NY Region Flood Presentation

Thank you, John. Good afternoon. These calls allow for regulator and banker communication outside of the examination process, which is a great way to make communication at examinations more productive and efficient. We hope you find it helpful to be informed of common errors and hot topics in this format. It's in everyone's interest that these issues are discussed more frequently than just at your institution's examination.

Flood Insurance rules affect lenders every day. We receive many questions during examinations about how it impacts your business. The FDIC also continues to see Flood Insurance violations frequently. Our objective today is to highlight the essential aspects of a Compliance Management System to ensure compliance with Flood Insurance rules, discuss common errors seen at recent examinations, and explain how the recent Biggert Waters Act affects you today and in the future.

We'll leave time at the end of the presentation for email and phone questions. We will also answer questions that were previously submitted.

Slide 3 addresses most components of a Compliance Management System, which I'll refer to as a CMS. We've identified particular aspects of these components that prevent Flood Insurance errors. These aspects will be applied in different ways depending on the resources and risk associated with your institution. The FDIC recognizes we regulate a broad spectrum of banks in terms of size, strategy, and resources. The CMS of a small community bank will look significantly different than the CMS of a large regional bank. Each institution must determine the most effective CMS structure for your business strategy, asset size, and exposure to regulatory risk. Ultimately, a good CMS is one that allows your institution to best manage its compliance risks.

Starting with Board and Senior Management Oversight in Slide 4, a critical part of complying with Flood Insurance rules is designating an individual to take ownership of the bank's responsibilities in this area. Many of our institutions have one individual who is extremely knowledgeable of Flood Insurance compliance. A challenge with oversight is that Flood requirements cross over into multiple departments, including Residential, Commercial, Consumer, and Loan Servicing. If your institution designated one individual to manage Flood compliance, it's critical that this individual has the authority to cross department lines to create appropriate accountability. It's common to see an institution effectively comply with Flood requirements in one department but have challenges in another.

Specifically, we often see fewer issues with residential loans, but many issues with commercial loans. Commercial loans are typically more complex, yet there is often less oversight for Flood Insurance compliance in the commercial area. For example, commercial lenders often take a security interest in a business owner's personal residence. There must be recognition that Flood Insurance rules apply to these scenarios. A flood determination must be performed for all buildings taken as collateral for a loan, including commercial loans. We've frequently seen commercial lenders who were not aware that Flood requirements apply in these situations, and violations were cited. You should ensure effective oversight for Flood Insurance exists in commercial lending as well as other areas.

Alternatively, if your institution spreads this responsibility to multiple individuals across different business lines, there must be clear expectations for these roles to avoid a requirement "slipping through the cracks." It might still be appropriate to designate one of these individuals as the point person for Flood Insurance oversight. An effective oversight structure for Flood compliance must be in place in order for other components of the CMS to function properly. Again, there is not a standard structure for all banks. Each bank must determine the appropriate oversight structure for Flood Insurance based on its available resources and risks.

Slide 5 provides key characteristics of sound Flood Insurance procedures. As I just mentioned, Flood Insurance compliance affects numerous areas and numerous parts of the lending process. Depending on your institution's size and complexity, multiple procedures may be necessary. One set of procedures, as long as they are comprehensive, may be sufficient. Institutions that successfully comply with Flood Insurance rules typically have specific and detailed procedures that refer to the individual, business line, or job title performing an action. For example, strong procedures might instruct the loan processor to 1) log on to a service provider's website to initiate a flood determination, 2) send an email to the loan underwriter that the collateral is in a flood zone, and then instruct the underwriter to 3) complete the coverage checklist to determine the required amount of flood insurance coverage. This level of detail and reference to specific individuals promotes accountability and eliminates confusion about what each individual is responsible for with respect to Flood Insurance compliance. It's important to have effective procedures for each department affected by Flood rules, whether those are within one document or outlined in separate documents.

Strong procedures also provide clear instructions for unique situations, such as when contents coverage is required, obtaining appropriate coverage for condominium loans, and initiating force placed insurance coverage. Institutions have been very successful with incorporating detailed checklists and other tools to ensure all Flood Insurance requirements are met. Given that the majority of your loans likely do not require flood insurance, lending personnel need refreshers on what to do when a loan is secured by property in a flood zone. Effective written procedures and job aids provide that support.

