

FLOOD INSURANCE AUTHORITY LAPSE

December 20, 2002

TO: CHIEF EXECUTIVE OFFICER

SUBJECT: Lapse of FEMA Authority to Issue Flood Insurance Contracts

This letter provides guidance to assist state member banks in dealing with the period following January 1, 2003 during which the authority of the Federal Emergency Management Agency ("FEMA") to issue flood insurance contracts under the National Flood Insurance Program (the "NFIP") will lapse.

Background: The Flood Disaster Protection Act of 1973, as amended, prohibits lenders from making, increasing, extending, or renewing loans secured by improved real property or a mobile home located in a special flood hazard area where federal flood insurance is available unless the building or mobile home is covered by flood insurance. *See* 42 U.S.C. § 4012a. This requirement is generally satisfied with coverage obtained through the NFIP.

The 107th Congress adjourned at the end of November 2002 without extending the statutory authority in the National Flood Insurance Act of 1968 to issue flood insurance policies under the NFIP. As a result, the authority of FEMA to issue new flood insurance policies, issue increased coverage on existing policies, and issue renewal policies will expire on December 31, 2002.

Borrowers, therefore, will not be able to obtain NFIP insurance for loans secured by property located in a special flood hazard area ("SFHA") that close after December 31, 2002 (or renew or increase existing policies after December 31, 2002) until the NFIP is reauthorized, except under the circumstances described below.

FEMA has indicated that it expects the new Congress to reauthorize the NFIP shortly after it convenes on January 7, 2003, and that the reauthorization will likely be made retroactive to January 1, 2003.

Nevertheless, there are no guarantees that Congress will reauthorize the NFIP, or that reauthorization will be given retroactive effect. This letter contains informal guidance on issues that may arise during this period of lapsed authorization for lenders and borrowers concerning loans that are or will be secured by property located in a SFHA.

Summary: State member banks may continue to make loans subject to the flood provisions of Regulation H, 12 C.F.R. § 208.25, without flood insurance during the period the NFIP is not available. Such lending does not violate 12 C.F.R. § 208.25. However, these institutions must continue to make flood determinations, provide timely, complete, and accurate notices to borrowers, comply with other parts of the flood insurance regulations, and evaluate safety and soundness risks and prudently manage

those risks during the lapse period. Further, regulated institutions should have a system in place to ensure that policies are obtained as soon as available following reauthorization for properties that are subject to mandatory flood insurance coverage.

The following discussion provides guidance to assist state member banks (hereinafter, “lenders”) in dealing with the period during which the authority to issue flood insurance contracts under the NFIP has lapsed.

Discussion:

Ability to Make Loans Unaffected by Lack of Authority

- Does the lapse in FEMA flood insurance authority mean that loans secured by improved real property located in flood hazard areas may not be made by lenders once the FEMA authority expires at year end 2002?

No, it does not. Lenders are not precluded during the lapse in flood insurance authority from making loans due to a lack of NFIP flood insurance.

FEMA has taken the position in a letter to the federal financial institution regulatory agencies dated December 12, 2002 that during the lapse in FEMA flood insurance authority, flood insurance will not be available under the NFIP. A copy of the FEMA document is attached to this letter.¹ During such time that flood insurance is unavailable under the NFIP, a lender may legally make a loan to a borrower secured by improved real property in a flood hazard area without requiring the borrower to obtain flood insurance coverage.

This does not mean, however, that a lender is relieved of other obligations under federal flood insurance law nor does it mean that safety and soundness considerations can be disregarded. (Both of these matters are dealt with in more detail below.)

- How long will this situation last?

FEMA is actively working with Congress to provide flood insurance reauthorization retroactively to January 1, 2003. FEMA has submitted model legislation that would accomplish this. We do not know whether or how long it will take for Congress to act after it convenes in January; nor can we affirmatively state that any renewal will be made retroactive.

Retroactivity of Reauthorized Flood Insurance Policies

¹ The December 12, 2002 letter from FEMA contains a “Notice 3” regarding “New Business or Coverage Increase Endorsements” to be provided by NFIP servicing agents to flood insurance applicants. Previously, on November 25, 2002, FEMA issued Notices 1 and 2 regarding renewals which are available through FEMA <http://bsa.nfipstat.com/wyobull/w-02082.pdf>. In addition, FEMA has issued Frequently Asked Questions (FAQs) on the lapsed insurance authority, which is available through FEMA <http://www.fema.gov/nfip/custfaq.htm>

- Why does retroactivity matter?

