

# The Banking Law Journal

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Editorial Office  
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# New Private Flood Insurance Guidance on Horizon for Banks

*Michael J. Heller\**

*In this article, the author discusses new guidance about private flood insurance proposed by federal bank regulators intended to help lenders comply with the regulators' joint rule implementing the private flood insurance provisions of the Biggert-Waters Flood Insurance Reform Act of 2012.*

In February 2019, the Office of the Comptroller of the Currency (“OCC”), the Board of Governors of the Federal Reserve System (“Board”), the Federal Deposit Insurance Corporation (“FDIC”), the Farm Credit Administration (“FCA”), and the National Credit Union Administration (“NCUA” and, together with the OCC, Board, FDIC, and FCA, the “Agencies”), finalized a rule implementing the private flood insurance-related provisions of the Biggert-Waters Flood Insurance Reform Act of 2012 (“Biggert-Waters Act”).<sup>1</sup> The Agencies subsequently committed to issuing questions and answers relating to their private flood insurance rule. Now, the Agencies have drafted 24 private flood insurance questions and answers that, when finalized, will be broadly applicable to supervised lenders and servicers.<sup>2</sup>

## BACKGROUND

The National Flood Insurance Act of 1968 created the National Flood Insurance Program (“NFIP”) administered by the Federal Emergency Management Agency. The NFIP was expanded by the Flood Disaster Protection Act of 1973, which made the purchase of flood insurance mandatory in connection with loans made by federally-regulated lending institutions for loans secured by improved real estate or mobile homes located in a special flood hazard area (“SFHA”).

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\* Michael J. Heller, a member of the Banking, Corporate, and Real Estate Practice Groups at Rivkin Radler LLP and a member of the Board of Editors of *The Banking Law Journal*, works extensively with bank clients on complex commercial loans, including Industrial Development Agency and Small Business Administration matters, and with private clients in real estate development and corporate transactions. He may be reached at michael.heller@rivkin.com.

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

<sup>2</sup> See <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20210311a1.pdf>.

The National Flood Insurance Reform Act of 1994<sup>3</sup> revised federal flood insurance statutes and required the Agencies to revise their flood insurance regulations; a joint final rule followed in the summer of 1996.

In February 2019, the Agencies finalized a rule implementing the private flood insurance-related provisions of the Biggert-Waters Act, requiring lenders to accept “private flood insurance.” To assist lenders in evaluating whether a flood insurance policy meets the definition of “private flood insurance,” the rule includes a compliance aid provision pursuant to which a lender may conclude that a policy meets the definition of private flood insurance, without further review, if the policy, or an endorsement to the policy, contains the compliance aid clause set forth in the rule. Moreover, the rule permits a lender, at its discretion, to accept a flood insurance policy issued by a private insurer, even if the policy does not meet the statutory and regulatory definition of “private flood insurance,” provided the policy meets certain requirements in the rule (“discretionary acceptance”). A lender also is permitted, at its discretion, to accept certain mutual aid plans that meet the conditions stated in the rule.

Now, the Agencies have drafted 24 private flood insurance questions and answers (“Q&As”) to be broadly applicable to supervised lenders and servicers.

## OVERVIEW

The proposed questions and answers fall into three sections:

- Private flood insurance: Mandatory acceptance;
- Private flood insurance: Discretionary acceptance; and
- Privacy flood insurance: General compliance.

## PRIVATE FLOOD INSURANCE—MANDATORY ACCEPTANCE

The Agencies propose nine new Q&As to address issues regarding the mandatory acceptance and the application of the compliance aid clause with respect to the private flood insurance provision of each Agencies’ current rule (the “Regulation”).<sup>4</sup> The new proposed Q&As are designated as Mandatory 1–9.

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<sup>3</sup> The National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973, as revised by the National Flood Insurance Reform Act of 1994, the Biggert-Waters Act, and the Homeowner Flood Insurance Affordability Act, codified at 42 U.S.C. 4001 *et seq.*, are referred to in this article as the “Act.”

<sup>4</sup> The Agencies’ rules are codified at 12 CFR part 22 (OCC), 12 CFR part 208 (Board), 12 CFR part 339 (FDIC), 12 CFR part 614 (FCA), and 12 CFR part 760 (NCUA).

