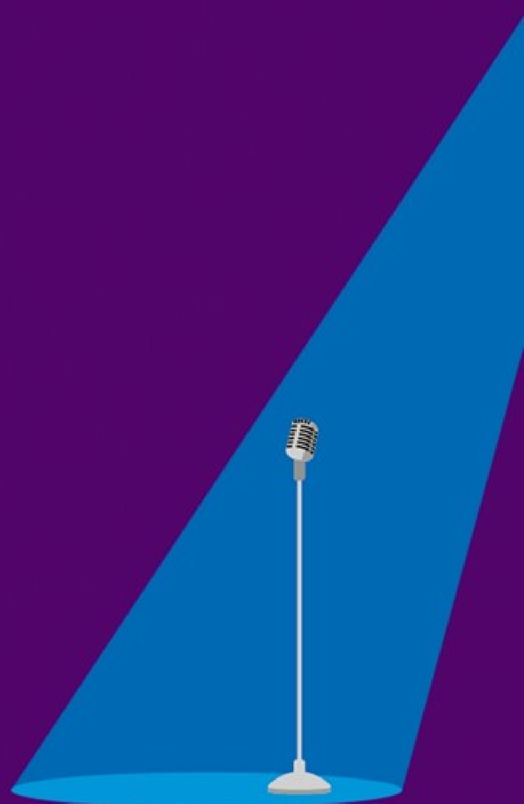
KPMG

Point of view

Analyzing Strategic Regulatory Policy Shifts

Americas FS Regulatory Center of Excellence



October 2016

Flood Insurance

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Glossary

BW Act:	Biggert-Waters Flood Insurance Reform Act of 2012.
FCA:	Farm Credit Administration.
FDIC:	Federal Deposit Insurance Corporation
FDPA:	Flood Disaster Protection Act
FEMA:	Federal Emergency Management Agency
FIRM:	Flood Insurance Rate Maps
FRB:	Federal Reserve Board
HELOC:	Home Equity Line of Credit
HFIAA:	Homeowner Flood Insurance Affordability Act of 2014
LOL:	Life of Loan
LOMA:	Letter of Map Amendments
LOMR:	Letter of Map Revisions
NCUA:	National Credit Union Administration.
NFIA:	National Flood Insurance Act
NFIP	National Flood Insurance Program
OCC:	Office of the Comptroller of the Currency
RCBAP:	Residential Condominium Building Association Policy
RESPA:	Real Estate Settlement Procedures Act
SFHA:	Special Flood Hazard Area
SFHD:	Standard Flood Hazard Determination Form
TILA:	Truth in Lending Act

Contents

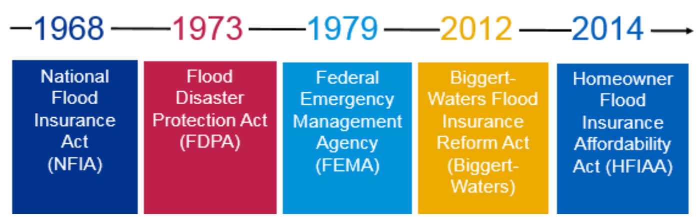
1. Executive summary

Between 1968 and 2014, the national flood insurance regulatory framework has expanded steadily. Financial institutions continue to struggle with regulatory flood insurance requirements related to the most recent reforms in 2012 and 2014. Many business processes are manual and may lack the appropriate level of controls, monitoring, reporting, and recordkeeping.

These deficiencies increasingly generate regulatory attention as banking supervision and exam activity continues to increase attention to federal flood insurance policy. Increased flood examinations (including follow-ups) are anticipated throughout 2017 and 2018. Banks are experiencing a surge in enforcement actions, civil money penalties and supervisory attention. They are also seeing an uptick in Matters Requiring Immediate Attention (MRIAs) and Matters Requiring Attention (MRAs) regarding flood insurance issues.

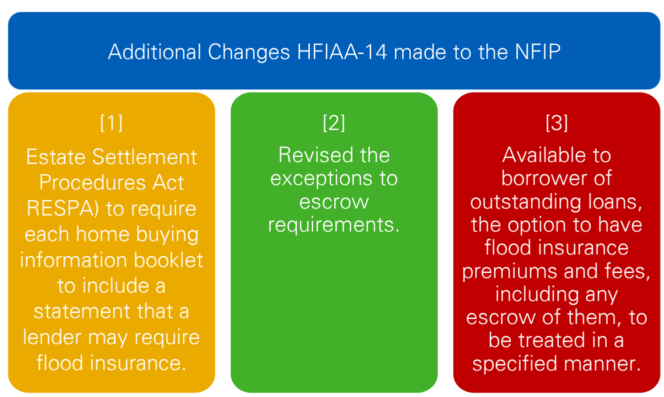
On July 21, 2015 the Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Federal Reserve Board (FRB), National Credit Union Administration (NCUA) and Farm Credit Administration (FCA) issued a joint final rule to amend their respective regulations regarding loans in special flood hazard areas. The final rule amends the agencies' regulations for loans in areas having special flood hazards. It incorporates and implements certain provisions in the Biggert-Waters Flood Insurance Reform Act of 2012 (BW Act or Biggert-Waters) and the Homeowner Flood Insurance Affordability Act of 2014 (HFIAA) regarding detached structures, force placement of flood insurance, and escrowing of flood insurance premiums and fees.[1]

