Why and How To Reduce Your Flood Risks

By Melissa Klimkiewicz and Brandy A. Hood

We get it: The simple mention of climate change invokes a visceral reaction from believers and skeptics alike. Rest assured; we are not trying to achieve consensus regarding the planet's future through this article.

We do, however, want lenders and servicers to take a fresh look at some uncontroversial facts to ensure they are approaching their flood risks with eyes wide open:

- Flooding is currently the most common and expensive U.S. natural disaster[i]
- Companies that violate the Flood Disaster Protection Act, which generally requires mortgaged properties in certain areas to have flood insurance, face greater potential liability than ever before[ii]

Why Read This?

- *Violating the Flood Disaster Protection Act, which generally requires mortgaged properties in certain areas to have flood insurance, can lead to significant regulatory and litigation risk*
- *Uninsured and underinsured flood losses increase loan defaults and diminish collateral values, which may result in unanticipated losses*

Floods increase defaults and decrease collateral value. A recent study of December 2017 mortgage data found that nearly 143,000 loans were 90 days or more delinquent because of hurricanes Harvey and Irma — about 20 percent of all severely delinquent loans nationwide.[iii]

IS MY COMPANY COMPLYING WITH ALL APPLICABLE LEGAL REQUIREMENTS?

Financial institutions are legally required to comply with myriad requirements related to flood insurance, including:

- The purchase of mandatory flood insurance under the FDPA
- Lender-placed insurance (LPI) requirements under the Real Estate Settlement Procedures Act
- Flood insurance requirements of the Federal Housing Administration, U.S. Department of Veterans Affairs, U.S. Department of Agriculture, Fannie Mae, Freddie Mac, private investors, or state-specific programs

Who Should Read This?

Companies that originate, service, invest in, or hold residential or commercial mortgage loans

[i] Fed. Emergency Mgmt. Agency, The National Flood Insurance Program: I Don't Have Flood Insurance—Why Do I Need It? (Sept. 15, 2017), https://www.fema.gov/national-flood-insurance-program.
[ii] *See* National Flood Insurance Act of 1968 and Flood Disaster Protection Act of 1973, 42 U.S.C. § 4012a(f).
[iii] Black Knight, Black Knight's First Look at December 2017 Mortgage Data (Jan. 23, 2018), http://www.bkfs.com/CorporateInformation/NewsRoom/Pages/20180123.aspx.

Applicability of these requirements varies. For example, the FDPA applies only to federally-regulated financial institutions and requires flood insurance only on loans secured by buildings located in special flood hazard areas (SFHAs) in communities that participate in the National Flood Insurance Program.[iv] The FDPA applies regardless of the purpose of the loan or the use of the property. In contrast, RESPA's LPI requirements apply generally to servicers, but only if they obtain LPI not required by the FDPA on properties secured by closed-end residential mortgage loans.[v]

Flooding is currently the most common and expensive natural disaster in the United States.

The first step for companies in addressing these requirements is to determine which program requirements apply, and then ensure that they have addressed them appropriately. This may involve:

- Cataloging all applicable legal requirements
- Implementing policies, procedures, and job aids to ensure compliance
- Tracking updates to the law, regulatory expectations, and industry best practices
- Monitoring and testing compliance (e.g., conducting periodic loan-file reviews)
- Ensuring proper reporting of violations, as well as prompt and effective corrective action
- Providing ongoing training to employees and agents
- Implementing sufficient vendor-management controls

This can be a surprisingly complex undertaking. The FDPA is highly technical and it is not uncommon for examiners to interpret the requirements differently. Further, a single financial institution adopting varying compliance approaches across departments can invite regulatory scrutiny. In fact, FDPA violations are a common basis for civil money penalties. Therefore, many financial institutions opt to centralize their flood insurance compliance function.

Failure to comply with relevant requirements may result in examination findings, costly look-backs, enforcement actions, and civil money penalties for "pattern or practice" violations, which are larger than they were in the past. Historically, some in the industry regarded civil money penalties under the FDPA as insignificant, but that changed in 2012 when the per-violation penalty increased to $2,000 and the annual cap was removed.[vi] Several banks have subsequently received six-figure penalties, and one bank recently received a $1.5 million penalty.

Noncompliance can also result in litigation and reputational risk. Recent cases involving allegations of excessive coverage requirements and LPI kickbacks have settled for millions of dollars. And, of course, there is significant exposure to actual flood losses if a financial institution fails to require legally mandated coverage and flooding occurs.

[iv] National Flood Insurance Act of 1968 and Flood Disaster Protection Act of 1973, 42 U.S.C. § 4012a(b)(1).
[v] Real Estate Settlement Procedures Act, 12 U.S.C. § 2605(1).
[vi] National Flood Insurance Act of 1968 and Flood Disaster Protection Act of 1973, 42 U.S.C. § 4012a(f)(5).