While you likely have multiple individuals performing tasks related to flood insurance, it's still important to have that one subject matter expert I referred to earlier who is familiar with all tasks. This individual can serve as a resource to employees in any department, especially when complex issues arise. This doesn't have to be the compliance officer, but should be someone with the authority to cross department lines.

Slide 6 outlines training guidelines to ensure flood compliance. Basic online instruction serves a purpose in promoting awareness of basic Flood Insurance requirements. It typically does not provide those with flood compliance responsibilities the full extent of knowledge needed to fulfill these duties. We've seen institutions supplement online courses in several ways. Banks with a training department or staff trainer have performed classroom instruction that includes more in-depth discussion of flood insurance rules. These types of training also allow for the discussion of real-life scenarios faced by bank employees. Such discussion also brings to light knowledge gaps or proactively prepares employees for complex situations they may not have come across.

Banks with fewer training resources have brought in third parties to provide similar classroom instruction. Another advantage of having classroom instruction is the ability to tailor training to your institution’s specific procedures, data systems, origination systems, and other elements that are specific to your bank. As with each CMS component, you can provide effective Flood Insurance training in a variety of ways. You should assess what method works best for your bank to fulfill its responsibility to comply with Flood Insurance rules.

Industry groups, regulatory agencies, and FEMA also sponsor various webinars and seminars. These are especially important to ensure your bank is aware of any changes to the NFIP as well as hot topics relating to Flood Insurance compliance that may impact your institution. Going back to the management oversight discussion, having clear expectations about who is responsible for overseeing and managing Flood Insurance compliance ensures the appropriate individuals attend these types of training.

The next slide speaks to monitoring and audit. I’m not suggesting these activities are one in the same, but they serve a similar role in ensuring your procedures are adequate and that they are executed appropriately by bank personnel. A typical question we receive is “how do we know how much Flood Insurance training is enough?” or “do we need to expand our written Flood Insurance Procedures?” The answers will always depend on multiple factors, such as your bank’s asset size, complexity, or staff experience. However, monitoring and audit results often give you the feedback needed to answer these questions yourself. Effective monitoring and audits for Flood Insurance frequently lead to good results at an examination.

So the ultimate question is how to confirm that your bank's monitoring efforts and audits for Flood Insurance are effective. Generally speaking, independence is critical for both elements. We've seen bank's achieve independence for monitoring in a variety of ways. In some cases, compliance officers can perform regular monitoring reviews for Flood Insurance compliance if they are not involved at the transactional level. This arrangement may be effective even if the compliance officer was involved in establishing Flood Insurance procedures. The monitoring activities are independent with respect to the execution of procedures. However, this structure should be complemented by a risk-targeted audit that closely analyzes the completeness of written procedures. The audit should also include file reviews to confirm that monitoring reviews are accurate and complete.

Other institutions achieve independent monitoring by having employees with flood compliance duties in one area review the work of those with compliance duties in other areas. For example, someone in loan servicing performs a review of the flood-related tasks completed in the loan origination area. Your institution should analyze its Flood Insurance process and ensure that independent monitoring exists. The scope of audits should consider monitoring activities and emphasize the parts of the process with the greatest risk.

Effective monitoring for flood loans typically occurs at multiple stages: prior to closing; after closing; and at regular intervals as you service loans. Pre-closing monitoring could include second signatures for coverage worksheets, verifying that the flood determination considered the correct property address, or documentation checklists. Post-closing monitoring might include re-verification of the required coverage amount, ensuring that appropriate documentation exists to provide proof of coverage, or a review of the appraisal to see if multiple structures exist on the subject property. If multiple structures did exist, post-closing monitoring would confirm that coverage was allocated appropriately to each structure. Monitoring on the servicing side could involve the review of policy expiration reports, monitoring of map change alerts associated with life-of-loan determination coverage, or tracking borrower responses when force placement notifications have been sent. These are some examples of monitoring activities, but certainly do not represent an exhaustive list.

Your institution must decide what monitoring activities are appropriate based on its resources and the level of risk associated with Flood Insurance rules at your bank. We've seen informal monitoring activities that are highly effective and formal monitoring programs that are ineffective. Each bank has to make this decision based on its own assessment of how it can best ensure compliance with Flood Insurance rules.

