IBC

International Bancshares
Corporation

December 22, 2014

Via email Rulemaking Portal: www.regulations.gov

Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Re: *Loans in Areas Having Special Flood Hazards; Proposed Rule;* FRB: Docket No. R-1498/RIN 7100 AE-22 (Regulation H, 12 C.F.R. Part 208); FDIC RIN 3064-AE03 (12 C.F.R. Parts 339)

Gentlemen:

The following comments are submitted on behalf of International Bancshares Corporation ("IBC"), a multi-bank financial holding company headquartered in Laredo, Texas. IBC holds four state nonmember banks serving Texas and Oklahoma. With over $12 billion in total consolidated assets, IBC is the largest Hispanic-owned financial holding company in the continental United States. IBC is a publicly-traded holding company. We appreciate the opportunity to comment on this proposal.

Overview.

The Federal Deposit Insurance Corporation ("FDIC"), the Board of Governors of the Federal Reserve System ("Federal Reserve"), and the other federal financial institution regulatory agencies (cumulatively, the "Agencies"), are jointly proposing to revise their respective regulations governing loans in areas with special flood hazards. More specifically, the Homeowner Flood Insurance Affordability Act of 2014 ("HFIAA") enacted several modifications to the flood insurance laws and, accordingly, the Agencies are now proposing the following amendments: 1) adding an exemption to the general mandatory flood insurance requirement for non-residential structures on a property but detached from the primary residence; 2) requiring lending institutions to escrow premiums and fees for flood insurance for certain secured residential loans made, increased, extended, or renewed on or after January 1, 2016; 3) implementing a small lender escrow exception and providing transition rules for institutions no longer qualifying for the exception; and 4) implementing other exceptions from escrow requirements as well as new and revised sample notice forms and clauses.

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<u>Comments</u>:

1. HFIAA § 13 – detached property not used as a "residence."

a. "Residence."

The Agencies' proposed amendments to the applicable rules exempt from the mandatory flood insurance purchase requirement "[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." This phrase is ambiguous a number of levels and should be revised for just the reasons stated in the Notice.

The notice of proposed rulemaking properly notes that there may be ambiguity as to when a detached structure serves as a residence as well as ambiguity as uses that change during the life of a loan. A garage apartment unoccupied at the time a regulated institution makes a mortgage loan provides the paradigmatic example of the ambiguities in HFIAA § 13 and the Agencies' proposed implementing rules. A guest cottage or house is another, and a detached structure that is unfinished at the time a regulated institution makes a mortgage loan but later becomes an apartment or residence is a third.

Other federal statutes do not define "residential property" or "residence." See, e.g., RESPA, 12 U.S.C. § 2602(1)(A); TILA, 15 U.S.C. § 1602 (w)-(x); Protecting Tenants at Foreclosure Act, Pub. L. 111-22 §§ 701-704 ["PTFA"]. Each leaves "residence" or "residential property" undefined and instead looks to functions or events as triggers for regulation. For example, PTFA applies regardless of where the tenant lives; lease of a garage apartment falls within the statutory purview. We suggest a similar approach to definition of detached property here.

The fundamental reason for requiring flood insurance on property secured by loans from regulated institutions is collateral protection. The notice of proposed rulemaking recognizes this when it states that lenders "as a matter of safety and soundness . . . may nevertheless require flood insurance on these detached structures." IBC urges the Agencies to clarify when the "not used as a residence" standard should be applied or that the definition be modified to some other terms that takes in more helpfully structures such as the vacant garage apartment.

b. "Detached."

The term "detached" as used in the proposed rule also contains latent ambiguity. In many areas of the country, a garage can be adjacent to the main home and reachable by a covered roofed walkway or breezeway. Is such a structure "detached" for purposes of the regulation? We believe that "detached" should be defined, once again bearing in mind that the purpose of NFIP and the implementing regulations is collateral protection. Defining "detached" as "standing alone; not joined by any structural connection to any structure as to which flood insurance is required" would be a possibility. Once again, providing a bright line test of this kind will make loan underwriting and examinations easier.

2. Escrow requirements.

The escrow requirements discussed in the Agencies' notice includes various carve-outs, which are discussed separately below.

Implicit in the Agencies' proposal is an unanswered question: once enacted, are escrow requirements and exceptions compliance/CAMELS issues? To the extent that they are, the lack of bright line standards becomes objectionable for regulated institutions, as more particularly set forth below.

As a general matter, regulations implemented by CFPB for mortgage escrows, including but not limited to regulations under 12 CFR Part 1026,[1] create conflicting exemptions. Note 27 of the current rulemaking document discusses the interaction between CFPB escrow regulations and the current regulations, but leaves regulated institutions facing two differing sets of escrow rules.