Given these considerations, companies may wish to review their policies, procedures, and practices to ensure accurate and full implementation of the various legal requirements.

DOES MY COMPANY'S PORTFOLIO INCLUDE CONCENTRATIONS OF RISK THAT SHOULD BE ADDRESSED?

Even if a financial institution correctly implements the "black letter" flood insurance requirements, it may still be exposed to significant risk. For example:

- The FDPA only requires flood insurance in SFHAs,[vii] but more than 20 percent of claims under the NFIP come from properties outside an SFHA,[viii] and one estimate found that more than 50 percent of Hurricane Harvey's flood damage occurred outside an SFHA[ix]
- NFIP caps coverage at $250,000 for most residential buildings and $500,000 for nonresidential buildings, and limits payouts to the "actual cash value" for many properties,[x] but the cost to rebuild properties or repay loans often significantly exceeds these caps
- Lenders may still be responsible for payments to securityholders on loans that are in default or forbearance,[xi] which can be a significant financial burden
- When mortgage insurance is available following foreclosure, uninsured flood damage may limit the value of the lender's mortgage insurance claim[xii]
- A property that does not flood can still be affected by flooding in the vicinity that impacts the borrower's ability to pay (e.g., if the borrower's income is affected) and the value of the property (e.g., if the flodding decreases the value of neighboring properties)

As a result, companies in the mortgage market may elect to identify and measure their concentrations of flood-related risk to ensure their exposure is acceptable. Risk assessments may include:

- Estimating the risk of flooding for properties located both inside and outside SFHAs using tools beyond the Federal Emergency Management Agency's flood maps, because FEMA's flood maps have been subject to criticism as outdated or inaccurate[xiii]
- Determining the extent to which the entity's interest in properties may be underinsured (e.g., because of NFIP coverage caps or the FHA's mortgage-insurance limitations)
- Assessing the potential impact of a community flooding on the entity's financial position (e.g., due to a high concentration of loans

[vii] National Flood Insurance Act of 1968 and Flood Disaster Protection Act of 1973, 42 U.S.C. § 4012a(b)(1). SFHAs are areas determined to have at least a one percent chance of flooding in any given year. *See* e.g., Loans in Areas Having Special Flood Hazards, 12 C.F.R. § 339.2.
[viii] Fed. Emergency Mgmt. Agency, *Answers to Questions About the NFIP*, FEMA F-084, p. 34 (Mar. 2011), https://www.fema.gov/media-library-data/20130726-1438-20490-1905/f084_atq_11aug11.pdf.
[ix] CoreLogic, MEDIA ADVISORY: CoreLogic Analysis Shows More Than 50 Percent of Properties in Houston at High and Moderate Risk of Flood Are Not in Designated Flood Zones (Aug. 28, 2017), https://www.businesswire.com/news/home/20170828005509/en/CoreLogic-Analysis-Shows-50-Percent-Properties-Houston.
[x] Fed. Emergency Mgmt. Agency, National Flood Insurance Program, Summary of Coverage, FEMA F-679 (Oct. 2012), https://www.fema.gov/media-library-data/20130726-1620-20490-9466/f_679_summaryofcoverage_11_2012.txt; Fed. Emergency Mgmt. Agency, National Flood Insurance Program, Summary of Coverage for Commercial Property, F-778 (Aug. 29, 2013), https://www.fema.gov/media-library-data/6a2ad0291e8d6a5452aa891a6c037039/fema_Summary_508C.pdf.
[xi] *See*, e.g., Government National Mortgage Association (i.e., Ginnie Mae) Mortgage-Backed Securities (MBS) Guide 5500.3, Rev. 1, Ch. 34 (Oct. 4, 2017), https://www.ginniemae.gov/issuers/program_guidelines/MBSGuideLib/Chapter_34.pdf.
[xii] *See,* e.g., Single Family Mortgage Insurance, 24 C.F.R. § 203.379(a); U.S. Department of Housing and Urban Development Handbook 4000.1 IV.A.2.a.ii(A).
[xiii] Michael Keller, *et al., Outdated and Unreliable: FEMA's Faulty Flood Maps Put Homeowners at Risk,* Bloomberg (Oct. 6, 2017), https://www.bloomberg.com/graphics/2017-fema-faulty-flood-maps/.

in the community or the need to pay security holders while loans are in forbearance or default)

Entities that discover they are subject to unacceptable flood risks can evaluate various options for reducing risks. These include enhancing communications with borrowers about their flood risks, requiring coverage in circumstances in which coverage is not legally required, adjusting underwriting or loan terms in higher-risk areas, divesting certain loans, and offering owners of at-risk properties loans to complete flood-mitigation activities.

If these policy changes are made, they must be carefully managed to avoid unintended consequences, which include fair lending or UDAAP risk, state-law limitations or prohibitions, or other legal risks.

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