Regardless of how your institution performs Flood Insurance monitoring, compliance audits should complement these activities. The less advanced and intensive monitoring is, the more advanced and intensive flood audits should be. These elements should work together to help the institution in the most efficient manner.

Going back again to management oversight, having one individual or a team of individuals with authority who are responsible for Flood Insurance is critical. This kind of leadership will promote strong procedures, training, and monitoring at your institution. Your bank must establish an effective compliance management system with respect to Flood Insurance rules in order to navigate around the common pitfalls we will discuss next. I've highlighted examples of an effective CMS, but you must decide what aspects are appropriate for your institution based on available resources and the level of risk your bank has with respect to Flood Insurance compliance.

So we'll enter into some specific discussion of Flood Insurance rules now. As I mentioned earlier, we frequently see Flood Insurance violations at examinations. We're going to discuss six particular issues that were commonly identified at examinations and provide some guidance on how to avoid these issues going forward. Slide eight lists the six issues. In most cases, violations occurred due to a deficiency in one or more of the CMS elements I just discussed.

Generally speaking, the greatest portion of violations pertained to either not having flood insurance coverage, or not having the sufficient amount of flood insurance coverage required at the time a designated loan was made, increased, extended, or renewed. The circumstances surrounding these violations varied significantly. I'll stress that the statute leaves no wiggle room for complying with this rule. The FDIC recognizes that there are often unique challenges with flood insurance, but the law is not flexible.

A common circumstance surrounding this violation was the lack of contents coverage for commercial loans. Examiners often referenced their reviews of loan files where a bank makes a commercial loan secured by a building in a Special Flood Hazard Area. The loans were also secured by contents stored within that building. In these cases, the bank obtained flood insurance for the building but not the contents in the building.

Flood Insurance requirements for contents are not new. With respect to contents, you must obtain flood insurance if you take a security interest in contents and a building, the building is located in a Special Flood Hazard Area, and the contents are stored in that building. I'll repeat that. Flood insurance for contents is required when you take a security interest in contents and a building, the subject building is located in a Special Flood Hazard Area, and the contents are stored in that building. Contents coverage is required only when all three factors are met. In some instances, the bank's commercial lending area was simply not aware of the requirements associated with flood insurance on contents. In other instances, this violation occurred when the underwriting process did not factor in the value of contents as collateral, but the bank used a mortgage or security agreement that took contents as collateral.

Flood Insurance requirements are not predicated on the method you use to secure your collateral. Even if your bank does not file a UCC to perfect a lien on contents, a mortgage or security agreement document that takes contents as collateral still triggers the requirement to obtain flood insurance on both the building and contents if the above factors are true. Each bank should closely review its loan agreements and legal documentation to determine if it has a security interest in contents and if flood insurance is required. Collateral taken as an abundance of caution can also trigger the need to obtain flood insurance.

I'll make a quick note that the valuation of contents is not always straight forward when determining how much contents coverage is required. The most recent version of the Flood Insurance Q&As from July 21, 2009 and the FDIC Press Release dated October 14, 2011 provide some guidance on this issue. Basically, contents will be considered to have a sufficient amount of flood insurance coverage for regulatory purposes as long as a reasonable method of valuating contents is used. There is leeway for you as a bank to determine what a reasonable valuation method is. You should be able to document and support any valuation method you use. So to wrap up this issue, if your institution takes any type of security interest in contents when making commercial real estate loans, be sure that you have proper procedures in place to comply with Flood Insurance requirements.

Another flood insurance issue that resulted in violations was confusion related to residential condominium loans, which you'll see referenced on slide 10. We've heard many concerns at examinations regarding flood compliance with condos. Most residential condominiums located in a Special Flood Hazard Area receive flood insurance coverage through a Residential Condominium Building Association Policy, or RCBAP. This type of policy insures a residential condominium owned by a condominium association. Confusion related to condos typically occurred when a condominium association did not obtain coverage for the full replacement cost value of the condominium. The same minimum coverage requirements apply for a residential condo unit as a single family home: the lesser of the loan amount; the insurable value, which in this case is the replacement cost value of the unit; or the maximum amount of coverage available under the National Flood Insurance Program (NFIP). The replacement cost value of the unit is determined by dividing the full replacement cost value of the condominium building by the number of units. When the amount of RCBAP coverage is not sufficient to meet minimum requirements, the borrower can make up the difference by getting the association to increase RCBAP coverage, or obtaining a different policy that benefits only the unit owner, a Dwelling Form policy.

