

January 24, 2019

**MEMORANDUM TO:** Board of Directors

**FROM:** Mark Pearce  
Director, Division of Depositor and Consumer Protection

**SUBJECT:** Final Rule: Loans in Areas Having Special Flood Hazards

**Summary of Recommendation**

Staff recommends that the FDIC's Board of Directors approve the attached Final Rule (FR), entitled *Loans in Areas Having Special Flood Hazards* for publication in the *Federal Register*. The FR amends the regulations regarding loans in areas having special flood hazards, set forth in Part 339 of Title 12 of the Code of Federal Regulations, to implement the private flood insurance provisions of the Biggert-Waters Flood Insurance Reform Act of 2012 (the BW Act).<sup>1</sup> Specifically, the FR: (1) requires regulated lending institutions to accept policies that meet the statutory definition of "private flood insurance" in the BW Act and includes a streamlined compliance aid provision to assist regulated lending institutions with evaluating private flood insurance; and (2) permits regulated lending institutions to exercise their discretion to accept flood insurance policies issued by private insurers and plans providing flood coverage issued by mutual aid societies, that do not meet the statutory definition of "private flood insurance," subject to certain conditions.

The FR would be promulgated jointly with the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Farm Credit Administration (FCA), and the National Credit Union Administration (NCUA) (collectively, the "Agencies").

**CONCUR:**

Charles Yi  
General Counsel  
Legal Division

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<sup>1</sup> Pub. L. 112-141, 126 Stat. 916 (2012).

## SUPPLEMENTARY INFORMATION:

### Rule Summary

#### I. Background

The National Flood Insurance Act of 1968 (1968 Act) and the Flood Disaster Protection Act of 1973 (FDPA), as amended (collectively referred to as Federal flood insurance legislation), make Federally subsidized flood insurance available to owners of improved real estate or mobile homes located in participating communities and require the purchase of flood insurance in connection with a loan made by a regulated lending institution when the loan is secured by improved real estate or a mobile home located in a special flood hazard area (SFHA) in which flood insurance is available under the National Flood Insurance Program (the NFIP).<sup>2</sup> The laws specify the amount of insurance that must be purchased and require that such insurance be maintained for the term of the loan. (The requirement to purchase flood insurance, and the term and amounts of such coverage, are hereinafter described as “the flood insurance purchase requirement.”)

The BW Act amended Federal flood insurance legislation to require the Agencies to issue a rule directing regulated lending institutions to accept “private flood insurance,” as defined by the BW Act. The Agencies fulfilled the other requirements imposed upon them by the BW Act through a previous rulemaking.

In October 2013, the Agencies jointly issued a proposed rule to implement the private flood insurance provisions (the First Proposed Rule).<sup>3</sup> The First Proposed Rule required a regulated lending institution to accept all policies meeting the statutory definition of “private flood insurance” in the BW Act (mandatory acceptance). The First Proposed Rule also included a safe harbor provision that would have allowed regulated lending institutions to rely on the expertise of State insurance regulators to determine whether a policy meets the statutory definition of “private flood insurance” and therefore would have been required to be accepted by the institution. Additionally, the Agencies asked whether the rule should include a provision expressly permitting regulated lending institutions to exercise their discretion to accept flood insurance provided by private insurers that does not meet the BW Act’s definition of “private flood insurance” (discretionary acceptance) and solicited comment on what criteria the Agencies might require for such a policy.

Out of 81 written comments received on the First Proposed Rule, 51 addressed some aspect of private flood insurance. Commenters generally requested more guidance regarding the statutory definition of “private flood insurance.” Commenters also generally supported a provision specifically permitting the discretionary acceptance of private flood insurance. However, many commenters raised concerns about the inclusion of rigid criteria in a discretionary acceptance provision, noting that private flood insurance policies vary based on the nature of the property

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<sup>2</sup> Administered by the FEMA, the NFIP is the means whereby Federally subsidized flood insurance is made available to owners of improved real estate or mobile homes located in participating communities.

<sup>3</sup> 78 FR 65108 (Oct. 30, 2013).

and the needs and financial capability of the borrower. Commenters also supported a safe harbor provision but some, including State insurance regulators, had concerns with the safe harbor as proposed.