Proposed new Q&A Mandatory 1 addresses whether a lender may decide to only accept private flood insurance policies under the mandatory acceptance provision of the Regulation. The proposed answer confirms that a lender may decide to only accept flood insurance policies issued by a private insurer that the lender is required to accept because the policies meet the definition of “private flood insurance” under the Regulation. The proposed answer also clarifies that a lender is not required to accept flood insurance policies that only meet the criteria set forth in the discretionary acceptance or the mutual aid provisions in the Regulation.

Proposed new Q&A Mandatory 2 addresses when a lender must review a flood policy issued by a private flood insurer to make sure the policy meets the mandatory acceptance criteria, other than at loan origination. The proposed response explains that, other than at origination, a lender must review a flood insurance policy issued by a private insurer when the policy is up for renewal, or any time the borrower presents the lender with any new flood insurance policy issued by a private insurer. The proposed response indicates that a lender must review the policy in these instances in addition to when a triggering event occurs (making, increasing, extending, or renewing a loan).

During this review, a lender may determine that the policy meets the mandatory acceptance criteria without further review if the policy or an endorsement to the policy includes the compliance aid clause. However, if the policy does not meet the mandatory acceptance criteria, the lender still may accept it if it meets the discretionary acceptance criteria or, if applicable, the mutual aid plan criteria. The proposed answer explains that if the policy does not meet any such criteria, the lender must notify the borrower in accordance with the force placement provisions of the Regulation. If the borrower does not purchase flood insurance that complies with the Regulation, the lender must purchase insurance on the borrower’s behalf. In addition, the proposed answer provides that a lender may rely on a previous review of a flood insurance policy under the discretionary acceptance provision, provided there are no changes to the terms of the policy.

Proposed new Q&A Mandatory 3 addresses whether the private flood insurance requirements under the Regulation require a lender to change its policy of not originating a mortgage in non-participating communities or coastal barrier regions where the NFIP is not available. The proposed answer explains that the Regulation does not require a lender to originate a loan that does not meet the lender’s underwriting criteria. The proposed answer notes that the flood insurance purchase requirement only applies to loans secured by structures located or to be located in an SFHA in which flood insurance is available under the Act. Because the flood insurance purchase requirement does



not apply within non-participating communities where NFIP insurance is not available under the Act, the proposed answer states that the lender does not need to change its policy of not originating mortgages in areas where NFIP insurance is unavailable solely because of the private flood insurance requirements under the Regulation.

Proposed new Q&A Mandatory 4 addresses whether the compliance aid clause could act as a conformity clause that would make a private policy conform to the definition of private flood insurance under the Regulation. The proposed answer provides that the compliance aid clause is not intended to act as a conformity clause but rather to facilitate the ability of lenders and consumers to recognize policies that meet the definition of “private flood insurance” and to promote the consistent acceptance of policies that meet this definition.

Proposed new Q&A Mandatory 5 provides that a lender is not required to accept a flood insurance policy issued by a private insurer solely because the policy contains the compliance aid clause if the lender chooses to conduct its own review and determines the flood insurance policy actually does not meet the mandatory acceptance requirements. The proposed answer also notes that if a flood insurance policy issued by a private insurer does not include the compliance aid clause, the lender still must review the policy to determine if it meets the requirements for private flood insurance as set forth in the Regulation before the lender may choose to reject the policy.

Proposed new Q&A Mandatory 6 discusses whether a lender is required to conduct an additional review of a flood insurance policy under the mandatory acceptance provision if the policy includes the compliance aid clause. The proposed answer states that under the mandatory acceptance provision of the Regulation, if a policy or an endorsement to the policy contains the compliance aid clause, a lender is not required to conduct any further review of the policy to determine that the policy meets the definition of “private flood insurance.” The proposed answer also provides that the language of the compliance aid clause must be stated as set forth in the Regulation for the lender to rely on its protections.

Proposed new Q&A Mandatory 7 describes additional reviews a lender must conduct when a flood insurance policy issued by a private insurer includes the compliance aid clause. Specifically, the lender also must ensure that the coverage is at least equal to the lesser of the outstanding principal balance of the designated loan or the maximum limit of coverage available for the particular type of property under the Act, and also should ensure that other key aspects of the policy are accurate, such as the borrower’s name and property address.