I'm sure there are at least a few on this call that encountered condominium associations that were not helpful in your efforts to comply with Flood Insurance rules. I acknowledge your frustration and recognize it's easier to tell you how to do it than to have to actually do it. Keep in mind though that you as a lender always have full control of meeting your compliance responsibilities. If your bank is comfortable making such a loan, you can fulfill your compliance responsibility by having your borrower obtain a dwelling policy to make up for the inadequate RCBAP coverage. Pages 45 through 50 of FEMA's Mandatory Purchase of Flood Insurance Guidelines provide further information on this scenario, as well as some risk management concerns associated with RCBAPs that do not insure a building to its full value. The main point I'd leave you with is to not rely only on the condominium association to comply with Flood Insurance rules in these transactions. Be proactive in determining if adequate flood coverage exists for a condo loan.

The last issue I'll cover before passing the torch to Erin is force placement requirements; move to slide 11. If a bank is aware that no coverage or inadequate coverage exists for a designated flood loan, Part 339 of the FDIC's Rules and Regulations requires a lender to purchase flood insurance on the borrower's behalf if the borrower fails to obtain insurance within 45 days of notification. You as a lender must notify the borrower if at any time you determine that flood insurance coverage is inadequate. Many examinations included violations pertaining to both failing to give proper or timely notification, and also failing to obtain coverage after the 45 day notification period expired. I think an example will help better describe the violations we've seen.

In one scenario, your servicing area notices that a borrower let the flood insurance policy expire. You send a letter letting them know that the policy expired and it must be renewed as soon as possible. After a month of no response, you send a more formal notice to the borrower that includes the required language and gives a 45 day deadline to obtain coverage or else the bank will force place coverage. A violation occurred because the 45 day notice should have been given a month earlier. Many institutions made this error because they wanted to present this problem to the borrower in a gentler way. That's understandable. That approach can be accomplished by sending a courtesy notice prior to the actual expiration of the insurance policy. That way you've started a less aggressive conversation with the borrower in advance, but you can still send the required 45 day notification at the proper time.

In another scenario, your bank sent the notice as required, with the required information in it, as soon as your borrower let their flood insurance expire. However, you did not force place the insurance immediately after the 45 day notification period expired. There was a delay because you wanted to give your borrower more time to obtain the coverage, which would likely be cheaper than force placed coverage. This results in a violation. Your bank should consider how it can provide strong customer service while still complying with Flood Insurance rules.

As I stated previously, Flood Insurance rules are inflexible; however, you can avoid violations with a proactive approach in these situations. If you have questions on these issues, you can email them to NYCalls@FDIC.gov or you will have the opportunity to ask a question at the end of the presentation.

Erin Skillman will now continue the conversation of common pitfalls to Flood Insurance compliance.

Thank you Sam. We've referenced a couple of different documents including the Interagency Q&As, and I wanted to highlight that slide # 18 lists some resources. There, you'll find links to Flood Guidance including the Q&As.

Let's move along to the remaining common pitfalls that we are discussing today, beginning with map changes on slide 12. As many of you may have recently encountered – FEMA continues to be busy remapping as part of their modernization efforts. Most of the banks we've been in have been receiving notifications from their third party flood certification companies because they subscribe to life of loan monitoring.

With life of loan monitoring the service provider alerts the bank of any mapping changes impacting the loan portfolio. When you receive notice that a property that previously was not in a flood zone is now in a flood zone, you have now been “made aware” that a loan that requires insurance does not have insurance. As such, Part 339 requires that a 45 day notification letter must be sent to borrowers so that they can obtain flood insurance.

Note that simply putting these remapped loans on your bank’s blanket insurance policy or obtaining private flood insurance may not meet the requirements of an NFIP-compliant policy. Generally, these policies should only be used in temporary situations. Please refer to Q&A # 64 for further information.