In response to subsequent legislation (specifically, the Homeowner Flood Insurance Affordability Act (HFIAA)) and comments received regarding the private flood insurance provisions of the First Proposed Rule, the Agencies decided to first finalize other requirements that were not related to private flood insurance coverage (specifically, provisions related to force-placement of flood insurance, escrows, and detached structures), which they did in July 2015,<sup>4</sup> and then to revise and re-propose the private flood insurance provisions. The Agencies re-proposed the private flood insurance rule in November 2016 (the Second Proposed Rule or proposed rule).<sup>5</sup>

The Second Proposed Rule significantly revised the proposed private flood insurance regulation. In addition to including provisions that would require regulated lending institutions to accept policies that meet the BW Act definition of “private flood insurance,” the Second Proposed Rule provided a compliance aid and further clarifications to assist regulated lending institutions in determining whether a policy meets the definition of “private flood insurance.” The Second Proposed Rule also permitted regulated lending institutions to exercise discretion in accepting private flood insurance that does not meet the statutory definition of “private flood insurance,” subject to certain conditions, and included an exception to these conditions for the acceptance of flood coverage provided by “mutual aid societies.”

The Agencies received approximately 60 comments on the Second Proposed Rule from a wide range of commenters, such as: financial institutions (including banks, credit unions, and farm credit institutions); various trade associations (including bankers’ trade associations, credit union trade associations, a farm credit trade association, and home building and realtor trade associations); the insurance industry (including insurance companies, trade associations, and brokers); individuals; nonprofit organizations, a flood risk management association, a State nonprofit corporation; a Federal agency, and a State agency. In addition to receiving written comments, the Agencies conferred with National Association of Insurance Commissioners (NAIC) staff to obtain further information on State regulation of insurance companies.

Commenters addressed several specific issues, such as: the regulatory definition of “private flood insurance;” the use of a compliance aid to facilitate compliance by regulated lending institutions; whether private flood insurance that does not conform to the statutory definition of “private flood insurance” can be accepted by regulated lending institutions; whether and what type of alternative criteria for such non-conforming private flood insurance should be required by the Agencies; and whether regulated lending institutions should be permitted to accept certain non-traditional, non-conforming flood insurance coverage, such as mutual aid society plans.

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<sup>4</sup> 80 FR 43216 (July 21, 2015).

<sup>5</sup> 81 FR 78063 (November 7, 2016).

## II. Summary of the Final Rule

The FR requires regulated lending institutions to accept “private flood insurance” defined in accordance with the BW Act. As suggested by commenters, the FR also includes a streamlined compliance aid provision to assist regulated lending institutions in evaluating whether a flood insurance policy meets the definition of “private flood insurance.” This provision allows a regulated lending institution to conclude that a private flood insurance policy meets the definition of “private flood insurance,” without further review of the policy, if the following statement is included within the policy or as an endorsement to the policy: “This policy meets the definition of private flood insurance contained in 42 U.S.C. 4012a(b)(7) and the corresponding regulation.”

In addition to mandating that regulated lending institutions accept policies that meet the definition of “private flood insurance,” the FR permits regulated lending institutions to exercise discretion to accept flood insurance policies issued by private insurers that do not meet the statutory and regulatory definition of private flood insurance, provided the policies meet certain conditions. As recommended by commenters, the FR no longer includes some of the proposed conditions on the acceptance of such policies. However, the conditions do include a requirement that the policy must provide sufficient protection of a designated loan, consistent with general safety and soundness principles, and the regulated lending institution must document its conclusion regarding sufficiency of the protection of the loan in writing. The FR also allows regulated lending institutions to exercise their discretion to accept certain plans providing flood coverage issued by mutual aid societies.

### Definitions

*Mutual aid society.* The Agencies proposed, and are including in the FR, a provision that would permit regulated lending institutions to exercise their discretion to accept, under certain circumstances, a flood insurance policy issued by a private insurer that does not meet the definition of “private flood insurance” in the BW Act. In addition, the Agencies also would allow the acceptance of plans providing flood coverage issued by mutual aid societies. In connection with this provision, the Agencies proposed to add a definition of “mutual aid society” to their rules.

Under the proposed definition, to qualify as a mutual aid society, an organization must meet three criteria: (1) the members must share a common religious, charitable, educational, or fraternal bond; (2) the organization must cover losses caused by damage to members’ property pursuant to an agreement, including damage caused by flooding, in accordance with this common bond; and (3) the organization must have a demonstrated history of fulfilling the terms of agreements to cover losses to members’ property caused by flooding. The FR adopts the definition as proposed.

