the insurance agent or company is unwilling to change its policy rating even after FEMA comes back with its determination review? In this case, the bank should send a notice to the insurance agent or company informing it of its duty to write the policy to the more hazardous flood zone. The notice should include the bank’s determination information (which could be its determination form or FEMA’s review) and a copy of FEMA’s letter of April 16, 2008 (W-08021),⁹ where insurance companies and agents are “directed to use the most hazardous flood zone for rating when presented with two different flood zones, unless the building qualifies for the ‘grandfathering rule.’”


Again, the lender should document in its files what it has done and sent.

How Much Insurance Should We Obtain?

While lenders welcomed the release of FEMA’s *Flood Insurance Guidelines* (the “blue book” that replaced the “yellow book”) back in September 2007, its definition of “full insurable value” caused and continues to cause quite a stir. To make matters worse, not all examiners are interpreting this definition in the same manner, leaving many lenders scratching their heads and fearful of what the next exam might bring.

■ **Appraised value.** So what exactly is “insurable value” for flood insurance purposes? Prior to the guidelines, “appraised value” was the wording used and thus the required standard. The problem with using that term, however, was that it was often confused with “market value.” Market value is nothing more than what someone (the market) is willing to pay for a property. Appraised value (for flood insurance purposes) and market value can be two very different things.

Consider the following example: a house in Nebraska (with stunning cornfield views) is worth \$100,000. If that same house is moved to California (with stunning ocean and wildlife views), how much would it be worth? Most people would answer “a lot more than \$100,000.” While this may be true for market value, it is not true for the property’s insurable value. Insurable value has nothing to do with market demand, location, or comparable sales. It is a “cost approach” that looks only at the cost to rebuild a property after a disaster. While one could argue that labor costs are significantly higher in California, the cost



of building materials such as lumber and bricks would be comparable to those in Nebraska. Therefore the insurable value of a house in Nebraska is at least close to the same as the house in California.

So what is the best way to determine insurable value? Hazard insurance valuations provide a close estimate but are not an exact representation of insurable value. Hazard insurance does not give a dollar per dollar value for anything below ground; rather, the industry standard is anywhere from 20 to 50 cents on the dollar. The reasoning behind this is that generally anything below ground is protected (from perils such as tornados, wind, hail, etc.) and unlikely to sustain damage. Thus a hazard insurance value is not a true reflection of what it takes to rebuild a property, especially one that is damaged or destroyed by flood. Floods are a unique hazard. They often cause damage to foundations, wipe out basement walls, and so forth, so when you look at obtaining flood insurance it makes sense that the amount of flood insurance should at least be the same as or even more than the hazard insurance on a particular property.

■ **Cost approach.** As discussed earlier, a cost approach is what's needed to determine the insurable value for flood insurance purposes. The problem here is that appraisers generally do not provide a cost approach (or an adequate one) in the appraisal process. They typically provide the market value. Lenders can get what they need by engaging the appraiser after the flood determination is obtained. If the determination indicates that the property is located in an SFHA, the lender can request that the appraiser provide a cost approach (otherwise known as replacement cost valuation) in addition to the market value. This gives lenders an exact figure to assist in calculating flood insurance coverage and to prove to examiners that they used the most accurate valuation.

■ **Replacement cost value (RCV).** Up to this point, the issue of insurable value does not seem like that big of a deal, but this is where the FEMA guidelines throw a wrench into the whole process. On page 27 of the Mandatory Purchase of Flood Insurance Guidelines, FEMA states the following:

To meet compliance requirements, the amount of flood insurance must at least be, but is not limited to, the lowest of: 1) the outstanding principal balances of the loan(s); 2) the maximum amount of coverage available under the NFIP for the particular type of building; or 3) the full insurable value of the building and/or its contents, **which is the same as 100% replacement cost value (RCV).**

But then the guidelines go on to state, “such a risk management strategy **meets or exceeds** the minimal compliance requirements.” In other words, requiring 100 percent RCV goes beyond what the law requires. Unfortunately, many examiners interpret this to mean that lenders must use 100

percent RCV, but the guidelines are simply that—guidelines—and guidelines do not replace the law.