If remapping identifies that a property is no longer in a Special Flood Hazard Area (SFHA), then you are no longer obligated to require mandatory flood insurance; however, your borrower can elect to convert the existing NFIP policy to a Preferred Risk Policy. A Preferred Risk Policy offers the same coverage at a lower rate because the property is now considered lower-risk. These lower cost policies are also available for the first couple of years for a property that was not previously in a flood zone and now is and requires insurance.

Also, remember that flood zones can only be appealed and disputed directly through FEMA. I’m now on slide 13. If the property owner disagrees with the bank that their property is in a SFHA the bank and the property owner can request that FEMA review the bank’s determination. This request must be done within 45 days of the date of the Notice to Borrower or Force Placement Letter in which you alerted the property owner that their property is in a SFHA and flood insurance is required. In response to this request FEMA will issue a Letter of Determination Review that either agrees with the bank’s determination or states that the property is not in the

SFHA as shown on the FEMA map. No change in the actual map is made. This determination remains in effect until that map is revised.

Alternatively, a LOMA or Letter of Map Amendment amends the FEMA map and establishes that a specific property is not located in an SFHA. To request a LOMA, additional information including elevation information certified by a licensed land surveyor or registered professional engineer must be sent with the request. This process is more costly and generally takes longer.

Before I move on please remember that you must have coverage in place while this process takes place.

Okay, let's move along to slide # 14 and discuss how you should handle zone discrepancies.

Discrepancies usually occur between the insurance agent (what is shown on the Policy) and the third party flood certification company (what is shown on the SFHDF). Generally speaking, when presented with two different zones, insurance companies are instructed by FEMA (per April 16, 2008 instructions) to use the more hazardous flood zone for rating the policy and the only exception would be if the property qualifies for the Grandfather Rule. Q&A's # 71 and 72 address discrepancies and what you as the lender should do if one is encountered. As a lender you should only be concerned with a discrepancy between a high-risk zone (A or V) and a low- or moderate-risk zone (B, D, C, or X).

So, if the Policy shows a lower risk zone than the SFHDF you should investigate. Again, you should first determine whether the difference results from the application of the NFIP's Grandfather Rule. This rule provides for the continued use of an older rating before a hazard rating change if continuous coverage was maintained. If this is the case you should document your findings as such within the file and no further action is required.

The zone difference could also be a mistake so this probability should be pursued next if grandfathering was not the issue. You should communicate with the third party flood certification company and recheck the determination. If the discrepancy is still not resolved, you and the property owner can request that FEMA review the discrepancy within 45 days from the date of the Notice to Borrower.

All of the bank's communication efforts and research must be documented within the file. As Sam discussed at the beginning of our presentation a solid CMS must be present for these issues to be handled in an efficient and timely manner. The bank must have a process in place to handle each scenario presented and all efforts must be documented within the respective files.

To wrap up our discussion of common pitfalls I'd also like to mention a couple of other items that occasionally arise during examinations. These are listed on slide # 15.

The first is related to the Notice to Borrower; we'd like to make a couple of points here.

First, unlike the SFHDF a bank cannot rely on a previous Notice to Borrower even if it's less than seven years old and it is the same property, same borrower, and same lender. Q&A # 79 addresses this and notes that neither the Regulation nor the preamble addresses waiving the requirement to provide the notice to the borrower. Therefore, the lender must provide a new notice to the borrower, even if a new determination is not required.

Second, let's not forget the acknowledgement or record of receipt by the borrower. Although the joint final Rule does not specifically state how this should be accomplished the FDIC (and other agencies) believe that the record of receipt should contain a statement from the borrower indicating that the borrower has received notification. Examples of this include the borrower's signed acknowledgment of a copy of the Notice, a borrower-initialed list of documents and disclosures that you provided, or a scanned electronic image of a receipt or other document signed by the borrower. Typically what we see at our banks is a signed copy of the Notice to Borrower. If this is your method you may be wondering what to do if the borrower doesn't return the signed Notice. You may never get it back or maybe the borrower brings it to the closing. In either scenario you must have it documented that it was sent a reasonable time before closing. Remember that Part 339 states that the bank shall retain a record of the receipt of the Notices for the period of time the bank owns the loan.

I also want to highlight what is meant by a "reasonable" amount of time prior to closing. You all know that the guideline here is generally 10 days because this gives the potential borrower enough time to get insurance and decide whether they want to go forward with the loan. However; note that even if the transaction is a refinance and the borrower already has flood coverage the Notice is still required to be provided and acknowledged; however, you don't have to abide by this "reasonable" amount of time prior to closing in these transactions.