Violations related to flood insurance continue to be among the most common cited by prudential regulators when they take action regarding bank internal processes.



2. Background

The National Flood Insurance Act (NFIA)23, establishes a Federal program (the National Flood Insurance Program of NFIP) to provide flood insurance to property owners if their community adopts floodplain management ordinances and minimum standards for new construction. The statute authorizes federal banking regulators to issue rules prohibiting supervised entities from making, extending, or renewing loans secured by improved real estate or mobile homes located, or to be located, in a special flood hazard area (SFHA) unless the structure is covered by adequate flood insurance. The Flood Disaster Protection Act (FDPA) defines the process by which the federal government defines areas subject to flood insurance protection.



1 OCC, FRB, FDIC, FCA, NCUA, "Loans in areas having special flood hazards," final rule, July 21, 2015. See 80 FR 43215.

2 Title XIII of Pub. L. 90-448, August 1, 1968, 82 Stat. 572, as amended, known as the National Flood Insurance Act of 1968.

Over the years since the NFIA was first enacted in 1968, homeowners and businesses have been exempted from rebuilding to successive iterations of higher standards. Many received subsidized rates that did not reflect their true risk - all while the costs and consequences of flood damage continued to increase. As of November 2012, the NFIP was more than $20 billion debt. For the NFIP to remain sustainable, its premium structure, among other things, had to change to reflect the true actuarial risks and costs of flooding. Consequently, in 2012, Biggert-Waters was introduced with the intent of modernizing flood regulations and providing reforms to stabilize the NFIP financially by:

- eliminating subsidies and discounts to reflect actual actuarial risk;
- updating Flood Insurance Rate Maps (FIRM);
- increasing fines and penalties to communities located in SFHAs for noncompliance; and
- introducing new and modified consumer disclosures and requirements

In addition, Biggert-Waters established additional requirements for supervised entities and expanded regulatory enforcement tools. These new requirements affect new originations as well as serviced-portfolios. Under the new requirements supervised entities must:

- refund premiums and fees for overlapping force-placed flood insurance within 30 days;
- accept private flood insurance policies that meet certain criteria;
- escrow flood insurance premiums and fees, unless an exception applies, for loans made, extended, or renewed after January 1, 2016; and
- give homeowners with flood insurance outstanding as of January 1, 2016, the option to escrow for flood insurance premiums and fees, unless an exception applies.

In an effort to mitigate some of the unforeseen effects of requiring full-risk premiums, Congress subsequently passed the Homeowners Flood Insurance Affordability Act of 2014 (HFIAA)4, which modified certain provisions of Biggert-Waters. HFIAA prevents premium hikes, of up to ten fold, by lowering the recent rate increases on some policies, preventing some future rate increases, and implementing a surcharge on all policyholders. These changes occur in addition to requiring gradual rate increases to properties now receiving subsidized rates, instead of immediate increases to full-risk rates.[5] However, HFIAA does not hinder policy holders from paying full actuarial risk premiums, nor does it restrain the additional enforcement tools established by Biggert-Waters.

Biggert Waters Escrow Exceptions

- Loan in a subordinate position secured by the same property for which flood insurance is being provided at origination
- Loan secured by property that is part of a condominium, cooperative, or other project development, if property is covered by a flood insurance policy meeting specific criteria
- secured by residential improved real estate or a mobile home used as collateral for a business purpose
- a home equity line of credit
- a nonperforming loan
- a term of no longer than 12 months

4 Pub L. 113-89, March 21, 2014, 128 Stat. 1020, known as the Homeowner Flood Insurance Affordability Act.

5 See Section 3-15 of the HFIAA.

3. Regulatory requirements and expectations

In today's regulatory environment, financial institutions are expected to adhere to regulatory requirements, as well as foster strong compliance, governance, and culture to meet regulatory expectations. Financial institutions are expected to have effective, efficient, and sustainable compliance controls integrated within all processes in support of a strong compliance framework. The following provides a brief discussion of areas of significant regulatory focus.