■ **Actual cost value (ACV).** So what is the magic number that will equate to full insurable value, since market value is out, hazard insurance value is not exact, and 100 percent RCV meets or exceeds the minimal compliance requirements? Another valuation method, actual cash value (ACV), is the amount to replace a building less present day physical depreciation. For example, on a 10-year-old building with 20-year shingles, the shingles might retain 50 percent of their original value. The brick might retain 95 percent of its original value. ACV depreciates every component of a building at a different rate. The biggest problem with ACV is that it is very detailed and very complicated to calculate.

NFIP Policies

The answer to the question of “what is that magic number?” is “who knows?” This is something that deserves another look and careful consideration by FEMA and the regulatory agencies. Requiring borrowers to maintain 100 percent replacement cost value is unfair and, quite frankly, a rip-off in many instances. To understand why, it is important to look at the types of NFIP flood insurance policies and how they pay in the event of a flood.

■ **Dwelling form.** This policy will pay RCV, but certain conditions must be met. First, the dwelling must be the policy owner's primary dwelling. The problem with this is that the NFIP does not define primary dwelling the same as other regulations. The NFIP states that the policy owner must live in the dwelling at least 80 percent of the last 365 days. This causes problems for customers who split time between summer and winter homes.

Second, the primary dwelling must be “fully insured” (meaning the industry standard of at least 80 percent insurance-to-value). Problems arise when the RCV changes (for example, in construction loan situations). At the time of closing, the property may be insured at 80 percent insurance-to-value, but due to higher building costs the RCV could increase. If the dwelling form policy is not increased, the insurance may fall below 80 percent insurance-to-value at the time of the flood loss.

Third, the dwelling must be a single unit. If any of these three conditions is not met, the dwelling policy will pay the borrower only ACV, which means the borrower will receive a check for less than his or her policy coverage amount at the time of loss.

■ **General policy.** The second type of policy, the general policy, is used for everything that is not a primary dwelling, such as secondary homes, rental homes, commercial, and agricultural buildings. This policy always pays ACV.

■ **Residential condominium building association policy (RCBAP).** The third type of policy covers condominiums, which is a topic for another day. The fact that these policies

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might not pay RCV is the biggest issue many have with the FEMA guidelines. Why would anyone purchase 100 percent RCV flood insurance when it will pay only ACV?

Limited Coverage

In addition, NFIP policies are limited and do not cover everything that might be damaged in a flood. While they cover most everything on the main floor and above, the policy does not cover anything below ground that isn't necessary to run the upper floors. For example, a policy will cover one water heater, a junction box, a furnace, etc., but will not cover a septic tank. It will cover putting up the walls (including drywall), but will not cover the cost to repaint, rehang wallpaper, or replace carpet. It will not cover damage to a patio, deck, retaining wall, or driveway. Following the guidelines, in this respect, could be a customer relations nightmare, not to mention an unfair and potentially deceptive practice.

Conclusion

So again, we're a little closer when it comes to dealing with some problematic flood insurance issues (construction loans, senior liens, and discrepancies), but unfortunately the proposed flood FAQs did not address the insurable value situation to anyone's satisfaction. But in any case, when dealing with any of these issues, document your file to explain how you encountered, interpreted, and dealt with the situation. BC

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Endnotes

- ¹ FEMA's Flood Insurance Manual, Revised October 2009, Page GR 4. and then some
- ² Interagency Questions and Answers Regarding Flood Insurance, #22.
- ³ Q&A #37.
- ⁴ id.
- ⁵ 74 FR 35929 (July 21, 2009).
- ⁶ Q&A #36.
- ⁷ 74 FR 35924.
- ⁸ Q&A #72.
- ⁹ Available at fema.nfipnextgen.com/pdf/bulletin/w-08021.pdf.