If authorization is not retroactive, new or renewal policies cannot be obtained for the period when the program was not authorized, UNLESS they are obtained prior to January 1, 2003. Thus, if authorization is not provided retroactively, the earliest date that new policies or renewals after the lapse would be effective would be the date of reauthorization. In this situation, flood loss sustained would not be covered by the NFIP if the loss occurred in the period subsequent to the lapse and prior to the date of Congressional reauthorization.

If the authorization IS retroactive, according to FEMA, a flood insurance policy applied and paid for during the lapse period prior to reauthorization will be deemed effective as of the date of application and payment. In other words, retroactive application of FEMA flood insurance authority to cover the lapse period will provide coverage in the event of a flood between January 1 and the date of reauthorization for those borrowers who apply and pay for NFIP flood insurance during the lapse.

Premium Payments Received Prior to January 1, 2003

- What about flood insurance payment premiums that are received before the expiration of FEMA's flood insurance issuance authority?

FEMA has stated in its letter of December 12, 2002, that if a completed application (including payment) or a renewal payment is received by NFIP Servicing Agents ON OR BEFORE December 31, 2002, the covered property will be protected in the event of a flood after that date. FEMA further states that claims under existing policies and policies issued based on premiums received prior to the lapse will be processed without delay. Therefore, according to FEMA, a borrower who makes an application for flood insurance and pays the premium on or before December 31, 2002, will receive coverage even if the effective date of the policy is after January 1, 2003.

This also applies to borrowers that renew policies on or before December 31, 2002, that would otherwise expire during the lapse period. Accordingly, to the extent possible, lenders are urged to encourage borrowers to complete applications for NFIP insurance and pay premiums before December 31, 2002.

Duty of Lenders to Make Flood Hazard Determinations and Provide Notice to Consumers Unaffected

- Do I still have to make flood hazard determinations?

Yes, you must continue to make standard flood hazard determinations and you must also give borrowers the notice of special flood hazards and availability of Federal disaster relief, if applicable, as required by 12 C.F.R. § 208.25.

Flood Insurance Coverage During the Lapse

- What are my options regarding new loans that will be affected by this problem?

If you know that you will be making a covered loan that will close after December 31, 2002, you should encourage the borrower to complete the application and pay the premium before that time. If the borrower does so, and the NFIP Servicing Agent receives it on or before December 31, 2002, the policy can be effective after December 31, regardless of the NFIP reauthorization status.

The following describes options for you to consider to address this situation after December 31, 2002:

- FEMA has stated that you can have the borrower complete the application and pay the premium, which will be held for processing pending Congressional reauthorization by the insurance company (see attached FEMA guidance). FEMA indicates that these applications will be processed as soon as the program is reauthorized and will be made effective to the fullest extent of that authority. FEMA has further stated that, if authorization is not granted within a reasonable period of time after Congress convenes, the premiums will be refunded and the new and renewal policies held in abeyance will not be issued. Banks should advise their borrowers that remittance of the application and payment will not result in immediate NFIP coverage and cannot legally be required until reauthorization, as well as the consequences of non-retroactive reauthorization. FEMA has provided standard language in the form of a notice for flood insurance agents to provide to borrowers regarding availability of insurance during this period. A copy of the notice is attached. You should ensure that borrowers with property in flood hazard areas are similarly informed of the implications of closing on a mortgage loan during this period.
- You may determine that the risk of loss is sufficient to justify postponing closing the loan until such time as the NFIP has been reauthorized.
- You may still require that the borrower obtain private flood insurance where available; however, the cost of such insurance may be a factor that would influence you or the borrower to postpone closing rather than incur a long-term obligation to address a short-term lapse.
- You may make the loan without requiring the borrower to apply for flood insurance and pay the premium pending reauthorization. However, this option poses a number of risks that should be carefully evaluated. Moreover, if Congress reauthorizes the NFIP, the agencies expect that flood insurance will be obtained for these loans, including, if necessary, by force-placement as provided in 12 C.F.R. § 208.25(g), "Forced placement of flood insurance." Before making such loans, you should ensure that borrowers are aware of the flood insurance requirements and that

force-placed insurance is typically more costly than borrower-obtained insurance. You should also have a system to identify these loans so that you can ensure that insurance is purchased if the NFIP is made available subsequent to closing.