3.1 Flood Hazard Area Determination

During the loan origination process, financial institutions must ensure that a flood hazard area determination is made for each loan secured by a residential or nonresidential building or mobile home. The joint final rules do permit financial institutions to rely on a previous determination in some circumstances. However, financial institutions must be cautious as guidance provided by the joint regulators makes clear that determinations conducted more than seven years prior cannot be used.[6] Financial institutions must also make certain that the determination is documented using the current version of the Federal Emergency Management Agency's (FEMA) Standard Flood Hazard Determination Form (SFHD or SFHDF).[7] It is imperative that policies and procedures assign responsibility for making a determination using the appropriate SFHD. They must also ensure the internal determination is based on an official determination rather than rely on an institution's unilateral determination of elevations at which floods may occur. Official elevation determinations and, therefore, letter of map amendments or revisions (LOMAs or LOMRs) may only be performed by FEMA.[8]

3.2 Required Flood Hazard and Insurance Availability Notice

Borrowers must receive from their lenders a Notice of Special Flood Hazards and Availability of Federal Disaster Relief Assistance (Flood Notice or Notice) when the property securing the loan is located in an SFHA, regardless of whether the community participates in the NFIP.[9] The notice must be provided at least 10 days prior to closing so purchasers can acquire appropriate flood insurance coverage for the property.

Even when these requirements have been met, financial institutions can still generate regulatory liability due to recordkeeping and retention violations, including with respect to real estate transactions involving loan servicers. Regulators continue to question financial institutions' data integrity, including record retention, which frequently results in violations.

3.3 Amount of coverage (Insurable value)

Determining the amount of flood insurance coverage is a complex process governed by a range of valuation standards. A miscalculation of the property's insurance value could cause financial institutions inadvertently to require the borrower to purchase too much or too little flood insurance coverage, resulting in a violation.[10] In addition, because an NFIP policy will not pay a claim in excess of a property's insurable value, it is important that this value be determined correctly.

Three key components impact the coverage process:

1. ***NFIP Maximum Coverage.*** The NFIP maximum coverage depends on two components: the type of structure and the type of flood insurance program. Different NFIP programs exist to address property type and community readiness disaggregated by property type, as noted in the tables below.

2. ***Insurable Value.*** The insurable value for each structure within a property located in an SFHA is based on both its actual and intended use.[11] Financial institutions commonly face challenges when determining the insurable value due to the lack of rules governing the estimation of replacement cost and the various sources of valuation (e.g. Replacement Cost Value in the Appraisal, Hazard Policy and Uniform Commercial Code filing). For example, when using an appraisal, financial

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6 OCC, FRB, FDIC, FCA, NCUA. "Loan in Areas Having Special Flood Hazards: Interagency Questions and Answers Regarding Flood Insurance, Notice, October 17, 2011. See 76 FR 64175
7 See FEMA Form 086-0-32, dated June 2016, available at http://www.fema.gov/media-library-data/1469556176499-3fb6b6e3f04108ff34fdd56f007ac05d/FEMA_Form_086_0_32_06_2016.pdf
8 The FRB released "Revised Interagency Examination Procedures for the Flood Disaster Protection Act" in it Community Affairs Letter CA 16-1, April 7, 2016.
9 OCC, FRB, FDIC, FCA, NCUA, "Loans in Areas Having Special Flood Hazards," final rule, July 21, 2015. See 80 FR 43215 § 22.9.
10 Consumer Compliance Outlook, Third-Fourth Quarter 2015, Federal Reserve System. Available at: https://www.consumercomplianceoutlook.org/2015/third-fourth-quarter/note-from-editors/
11 ibid.

institutions must recognize the NFIP will not cover certain property (e.g., a detached structure that is not a dwelling), some personal belongings, and any property outside the building (e.g., land or a swimming pool).

3. ***Outstanding Principal Balance*** The minimum amount of required flood insurance must be at least equal to the lesser of (i) the outstanding principal balance of the loan, (ii) the maximum amount available under the NFIP, or (iii) the insurable value of the property. Frequently, financial institutions overlook the need to calculate the "sum of liens" when determining the outstanding principal balance. Specifically, financial institutions must take into consideration *all* outstanding liens on the property, including any second lien such a Home Equity Line of Credit (HELOC) or second mortgage when determining the outstanding principal balance.

In order to mitigate these risks, financial institutions must maintain strong training programs, together with strong, descriptive policies and procedures outlining the financial institution's position on valuation for some of the more ambiguous structures/items within securing the loan.

