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Revisiting 2015's New Flood Regulations, Part 2

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Revisiting 2015's New Flood Regulations Part 2

The second of a two-part analysis of the impact of the Final Flood Rule on lenders' and servicers' compliance with the mandatory purchase requirements

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ESCROW PROVISIONS

The Final Flood Rule also imposes new requirements related to the escrow of flood insurance premiums and fees. Previously, flood insurance premiums and fees were required to be escrowed if (1) any taxes, insurance premiums, fees, or other charges were required to be escrowed; and (2) the loan was secured by residential improved real estate or a mobile home and made, increased, extended, or renewed on or after October 1, 1996. However, Biggert-Waters and HFIAA directed the Agencies to (1) expand the mandatory escrow requirements to include most closed-end residential loans made, increased, extended, or renewed on or after January 1, 2016, even if no other charges are escrowed; and (2) require non-exempt lenders to provide borrowers with an option to escrow flood insurance premiums and fees for loans that are outstanding as of January 1, 2016, unless an exception applies. The Agencies also implemented notice requirements consistent with these provisions.

1. ESCROW REQUIREMENTS

Under the new escrow requirements, a lender must escrow all premiums and fees for flood insurance if all of the following conditions are satisfied:

- Flood insurance is required on the loan under the mandatory purchase requirements;
- The loan is made, increased, extended, or renewed on or after January 1, 2016. This does not include a situation where a flood map change reclassifies a property as being within an SFHA without the loan being made, increased, extended, or renewed;
- The loan is secured by residential improved real estate or a mobile home; and
- Neither the loan nor the lender qualifies for any of the exceptions discussed below.

If the escrow requirement applies, payments for flood insurance premiums and fees must be collected with

the same frequency as payments on the loan are made.

In addition, a lender must give borrowers the option to escrow flood insurance premiums and fees if all of the following conditions are satisfied:

- Flood insurance is required on the loan under the mandatory purchase requirements;
- The loan is outstanding as of January 1, 2016; and
- Neither the loan nor the lender qualifies for any of the exceptions discussed below.

If the option to escrow requirement applies, notice of the option must be given, as discussed below. However, the option to escrow notice does not need to be given if flood insurance premiums and fees already are being escrowed.

2. LOAN-RELATED EXCEPTIONS

The Final Flood Rule provides certain exceptions to the new mandatory and optional escrow requirements based on the type of loan as well as the type of lender. The following loans are exempt from the new escrow requirements:

- Loans that are in a subordinate position to a senior lien secured by the same property for which flood insurance is being provided;
- Loans secured by residential improved real estate or a mobile home that is part of a condominium, cooperative, or other project development, if it is covered by flood insurance that satisfies all of the following conditions:
 - o The insurance policy meets the mandatory purchase requirements;
 - o The policy is provided by the condominium association, cooperative, homeowners association, or other applicable group; and
 - o The premium is paid by the condominium association, cooperative, homeowners association, or other applicable group as a common expense.

If, however, the association or group's policy does not satisfy the mandatory purchase requirements, the borrower must obtain a supplemental policy for which premiums and fees must be es-

crowed, unless the small lender exception discussed below applies;

- Loans that are primarily for a business, commercial, or agricultural purpose;
- Home equity lines of credit;
- Nonperforming loans, which means loans that are 90 or more days past due. A loan continues to be "nonperforming" until it is either permanently modified or the entire amount past due—which includes principal, accrued interest, and penalty interest incurred as a result of past due status—is collected or otherwise discharged in full; and
- Loans with terms of 12 months or less. This includes a loan that is extended or renewed for 12 months or less.

Furthermore, the new escrow requirements do not apply to reverse mortgages because a borrower does not make any payments on a reverse mortgage, and lenders are only required to collect payments for flood insurance premiums and fees with the same frequency as payments on the loan are made.

It should be noted that the Final Flood Rule does not impose an ongoing duty to evaluate whether a loan-related exception continues to apply, but if a lender determines at any point during the life of the loan that an exception no longer applies, the lender must begin escrowing flood insurance premiums and fees as soon as reasonably practicable. For example, if a loan initially qualifies for the subordinate lien exemption but the lender receives notice that the senior lien has been paid off, the lender must begin escrowing flood insurance premiums and fees. Therefore, as a matter of practice with respect to a subordinate loan, lenders should ensure that the loan documents allow for the mandatory escrowing of premiums and fees in case the loan takes a first lien position and thus becomes subject to the new escrow requirements.

