Flood Insurance: Are You In Over Your Head?

By: The CAMELSolutions Compliance Team

Flood Insurance compliance should be a simple concept: determine whether a building securing a loan is in a Special Flood Hazard Area (SFHA); if it is, get adequate insurance. If Flood Insurance is that simple, why did the regulators issue eleven Orders to Pay Civil Money Penalties, totaling more than $180,000, in the first three months of 2010? Obviously, the topic is more complex than it appears.

The Federal Emergency Management Agency (FEMA) and the banking regulators have issued guidelines, booklets, and questions to address the many details, with the latest edition of the "Interagency Questions and Answers (Q&A)" regarding flood insurance issued last July. The new Q&A clarified several issues, such as dealing with construction loans, junior lien loans, and dealing with flood zone discrepancies. However, one of the largest issues - what constitutes "insurable value"- is still subject to interpretation. Let's look at each of these issues and see how murky the waters really are.

Construction Loans

Getting Flood Insurance right for construction loans has been a thorny issue for lenders for a long time. When should a determination be made? If the building is in an SFHA, when should coverage be purchased? When should coverage begin? Don't give in to temptation and put off these issues until there is something physical to insure – a building, or part of one. That is a sure path to writing a check for flood insurance violations.

Most responsibilities for flood insurance on a construction loan are no different from those on a loan for an existing structure. The determination must be performed prior to origination – before a lender makes, renews, increases, or extends the loan, and prior to the onset of the construction process. If the building will be located in an SFHA, the borrower must receive notice prior to origination and he must secure proper insurance. The lender must make certain that the amount of coverage will be sufficient before any loan documents are executed or funds disbursed.

However, there is flexibility in how and when the policy must be in place and when coverage begins. Buildings under construction are eligible for flood insurance coverage. However, when does construction begin? The FEMA *Flood Insurance Manual* describes the "start of construction" as when the first placement of permanent construction on a building site, such as pouring of a slab or footing, the installation of piles, the construction of columns, or any work beyond the stage of excavation. Note that materials may also be eligible for flood insurance coverage.

Junior Liens

Making junior lien loans does not relieve a lender of flood compliance responsibilities. A lender may be able to rely on a previous determination done on the property, but if insurance is required, an extra step may be necessary.

In cases where the same institution holds the senior lien, the Q&A indicates that a lender may rely on the determination made when making the first mortgage. To qualify for this treatment, the previous determination must be less than seven years old, have been recorded on the Standard Flood Hazard Determination form, and there may have been no map amendments since that previous determination.

How much insurance is required will depend upon what the previous lienholder(s) did and how much coverage currently exists. The total coverage obtained need not exceed "the combined outstanding principal balances of the first and second loan (so long as this total is less than the insurable value of the property and the maximum coverage available)."

Junior lienholders are required to ensure that coverage is adequate to cover both the first lien and the junior lien. Procedures are required to determine the extent of the previous coverage and calculate the coverage required. Junior lienholders can be liable for the deficiencies of the senior lienholder. This may result in a "triple whammy" payout: a civil money penalty for regulatory non-compliance, a larger than necessary loan loss, and lender liability for negligence.

Flood Zone Discrepancies

A persistent issue in flood insurance compliance is how to deal with differences in the flood zone documented on the standard determination form and noted on the insurance policy. The flood zone is used by the insurer to rate the policy and determine the premium. The carrier or agent may make its own determination of the flood zone- which may differ from the lender's information. Regardless of the insurance carrier's determination, the bank is responsible for ensuring that adequate coverage is obtained once your determination indicates that flood insurance is required.

Processes must be in place to "identify and resolve flood zone discrepancies." The bank must be able to "substantiate in its loan file a bona fide effort to resolve

a discrepancy" To avoid a violation citation. However, failure to attempt to resolve discrepancies can lead to a citation for a pattern or practice of violations. Procedures should be in place to determine (1) if there is a discrepancy; and (2) if a discrepancy exists, what action (if any) is necessary.

Don't assume your existing staff can address these issues: an experienced consulting firm will have the experience to help your institution develop policies to define what types of discrepancies will be resolved and procedures to effectively deal with each of the possible reasons for the discrepancy.

Determination of Required Coverage

The 2007 issuance of the *Flood Insurance Guidelines* introduced the concept of "full insurable value"; however, this definition continues to cause uncertainty and problems. The lack of uniformity by examiners in interpreting the definition has added to the confusion. So, what is "insurable value" for flood insurance purposes?

Prior to issuance of the guidelines, "appraised value" was the standard. Appraised value is too often confused with "market value", but appraised value for purposes of flood insurance can be quite different from market value. "Insurable value" is not affected by market demand, location, or comparable sales: it is the cost to rebuild a structure after a disaster.

So what is the best way to determine insurable value? Hazard insurance valuations provide a close estimate but are not an exact representation of insurable value. Hazard insurance discounts the value of below-grade improvements by as much as 50%-80%. Thus, a hazard insurance value is not a true reflection of the cost to rebuild a property damaged or destroyed by flood, where the below-grade improvements are more likely to be affected.

Some type of cost approach is needed to determine the insurable value for flood insurance purposes. The problem is that appraisers may not provide an adequate cost approach in the appraisal process (especially for commercial properties) since appraisers typically provide market value.

Another possible approach is Actual Cash Value (ACV). The ACV is the amount to replace the building less the present-day physical depreciation. The problem with ACV is that it is very detailed and extremely complicated to calculate.

Some form of replacement cost value (RCV) seems to offer the best compromise. However, the FEMA *Mandatory Purchase of Flood Insurance Guidelines* complicates the issue:

> "To meet the compliance requirements, the amount of flood insurance coverage must at least be, but is not limited to, the lowest of: (1) the outstanding principal balances of the loan(s); (2) the maximum amount of coverage available under the NFIP for the particular type of building; or (3) the full insurable value of the building and/or its contents, **which is the same as 100% replacement cost value (RCV)"** (emphasis added).

The *Guidelines* go on to say "such a risk management strategy **meets or exceeds** the compliance requirements."

Lastly, flood insurance polices will not cover everything that might be damaged in a flood. For example, NFIP policies will only cover one water heater, one furnace, one junction box, etc. Septic tanks are not covered. While the costs of replacing walls are covered, the cost of paint or wallpaper is not. Neither is replacement of carpet. Patios, decks, retaining walls, and driveways are not covered. Forcing the borrower to obtain coverage for the cost of these items when the insurance will not replace them is unfair, and may be a customer relations nightmare. It may even be considered a deceptive practice.

So, what is the magic number? Currently, many examiners interpret this statement to mean that 100% RCV is required to comply with the law. Given the lack of uniformity on this issue, determining what method to use for arriving at "insurable value" will continue to be difficult.

Conclusion

The new Q&A's helped clarify many issues. However, further clarification on the concept of "insurable value" is clearly needed. CAMELSolutions can assist you in developing policies and procedures that will help you document when coverage was effective for construction loans and your efforts to determine required coverage for junior liens, and help you calculate insurable value in compliance with current regulatory interpretations.

Don't let the rising waters of flood insurance compliance hit your bank with a wave of unnecessary costs. CAMELSolutions can help you develop sound policies and procedures to meet these and other regulatory challenges.

The CAMELSolutions Compliance Team has decades of compliance management experience. To discuss how CAMELSolutions can assist you in ensuring you comply with Flood Insurance and other regulatory requirements, contact us via e-mail at Info@camelsolutions.com or via phone at 312-351-4355.