*Private flood insurance.* Both proposed rules included the definition of “private flood insurance” as specified in the BW Act. Specifically, the proposed rules defined “private flood insurance” consistently with the statutory definition, with some clarifying edits, to mean an insurance policy that:

- (1) is issued by an insurance company licensed, admitted, or otherwise approved to engage in the business of insurance in the State or jurisdiction in which the property to be insured is located, by the insurance regulator of that State or jurisdiction or, in the case of a policy of difference in conditions, multiple peril, all risk, or other blanket coverage insuring nonresidential commercial property, is recognized, or not disapproved, as a surplus lines insurer by the State insurance regulator of the State or jurisdiction where the property to be insured is located;
- (2) provides coverage at least as broad as the coverage provided under a standard flood insurance policy (SFIP), including when considering deductibles, exclusions, and conditions offered by the insurer;
- (3) includes a requirement for the insurer to give written notice 45 days before cancellation or non-renewal of flood insurance coverage to the insured and the regulated lending institution, or a servicer acting on the institution's behalf;
- (4) includes information about flood insurance coverage availability under the NFIP;
- (5) includes a mortgage interest clause similar to that provided under the NFIP;
- (6) includes a provision requiring an insured to file suit not later than one year after the date of a written denial for all or part of a claim under a policy; and
- (7) contains cancellation provisions as restrictive as those under the NFIP.

The definition of the term "private flood insurance" would be adopted largely as proposed. However, the proposed requirement that the private flood insurance policy cover both the mortgagor(s) and the mortgagee(s) as loss payees will be removed because it is unnecessary given the statutory requirement for a policy to include a mortgage interest clause similar to that contained in an SFIP, which, in general, provides for coverage of the mortgagor and mortgagee. The FR will also clarify that for a policy with coverage exceeding that available under the NFIP, the policy must only meet the deductible for the amount of coverage available under an SFIP.

The FR will also explain that different or additional exclusions are impermissible, unless the exclusions have the effect of providing broader coverage to the policyholder. Non-substantive changes have also been made to simplify the wording.

*SFIP.* The proposed rule defined "SFIP" to mean a standard flood insurance policy issued under the NFIP in effect as of the date the private policy is provided to a regulated lending institution. The FR will adopt the definition as proposed with technical changes. For example, instead of defining SFIP with reference to the date a "private policy" is provided to a regulated lending institution, the definition references the date "private flood insurance" is provided to the institution.

### **Requirement to Purchase Flood Insurance**

The Agencies proposed to amend their rules to implement the BW Act requirement that all regulated lending institutions accept "private flood insurance," if the policy meets the requirements for coverage under the flood insurance purchase requirement. In other words, the policy must cover the building or mobile home and any personal property securing the loan in an amount at least equal to the outstanding principal balance of the loan or the maximum limit of coverage made available under the Federal flood insurance statutes with respect to the particular

type of property, whichever is less. The FR makes technical corrections to the mandatory acceptance provision to add a cross-reference citation for the flood insurance purchase requirement and to make nonsubstantive changes to simplify its wording.

### **Compliance Aid for Mandatory Acceptance**

The Second Proposed Rule included a compliance aid that provided a policy would be deemed to meet the definition of “private flood insurance” if the following three criteria were met:

- (1) the policy includes, or is accompanied by, a written summary that demonstrates how the policy meets the definition of private flood insurance by identifying the provisions of the policy that meet each criterion in the definition, and confirms that the insurer is regulated in accordance with that definition;
- (2) the regulated lending institution verifies in writing that the policy includes the provisions identified by the insurer in its summary and that these provisions satisfy the criteria included in the definition; and
- (3) the policy includes the following statement within the policy or as an endorsement to the policy: “This policy meets the definition of private flood insurance contained in 42 U.S.C. 4012a(b)(7) and the corresponding regulation.”

In response to comments, the FR modifies the compliance aid provision to provide that a regulated lending institution may determine that a policy meets the definition of private flood insurance, without further review of the policy, if only the third criterion above is met. Under the revised compliance aid provision, if a policy includes this statement, the regulated lending institution may rely on the statement and would not need to review the policy to determine whether it meets the definition of “private flood insurance.” However, the institution could choose not to rely on this statement and instead make its own determination.

### **Discretionary Acceptance**

The Agencies proposed that regulated lending institutions could accept, on a discretionary basis, a flood insurance policy issued by a private insurer when the policy meets the amount and term requirements specified in the flood insurance purchase requirement, and if the policy:

- (1) is issued by an insurer that is licensed, admitted, or otherwise approved to engage in the business of insurance in the State or jurisdiction in which the property to be insured is located by the insurance regulator of that State; or in the case of a policy of difference in conditions, multiple peril, all risk, or other blanket coverage insuring nonresidential commercial property, is issued by a surplus lines insurer recognized, or not disapproved, by the insurance regulator of the State where the property to be insured is located;
- (2) covers both mortgagor and mortgagee as loss payees;
- (3) provides for cancellation following reasonable notice to the borrower only for reasons permitted for an SFIP or when cancellation is mandated pursuant to State law; and
- (4) is *either* “at least as broad” as the coverage provided under an SFIP *or* provides coverage “similar” to SFIP coverage, including when considering deductibles, exclusions, and conditions offered by the insurer.