3. LENDER-RELATED EXCEPTIONS

The Final Flood Rule also provides a small lender exception to the new escrow requirements. Unless otherwise provided by state law, a lender is ▶

not required to escrow flood insurance premiums and fees if the lender:

- Has total assets of less than \$1 billion as of December 31 of either of the two prior calendar years. This is based on the assets of the lender itself, and not of any other institutions under common ownership;
- On or before July 6, 2012, was not required by federal or state law to escrow taxes, insurance, or other charges for the entire term of any loan secured by residential improved real estate or a mobile home; and
- On or before July 6, 2012, did not have a policy of uniformly and consistently requiring the escrow of taxes, insurance, or other charges for any loans secured by residential improved real estate or a mobile home. Here, as a practical matter, a lender should review its policy relating to all loans secured by residential improved real estate or a mobile home, regardless of whether the loan is for a consumer purpose.

As an example, a lender with assets of at least \$1 billion as of both December 31, 2014 and December 31, 2015 would not qualify for the small lender exception in 2016. By contrast, a lender with assets of less than \$1 billion as of either December 31, 2014 or December 31, 2015 would qualify for the exception in 2016, provided the other conditions for the exception are satisfied.

If a lender qualifies for the small lender exception but later loses its small lender status, it will be required to escrow flood insurance premiums and fees for any loans made, increased, extended, or renewed on or after July 1 of the succeeding calendar year after the status change. For example, if a lender qualifies for the exception in 2016 but then has assets of \$1 billion or more as of December 31, 2016 and December 31, 2017, the lender will be subject to the new escrow requirements for any loans that it makes, increases, extends, or renews on or after July 1, 2018.

Similarly, a lender that loses its small lender status can also regain the status and thereby be exempt, once again, from the new escrow requirements. However, as a practical matter, it may not

make sense for a lender to abandon an escrow program once the lender has invested resources to develop such a program, as this could confuse borrowers who have grown accustomed to escrowing flood insurance premiums and fees—especially if the lender may lose its small lender status again in the future.

4. NOTICE REQUIREMENTS

The Final Flood Rule also imposes new notice requirements in connection with the new escrow requirements.

a. Loans Made, Increased, Extended, or Renewed on or after January 1, 2016

For loans made, increased, extended, or renewed on or after January 1, 2016 that are secured by improved real property located in an SFHA, a lender must provide notice of the new mandatory escrow requirement with or in the Notice of Special Flood Hazards. Specifically, notice is required if either (1) the mandatory escrow requirement applies at the time the Notice of Special Flood Hazards is provided, or (2) the mandatory escrow requirement could apply at some point during the term of the loan (i.e., the loan currently qualifies for an exception from the mandatory escrow requirement but could lose the exception during the term of the loan).

The Final Flood Rule amended Appendix A to the mandatory purchase regulations—which provides a sample Notice of Special Flood Hazards—to add language that complies with this requirement and to make other revisions consistent with Biggert-Waters and HFIAA.

b. Loans Outstanding as of January 1, 2016

Lenders must provide a notice of the option to escrow for loans that are outstanding as of January 1, 2016 and that would have been subject to the mandatory escrow requirement if they were made, increased, extended, or renewed on or after that date. This notice must be provided by June 30, 2016.

The notice must be provided even if escrow has been waived or if the lender has previously offered the option to escrow. However, lenders will not need to provide the notice if the loan is increased,

extended, or renewed so that the mandatory escrow requirement is triggered before the notice is required to be sent.


Furthermore, if a lender that qualifies for the small lender exemption loses its small lender status, it must provide the notice by September 30 of the first calendar year of the status change.

The Final Flood Rule amended Appendix B to the mandatory purchase regulations to add a model clause meeting the option to escrow requirement.

WRAP-UP

While at first blush the new Final Flood Rule might seem difficult to navigate, recalling the following should help lenders stay the course:

- With respect to LPI:
 - A lender may charge a borrower for LPI beginning on the date on which the borrower's coverage lapsed or became insufficient;
 - A lender must cancel LPI and refund unearned premiums within 30 days of receipt of acceptable borrower-obtained flood insurance; and
 - A lender must accept as proof of borrower-purchased insurance a declarations page that includes certain specified information.
- Detached structures that meet certain criteria are now exempt from the mandatory purchase requirements.
- With respect to the escrow of flood insurance premiums and fees:
 - Escrow will be required for most closed-end residential loans made, increased, extended, or renewed on or after January 1, 2016, even if no other charges are escrowed;
 - Lenders must provide borrowers with the option to escrow for most closed-end residential loans that are outstanding as of January 1, 2016;
 - Lenders must also provide certain notices to borrowers consistent with the above requirements; and

- There are new loan- and lender-related exceptions to these escrow requirements. 

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