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1 The CFPB rulemaking document promulgating the final rules for 12 CFR §1026.35 creates an exemption

from the escrow requirement for small creditors that operate predominately in rural or underserved areas. Specifically, to be eligible for the exemption, a creditor must: (1) make more than half of its first-lien mortgages in rural or underserved areas; (2) have an asset size less than $2 billion; (3) together with its affiliates, have originated 500 or fewer first-lien mortgages during the preceding calendar year; and (4) together with its affiliates, not escrow for any mortgage it or its affiliates currently services, except in limited instances. Under the rule, eligible creditors need not establish escrow accounts for mortgages intended at consummation to be held in portfolio, but must establish accounts at consummation for mortgages that are subject to a forward commitment to be purchased by an investor that does not itself qualify for the exemption.

a. Exemptions.

i. "Primarily for a business purpose."

Subsection 22.5(b)(ii) contains the language used in each of the proposed sections; it exempts from the escrow requirements those loans that are "an extension of credit primarily for business, commercial, or agricultural purposes."[2] The proposed rules do not define "primarily" or provide any criteria that can be used by a lender or servicer in determining whether a loan is for one of the exempted purposes. As an example, consider a loan on a parcel of land, some of which contains a principal residence and the rest of which is used for a family business or farm.[3] Another example is a residential home where one or more of the rooms are used for a home business. A loan secured by a residence that is used partly for vacation home but primarily for a rental property is considered a commercial loan under Regulation Z and is exempt.

How shall the lender or servicer determine what the primary use is? Collateral value? What evidence should the lender or servicer use – and more particularly, what evidence should the lender or servicer place in the loan file for later use during an examination – to make the determination?

The only guidance apparently available on this issue is in Questions 11 and 12 of the Interagency "Qs and As" relating to the distinction between residential buildings and non-residential buildings. The OCC Truth in Lending Handbook[4] demonstrates that the decision as to whether the extension of a particular loan is for consumer or business purposes, that in most cases lenders will simply require escrowing rather than subject themselves to post hoc criticism or even CMPs for having judged a loan's primary purpose incorrectly. At a minimum, the proposed rules should adopt, refer to or incorporate the official interpretations of this concept promulgated under Regulation Z.

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2 It appears that this language is intended to track Regulation Z, 12 CFR 226.3(a). However OCC's Truth in Lending Handbook at 8-9 makes clear that any decision as to whether credit is for business or consumer purposes is highly nuanced and case specific. (http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/truth-in-lending-handbook.pdf.)

3 It is worth noting that the parcel in this scenario likely will contain detached structures not used as residences that therefore may be exempt from flood insurance requirements even though they provide a substantial portion of the collateral value for the loan.

4 *See* note 3 and accompanying text, *supra*.

Additionally, the proposed rules do not specify whether the escrow exemption is applied once at the time the loan is initially made or whether the escrow decision must be revisited each time a MIRE event occurs. The proposed rules should clarify this omission.

ii. Junior loans/condominium loans.

These loans share a common factor: another source provides compliant flood insurance coverage. The problem with the escrow exemption where flood insurance comes from another source is the same as the existing exemption for certain junior loans (*see* Interagency Questions 36-37): the junior lienholder, condo lender or servicer likely will not have access to adequate proof that sufficient compliant flood insurance is in place on the property. (*See* Interagency Question 36, Example 2.) This discrepancy is like to hit servicers more directly because of the communications gaps that often develop over the life of a loan. The upshot is that this exemption provides little if any practical assistance. As long as the lenders described in this section remain independently responsible for ensuring full compliance with flood insurance requirements, this exemption potentially imposes a significant administrative burden and provides no real assistance in avoiding escrow or other flood insurance requirements.

iii. Home equity lines of credit.

This exemption apparently operates in a straightforward fashion and appears to track Interagency Question 35.

iv. Non-performing loans.

This exemption applies only to escrow of flood insurance premiums and not to the requirement that flood insurance be maintained on property that is encumbered by a non-performing loan. We understand that all of a lender's requirements with respect to maintaining flood insurance on a mortgaged property, including the force-place requirements in Interagency Questions 57-62 remain in effect. The proposed rule should so specify.

v. Other exemptions.

The exemption for loans of less than one year is sensible. Interagency Question 18 notes that loans whose original balance is less than $5,000 are exempt from flood insurance requirements. It would be appropriate to extend the one-year exemption to these loans.

vi. Small lender exemption.