In response to comments, the FR's discretionary acceptance provision is less burdensome and restrictive than that included in the proposed rule, and it more closely reflects the Agencies' current policy with respect to both private flood insurance and hazard insurance. In order to address commenters' concerns, the discretionary acceptance provision no longer requires that a flood insurance policy issued by a private insurer include a specific cancellation clause or be "at least as broad as" or "similar to" an SFIP.

In response to public comment, the FR also modifies the mortgage interest clause provision to provide that to be accepted under the discretionary acceptance provision, the policy must cover both the mortgagor(s) and the mortgagee(s) as loss payees, except in the case of a policy that is provided by a condominium association, cooperative, homeowners association, or other applicable group and for which the premium is paid by the condominium association, cooperative, homeowners association or other applicable group as a common expense. This exception is identical to the exception provided for the requirement to escrow flood premiums currently contained in the Agencies' flood insurance rules.

The FR also makes technical amendments to the discretionary acceptance provision. The FR removes the provision that the policy must meet the "term requirements" of the flood insurance purchase requirement because this is not usually included as a provision in a flood insurance policy. In addition, the FR replaces the phrase "loan secured by the property located in a special flood hazard area" with the more accurate defined term "designated loan" and adds "jurisdiction" each time "State" is referenced to correct inconsistencies in the proposed rule. Non-substantive changes have also been made to simplify wording.

In summary, the FR permits regulated lending institutions to accept flood insurance policies issued by private insurers that do not meet the statutory and regulatory definition of "private flood insurance" if the policy:

- (1) provides coverage in the amount required by the flood insurance purchase requirement;
- (2) is issued by an insurer that is licensed, admitted, or otherwise approved to engage in the business of insurance by the insurance regulator of the State or jurisdiction in which the property to be insured is located; or in the case of a policy of difference in conditions, multiple peril, all risk, or other blanket coverage insuring nonresidential commercial property, is issued by a surplus lines insurer recognized, or not disapproved, by the insurance regulator of the State or jurisdiction where the property to be insured is located;
- (3) covers both the mortgagor(s) and the mortgagee(s) as loss payees, except in the case of a policy that is provided by a condominium association, cooperative, homeowners association, or other applicable group and for which the premium is paid by the condominium association, cooperative, homeowners association, or other applicable group as a common expense; and
- (4) provides sufficient protection of the designated loan, consistent with general safety and soundness principles, and the regulated lending institution must document its conclusion regarding sufficiency of the protection of the loan in writing.

## **Mutual Aid Societies**

In response to comments, the FR simplifies and streamlines the criteria for mutual aid society flood plans to be accepted by regulated lending institutions. The proposed provision to require a regulated lending institution to consider the policy provider's ability to satisfy claims such as whether the policy provider has a demonstrated record of covering losses is eliminated as duplicative and unnecessary. Instead, the FR includes a specific cross-reference to the definition of "mutual aid society," which includes this language. The FR also removes the reference to deductibles to parallel the revised discretionary acceptance provision, which does not specifically list factors that a regulated lending institution could consider when determining whether a private insurance policy is consistent with safety and soundness. The FR makes one additional technical change to the mutual aid society by replacing the word "policy" with "plan" to more accurately describe the type of agreement issued by mutual aid societies. The Agencies also have removed the superfluous phrase "types of" in this criterion.

Under the FR, a regulated lending institution, in satisfaction of the mandatory flood insurance requirement, may accept a plan issued by a mutual aid society, as defined above, if the regulated lending institution's primary Federal supervisory agency has determined that such plans qualify as flood insurance for purposes of the Act and the plan:

- (1) provides coverage in the amount required by the flood insurance purchase requirement;
- (2) covers both the mortgagor(s) and the mortgagee(s) as loss payees; and
- (3) provides sufficient protection of the designated loan, consistent with general safety and soundness principles, and the lending institution documents its conclusion regarding sufficiency of the protection of the loan in writing.

## **Effective Date**

July 1, 2019.

## **Recommendation**

Staff recommends that the Board approve the attached Resolution to authorize publication of the attached FR entitled *Final Rule: Loans in Areas Having Special Flood Hazards*.

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Attachments