Proposed new Q&A Mandatory 8 addresses whether a lender may use the criteria under the discretionary acceptance provision to decide whether to accept a policy that does not contain the compliance aid clause without first reviewing the policy to determine if it meets the mandatory acceptance provision. The proposed answer clarifies that a lender may first review the policy to determine whether it meets the criteria under the discretionary acceptance provision. However, if the policy is not accepted under the discretionary acceptance provision, the lender would still need to determine whether it must accept the policy under the mandatory acceptance criteria. The proposed answer reminds lenders to document that a policy provides sufficient protection of the loan if the lender accepts the policy under the discretionary acceptance provision of the Regulation.

Lastly, proposed new Q&A Mandatory 9 notes that if the compliance aid clause is included on the declarations page, a lender may accept the policy without further review to determine whether the policy meets the definition of private flood insurance. However, a lender also must ensure compliance with the mandatory purchase requirement.

#### **PRIVATE FLOOD INSURANCE—DISCRETIONARY ACCEPTANCE**

The Agencies propose to add four new Q&As regarding the discretionary acceptance provision of the Regulation. These new Q&As are designated as Discretionary 1–4.

Proposed new Q&A Discretionary 1 addresses whether lenders are required to accept flood insurance policies that meet the discretionary acceptance criteria. The proposed answer notes that the discretionary acceptance criteria in the Regulation set forth the minimum acceptable criteria that a flood insurance policy must have for the lender to accept the policy under the discretionary acceptance provision. The proposed answer clarifies that it is at the lender's discretion to accept a policy that meets the discretionary acceptance criteria so long as the policy does not meet the mandatory acceptance criteria.

Proposed new Q&A Discretionary 2 addresses the requirements for documentation to demonstrate that a policy provides sufficient protection of a loan when a lender accepts that policy under the discretionary acceptance criteria. The proposed answer explains that the Regulation requires the lender to document its conclusion in writing that the policy provides sufficient protection of the loan, consistent with safety and soundness principles. Furthermore, the proposed answer notes that although the Regulation does not require any specific documentation to demonstrate that the policy provides sufficient protection of the loan, lenders may include any information that reasonably supports the lender's conclusion following review of the policy.

Proposed new Q&A Discretionary 3 addresses how a lender may evaluate concerns related to an insurer's solvency, strength, and ability to pay claims to determine whether an insurance policy provides sufficient protection of a loan, consistent with general safety and soundness principles. The proposed answer provides that a lender may evaluate an insurer's solvency, strength, and ability to satisfy claims by obtaining information from the state insurance regulator's office of the state in which the property securing the loan is located, among other options. The proposed answer further indicates that a lender may rely on the licensing or other processes used by the state insurance regulator for such an evaluation.

Proposed new Q&A Discretionary 4 addresses whether a lender is required to review a flood insurance policy upon renewal if that policy was issued by a private insurer and was originally accepted in accordance with the discretionary acceptance requirements. The proposed answer provides that if a lender had accepted a flood insurance policy issued by a private insurer in accordance with the discretionary acceptance requirements and the policy is renewed, the lender would be required to review the policy upon renewal to ensure that it continues to meet the discretionary acceptance requirements. The proposed answer also states that a lender would need to document its conclusion regarding sufficiency of the protection of the loan in writing upon each renewal to indicate that the policy continues to provide sufficient protection of the loan.

### **PRIVATE FLOOD INSURANCE—GENERAL COMPLIANCE**

The Agencies propose to add 11 new Q&As on topics related to the private flood insurance provisions of the Regulation that are not covered in the first two sections. The new proposed Q&As are designated as Private Flood Compliance 1–11.

Proposed new Q&A Private Flood Compliance 1 addresses the maximum deductible that a flood insurance policy issued by a private insurer can have for properties located in an SFHA. Under the proposed answer, the analysis depends on whether the lender is accepting the flood insurance policy under the mandatory acceptance provision or the discretionary acceptance provision.

Specifically, for a private flood insurance policy that the lender is accepting under the mandatory acceptance provision, the proposed answer states that the policy must contain a deductible that is “at least as broad as” the maximum deductible in the Standard Flood Insurance Policy (“SFIP”) under the NFIP, which means that the deductible is no higher than the specified maximum under an SFIP for any total coverage amount up to the maximum available under the NFIP at the time the policy is provided to the lender. The proposed

answer provides that a policy with a coverage amount exceeding that available under the NFIP may have a deductible exceeding the specific maximum deductible under an SFIP.