Next, we wanted to mention what is needed to evidence proof of coverage before closing. Generally, to satisfy the proof of coverage requirement a copy of the Flood Insurance application and paid receipt or a copy of the Declarations Page is sufficient for a new policy. For a policy renewal, Certificates of Insurance are sufficient. Many banks continue to present binders as proof of coverage but these are not sufficient since it does not mean that a formal one year policy has been issued. Also, the NFIP does not recognize binders.

Lastly, we wanted to highlight that you should always be pulling SFHDFs on loans secured by or to be secured by a building in the course of construction. If the property is in a SFHA and flood insurance is available, Part 339 requirements apply including the need to send the Notice to Borrower and obtain flood insurance.

As noted in the Q&A's, you may still require the purchase of flood insurance at the time the loan is made. This is the most typical scenario that we see. However, the Q&A's do allow for you to not require insurance until the foundation slab is poured or elevation certificate is issued (doesn't have to be both) provided you have adequate internal controls to ensure that the borrower obtains the insurance when required.

This means that coverage is required even if the structure is not yet walled and roofed; generally, any initial work on a site beyond excavation (i.e. pouring of a slab or footing). Please refer to Q&A's 21 and 22, which discuss these alternative timing options for insuring construction loans. I will refer again back to the importance of the CMS surrounding Flood. The bank must have adequate procedures in place at origination to ensure that the borrower obtains flood insurance no later than when the foundation slab has been poured or an elevation certificate has been issued.

Now, let's move along to our final two topics beginning on slide # 16 please.

We will briefly discuss Flood Civil Money Penalties. When an examination results in certain Flood violations we are required to consider CMPs if a pattern or practice of these violations exist. In making this determination we review many factors including the bank's historical compliance, the apparent strengths and weaknesses of the CMS as it relates to Flood, whether or not the violations are willful and why the violations have occurred. Just like we do with all other regulatory violations we try to determine the root cause.

Please refer to Q&A # 81where the violations that can result in mandatory CMPs are referenced and Q&A # 82 where there is a discussion of pattern or practice. If a pattern or practice is detected you are required to conduct a four-year look back of all impacted loans, including closed (paid-off) loans. To be clear, the four-year look pack period is four years from the date of the current examination back and includes all loans made, extended, increased, or renewed during the previous four years, unless flood insurance CMPs were imposed at the prior examination.

In light of the number of modifications (restructuring of loans to avoid default), I want to highlight when Part 339 is applicable. Of course, we have the typical "tripwires" or triggers of the Flood requirements, which are when you make, increase, renew or extend a loan. In general, the regulations requirements are triggered when there is an increase in the loan amount or a term extension. Please refer to Q&A # 5.

Also, some banks have asked about coverage for detached garages and the guidance is that, in general, a separate flood insurance policy is not required since it's usually covered as an extension of the dwelling policy.

Lastly, before we move along to our question and answer session, I will briefly touch upon the Biggert-Waters Reform Act – slide # 17. This Act was signed into law via the Moving Ahead for Progress in the 21st Century Act by the President on July 6, 2012, and it extends the NFIP a full five years, until September 30, 2017.

There are several changes included, but a few highlights include increases in CMP amounts up from a maximum of $385 per violation to a maximum of up to $2,000 per violation. Keep in mind that this dollar amount is per violation and not per loan. One loan can have multiple violations. There are 5 sections of Part 339 in which we are required to cite CMPs if a pattern or practice is identified. One loan could potentially result in CMPs of over $10,000. Also, another change regarding CMP amounts is the elimination of the annual statutory cap of $135,000 in CMP assessments. Other changes with the Biggert-Waters Reform Act include new force-placed insurance termination rules, phased out subsidies on properties with repetitive losses, establishing escrows for flood insurance premiums with certain exceptions for institutions less than $1 billion by July 6, 2014, and a new disclosure regarding availability of flood insurance.

Since an implementing regulation has not yet been written, you are not yet subject to all of the acts provisions. However, the FDIC will be issuing a Financial Institution Letter (FIL) related to the Act and any actions required to be taken at your institution.