Each lender remains responsible for protecting its collateral from risk in a manner appropriate to the circumstances and for ensuring the overall safety and soundness of its loan portfolio. You should consider the options above in the context of the overall credit quality of your loan portfolio, safe and sound banking practices, and effective risk management principles. Among the factors to consider are your volume and concentration of lending in special flood hazard areas, including loans already in your portfolio that may be subject to renewal and those to be made during the lapse period. Lenders with an elevated level of risk of flood hazard should conduct their operations by taking advantage of the available options in a manner that minimizes undue risk.

Renewals of Flood Insurance Policies

- What happens to renewals?

The situation is similar to that of making new loans. If possible, lenders and servicers should try to accelerate the payment of renewal premiums due in the period immediately following January 1, 2003. If the NFIP servicing agents and Write Your Own ("WYO") companies that act on behalf of FEMA receive such payments prior to January 1, 2003, FEMA has stated that there will be no lapse in coverage. For applications and premiums received on or after January 1, 2003, FEMA has committed to process all renewals as soon as the program is reauthorized. FEMA has provided standard notices for NFIP servicing agents and WYO companies to provide to policyholders, and suggests that these companies continue to collect premiums and hold them for processing until the time that NFIP flood insurance policies are reauthorized. Lenders are encouraged to notify their servicers that flood insurance payment premiums may continue to be processed during the lapse. Lenders who act as their own servicers may also continue to process such payments during the period of lapsed authority.

Alternatively, depending on the terms of the mortgage, you may be able to require borrowers to obtain coverage outside the NFIP, as a risk management measure.

Securitization of Mortgage Loans and the Secondary Market

- Will I be able to sell loans on the secondary market that do not have flood insurance coverage?

That will depend on the decisions of your purchaser. You should consult them about, among other things, eligibility requirements and post closing obligations before closing a loan affected by this problem.

The Federal Home Loan Mortgage Corporation ("Freddie Mac"), a principal purchaser of securitized mortgages on the secondary market, issued an announcement on December

16, 2002 that set forth its policies on flood insurance for loans during the lapse period. A copy of the announcement is attached to this letter.

Federal Housing Authority (FHA)/Veterans Administration (VA) Loans

- Will I be able to make FHA and VA loans, and other federally guaranteed or insured loans?

You should consult with FHA, VA or other federal guarantee agency, as appropriate.

Agency Flood Insurance Enforcement

- Will my financial institution violate 12 C.F.R. § 208.25 by not obtaining flood insurance coverage of loans made while the NFIP statutory authority has lapsed?

No. The flood insurance rule defines a "designated loan" as a loan secured by a building or a mobile home that is located or to be located in a special flood hazard area in which flood insurance is available under the NFIP. Because no flood insurance will be available under the NFIP during the lapse, lenders will not be in violation of the prohibition against making loans without flood insurance coverage during that period.

Lenders, however, must still make flood determinations, provide timely, complete, and accurate notices to borrowers, and comply with other parts of the flood insurance regulations that have not lapsed. Moreover, lenders must carefully evaluate safety and soundness risks and prudently manage those risks during the lapse period. The federal financial institution regulatory agencies will notify financial institutions of any Congressional action to reauthorize the NFIP. Upon such reauthorization, flood insurance coverage must be obtained for any loan where it would have been required but for the lapse in FEMA authority. If necessary, this must be accomplished through forced placement of flood insurance by the lender. Failure to require insurance once the NFIP is reauthorized would constitute a violation of the flood rule.

Attachments:

FEMA Letter of December 12, 2002 to the Federal Financial Institution Regulatory Agencies Concerning the Lapse in Flood Insurance Authority

Freddie Mac Announcement of December 16, 2002

<http://www.freddie.com/sell/selnews/fyam2.html> (Electronic version)