The proposed answer also advises that for safety and soundness purposes, the lender should consider whether the deductible is reasonable based on the borrower's financial condition. The proposed answer also sets forth examples to aid in compliance.

Proposed Q&A Private Flood Compliance 1 also provides guidance for accepting flood insurance policies issued by private insurers under the discretionary acceptance provision. It notes that among the factors a lender could consider in determining whether a policy provides sufficient protection of a loan is whether the policy's deductible is reasonable based on the borrower's financial condition. Therefore, unlike the limitation on deductibles for policies accepted under the mandatory acceptance provision for any total coverage amount up to the maximum available under the NFIP, the proposed answer provides that a lender can accept a flood insurance policy issued by a private insurer under the discretionary acceptance provision with a deductible higher than that for an SFIP for a similar type of property, provided the lender has determined the policy provides sufficient protection of the loan, consistent with general safety and soundness principles.

Proposed Q&A Private Flood Compliance 1 also includes a reminder that a lender may not allow the borrower to use a deductible amount equal to the insurable value of the property to avoid the mandatory purchase requirement for flood insurance. This principle applies whether the lender is evaluating the policy under the mandatory acceptance provision or the discretionary acceptance provision.

Proposed new Q&A Private Flood Compliance 2 clarifies that a lender may require that the deductible of any flood insurance policy issued by a private insurer be lower than the maximum deductible for an NFIP policy under both the mandatory acceptance provision and the discretionary acceptance provision.

Proposed new Q&A Private Flood Compliance 3 provides guidance regarding whether a lender may charge fees to the borrower for the lender's use of a third party to review flood insurance policies. The proposed answer provides that the Act and the Regulation do not prohibit lenders from charging fees to borrowers for contracting with a third party to review flood insurance policies.

Proposed new Q&A Private Flood Compliance 4 addresses the lender's responsibility to ensure a flood insurance policy issued by a private insurer meets the requirements of the Regulation if the policy is not available prior to loan closing. The proposed answer provides that the Act and Regulation do not

specify the acceptable types of documentation for a lender to rely on when reviewing a flood insurance policy issued by a private insurer. The proposed answer also advises that lenders should determine whether they have sufficient evidence to show the policy meets the requirements under the Regulation and that if the lender does not have enough information to determine if the policy meets the private flood insurance requirements under the Regulation, then the lender should timely request additional information as necessary to complete its review. The proposed answer also suggests some optional steps that a lender could take to mitigate against closing delays.

Proposed new Q&A Private Flood Compliance 5 notes that whether a declarations page provides sufficient information for a lender to determine whether the policy complies with the Regulation depends on the information contained in the declarations page. Under the proposed answer, if the declarations page provides sufficient information for the lender to determine whether the policy meets the mandatory acceptance provision or the discretionary acceptance provision of the Regulation or if the declarations page contains the compliance aid clause, then the lender may rely on the declarations page. However, if the declarations page does not provide sufficient information for the lender to determine whether the policy satisfies the mandatory acceptance or the discretionary acceptance provision of the Regulation, the proposed answer suggests that the lender should request additional information about the policy to aid its determination.

Proposed new Q&A Private Flood Compliance 6 provides that a lender may accept multiple-peril policies that cover the hazard of flood under the private flood insurance provisions of the Regulation, provided they meet the requirements of the Regulation.

Proposed new Q&A Private Flood Compliance 7 addresses the question of how the private flood insurance requirements of the Regulation work in conjunction with requirements of secondary market investors, such as the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”). The proposed answer first reminds lenders that they must comply with the federal flood insurance requirements. The proposed answer then notes that secondary market investor requirements are separate from the requirements of the Regulation. Therefore, if a lender plans to sell loans to such an investor, the proposed answer advises that a lender should carefully review the investor’s requirements and direct questions regarding these requirements to the appropriate entities.