The "small lender" exemption in the proposed rules applies only if three conditions are met: (1) the lender has less than $1 billion in total assets on December 31 of either of the two preceding calendar years; (2) the lender was not required by federal or state law to escrow taxes, insurance and fees for specified loans; *and* (3) the lender did not "have a policy of consistently and uniformly" requiring escrow. The proposed rules have a transition provision for lenders that exceed $1 billion in total assets, but no provision for lenders that decrease in size.[5] Additionally, because an institution must meet all three of the listed criteria to escape the mandatory escrow requirement, it is unclear how much realistic value the purported exemption has.

If it is the intent of this proposal to state that once an institution exceeds $1 billion in total assets it must escrow flood insurance premiums even if the institution later shrinks back in total asset size, the rule should make that clear. At the present time, institutions "on the cusp" of $1 billion in total assets are left to wonder from year to year whether the exemption will apply.

There currently is an ambiguity in the exemption with respect to whether the $1 billion total asset exemption applies per "institution" – i.e., per charter – or whether the assets of all "institutions" with common ownership – e.g., a common holding company – must be aggregated. The notice's language suggests that "institution" means the particular entity making the loan. This should be clarified.

Use of the phrase "have a policy of consistently and uniformly" injects a further element of ambiguity into application of the exemption. When does a policy become consistent and uniform? If an institution requires all mortgages of one particular class or type to have escrow accounts but does not require another to have escrow accounts, is that a consistent and uniform policy of requiring escrow? The apparent purpose of the criteria in this exemption is to help institutions lacking in the infrastructure to manage escrow from having to create that structure. If so, the motivation in the proposed rule is laudable, but the exemption would be better phrased in terms of some brighter line; for example, it would be easier for institutions to determine whether the exemption applies if there was a numerical cutoff of, hypothetically, less than 100 mortgages per year in addition to asset size. Such a bright line test is easier to administer than any test based on "consistently and uniformly" doing anything.

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5 This does not imply that an institution is failing. A small change in assets from year to year may be sufficient to move a lender into or out of exempt status.

The rule also should be clarified or supplemented to address situations where an exempt lender sells a loan to a lender outside of the exemption or vice versa. *See* Interagency Questions 44.

vii. Option to escrow.

There are several concerns with the option to escrow in subsection (d).

(1) ***Transfer of loans.*** Subsection (d) does not address situations where a loan originated by an exempt lender is transferred to a regulated lender or vice versa.

(2) ***Necessity.*** For many lenders, the mandatory nature of this provision appears to impose significant administrative cost as there is no exception for loans where flood insurance already is escrowed. The Agencies should create an exception for residential loans outside the exemptions in sections (a)(2) and (c) where flood insurance already is escrowed.[6]

(3) ***Cost allocation.*** The costs associated with the creation and management of this escrow must be allocated. It does not seem likely that borrowers will be willing to pay such costs and the arbitrary imposition of such costs on lenders is inappropriate.

(4) ***Notice and timing.*** Because the notice and timing of escrow will depend upon execution of new or amended contract documents, the notice provided for in the proposed rulemaking document is insufficient. Taking funds from a borrower is not, as a matter of fundamental contract law, simply something that is done "as soon as possible." This provision should be reevaluated in light of applicable legal requirements.

3. Other Issues.

Another issue left unclear by the current notice relates to condominium valuation. The current guidance suggests that the total condo value, divided by the number of units, must be used to determine the amount of flood insurance required for each individual unit. Because many, if not most, condo projects have a wide variety of unit sizes, using the suggested method results in overvaluing the smaller units and thus, creating a flood insurance requirement which is higher than the value of the unit. The suggested method also undervalues larger units.

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6 The section relating to the "option" states that it does not apply if subsection (a)(2) or (c) applies. Section (c) is the small lender exception, which does not apply to loans from lenders outside the exemption. Section (a)(2) applies only to specific enumerated classes of loans.

The "Catch 22" for smaller units is that flood insurance will not pay more than the replacement cost and a reputable agent will not write excess coverage. Therefore, the only way lenders can comply with the required flood insurance amount is to find an agent willing to over-insure the property, knowing that the over insured amount will never be paid on a loss.

4. Conclusion.

Unfortunately, the current Notice appears to carry over many of the defects contained in the October 2013 Notice, without considering the interplay between the Agencies' proposals and other applicable state and federal laws and regulations. We respectfully request that the notice be withdrawn or reconsidered in conjunction after adequate consultation with the regulated community.

Thank you for your consideration.

Respectfully,

Dennis E. Nixon
President