Proposed new Q&A Private Flood Compliance 8 provides guidance to servicers for loans covered by flood insurance mandated by the Act. Specifically, the proposed answer provides that for loans serviced on behalf of lenders

supervised by the Agencies, the servicer must comply with the Regulation in determining whether a flood insurance policy issued by a private insurer must be accepted under the mandatory acceptance provision or may be accepted under the discretionary acceptance or mutual aid provisions.

However, for loans serviced on behalf of other entities not supervised by the Agencies, the proposed answer states that the servicer should comply with the terms of its contract with such an entity. The proposed answer suggests that when servicing loans on behalf of Fannie Mae or Freddie Mac, where there are insurer rating requirements specified within those entities' servicing guidance or other relevant authorities that are not included in the Regulation, the servicer should adhere to those servicing requirements.

Three proposed Q&As provides guidance regarding optional methods lenders can use to address questions on whether an insurer is licensed, admitted, or otherwise approved to do business in a particular state, which is one of the factors lenders must evaluate under both the mandatory acceptance and discretionary acceptance provisions.

Proposed new Q&A Private Flood Compliance 9 explains how a lender could determine whether an insurer is licensed, admitted, or otherwise approved in a particular state, or whether a surplus lines or nonadmitted alien insurer is permitted to issue an insurance policy in a particular state. The proposed answer suggests that a lender may review the website of the state insurance regulator where the collateral property is located to determine whether a particular insurer is licensed, admitted, or otherwise permitted to issue insurance in a particular state. The proposed answer also advises that a lender could contact the state insurance regulator directly. Further, the proposed answer notes that the information with respect to surplus lines insurer eligibility may be available in the Consumer Insurance Search ("CIS") tool available on the National Association of Insurance Commissioners ("NAIC") website. The proposed answer states that lenders also may consult commercial service providers regarding the eligibility of surplus lines insurers in particular states as long as the lenders have a reasonable basis to believe that these service providers have reliable information. With regard to nonadmitted alien insurers in particular, the proposed answer suggests that lenders could review the NAIC's Quarterly Listing of Alien Insurers.

Proposed new Q&A Private Flood Compliance 10 addresses whether lenders may accept policies issued by private insurers that are surplus lines insurers for noncommercial residential properties. The proposed answer explains that if the surplus lines insurer is eligible or not disapproved to place insurance in the state or jurisdiction in which the property to be insured is located, lenders may accept policies issued by surplus lines insurers as coverage for noncommercial

(i.e., residential) properties. In addition, the proposed answer confirms that policies issued by surplus lines insurers for noncommercial properties are covered in the definition of “private flood insurance” and in the discretionary acceptance provision. The proposed answer also notes that within the discretionary acceptance provision, noncommercial residential policies issued by surplus lines carriers are covered as policies that are issued by private insurance companies that are “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.

The proposed answer also notes that even if the surplus lines insurer is not considered to be engaged in the business of insurance under applicable state law, the surplus lines insurer nevertheless would meet the criteria only for purposes of this provision of the Regulation if the insurer is eligible or not disapproved to place insurance in the state or jurisdiction in which a property to be insured is located.

Proposed new Q&A Private Flood Compliance 11 addresses whether a lender may accept a private flood insurance policy that includes a compliance aid clause, but also includes a disclaimer that the “insurer is not licensed” in the state or jurisdiction in which the property is located. The proposed answer explains that there are circumstances under which lenders may accept a policy issued by an insurer that is not licensed in the state or jurisdiction in which the property is located. For example, a lender would be able to accept a policy issued by a surplus lines insurer recognized or not disapproved by the relevant state insurance regulator as protection for loan collateral that is a nonresidential commercial property. The proposed answer also provides that a lender may accept a policy issued by a surplus lines insurer as protection for loan collateral that includes residential property as a policy issued by an insurance company that is “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.”

## CONCLUSION

As should be clear from this discussion, the proposed Q&As contain a great deal of important information regarding private flood insurance. Banks certainly will benefit by the guidance to be provided in the Q&As when they are finalized. Toward that end, mortgage lending teams and those who ensure compliance should make certain that they are familiar with the proposed Q&As before their effective date.

Importantly, as of this writing, there has not been much if any news out of Washington about the proposed Q&As although the period for providing

comments to the Agencies has closed. Accordingly, it will be important to keep an eye on the Q&As as they are finalized and to closely review any changes from the Agencies' proposal to determine their effect on bank mortgage lending practices.