NFIP Maximum Coverage by Program					
Emergency Program			Regular Program		
Structure type	NFIP maximum structure coverage	NFIP maximum content coverage	Structure type	NFIP maximum structure coverage	NFIP maximum content coverage
Single Family	$35,000.00	$10,000.00	Single Family	$250,000.00	$100,000.00
Other Residential	$100,000.00	$10,000.00	Other Residential	$500,000.00	$100,000.00
Non Residential	$100,000.00	$100,000.00	Commercial	$500,000.00	$500,000.00

3.4 Escrowing flood insurance premiums and fees

Financial Institutions must escrow flood insurance premia and fees for loans secured by improved residential real estate or a mobile home.[12] Two types of exceptions exist, largely focused on *de minimus* lending arrangements. First, a small lender exception for banks with less than $1 billion in assets as of the end of the prior calendar year. Second, subordinated, HELOC, nonperforming, and short-term loans are all exempt from the escrow arrangements, as are loans covered under an adequate Residential Condominium Building Association Policy (RCBAP).[13]

3.5 Force placement of flood insurance

Financial institutions must monitor for adequate flood insurance coverage throughout the term of the loan, and purchase flood insurance on behalf of the borrower if the institution or its servicer determines at any time that flood insurance coverage is deficient. If borrowers have not purchased the necessary insurance, the financial institution must purchase insurance on the borrower's behalf on the 46th day after notifying the borrower of the lapse in coverage. This is referred to as "force-placed insurance." Under the new rules, financial institutions may charge the borrower for the cost of force-placed insurance from the date of lapse.

Generally, creditors use third party flood insurance vendors to monitor flood insurance for designated loans during the life of the loan. Consequently, specialized and robust monitoring programs must be established to assess the performance of third party vendors. Moreover, while institutions are not required by law to monitor for map changes, many institutions also rely on third party vendors to undertake life of loan (LOL) monitoring for risk management purposes.

When engaging a third party vendor for purposes of LOL monitoring, financial institutions should be conscious of certain associated risks, particularly with respect to fees that may need to comply with the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA). Furthermore, if flood monitoring is in effect, financial Institutions should monitor FEMA flood map changes closely as changes may result in force placement or cancellation of a previously force placed flood insurance policy.

3.6 Cancellation of force placed flood insurance

If duplicate coverage occurs, financial institutions must refund the premiums and charges incurred by the borrower during the period of duplicate coverage. Acceptable forms of insurance evidence that the borrower may provide include: the declaration page, the flood policy, RCBAP, and the flood insurance application with proof of payment. A financial institution need only notify its insurer that evidence of insurance has been received from the borrower in order to terminate the force-placed policy in order to comply with the termination requirement.[14] While financial institutions only need to notify the insurer, they should also ensure the appropriate refund is processed timely.

12 OCC, FRB, FDIC, FCA, NCUA, "Loans in Areas Having Special Flood Hazards," final rule, July 21, 2015. See 80 FR 43215 § 22.5.
13 OCC, FRB, FDIC, FCA, NCUA, "Loans in Areas Having Special Flood Hazards," final rule, July 21, 2015. See 80 FR 43215

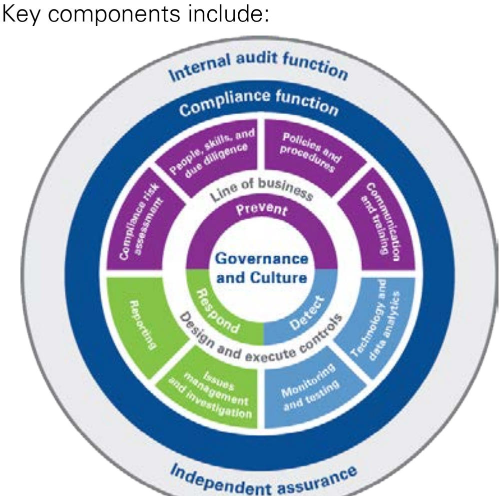
14 FDIC, Compliance Examination Manual, Chapter V-6, Flood Insurance, updated April 2016.

4. Conclusion: Flood compliance program considerations

The new regulations increase the regulatory focus on flood insurance compliance. Overall, financial institutions should fundamentally reassess and retool their flood operations by incorporating or implementing these considerations into their compliance and strategic programs.

Financial institutions need to be able to manage flood compliance more effectively and efficiently while mitigating regulatory, financial and operational risks associated with a tailored approached. Therefore, it is important for financial institutions to assess the design and effectiveness of their flood compliance programs.

Compliance leaders can take several actions immediately to enhance their compliance effectiveness and efficiency while simultaneously increasing their organizational agility. KPMG's Compliance Transformation framework, which consists of eight program components, provides relevant components that will help facilitate proactive flood insurance compliance program architecture that can respond flexibly to the evolving regulatory expectations discussed in this Point of View. Key components include:



Preventive elements

- Developing well written procedures that provide clear instruction with respect determining insurable value calculation.
- Outlining roles and responsibilities across the organization to help ensure appropriate processing and rigorous quality control over the timeliness of flood activities.

Detective elements

- Sustaining robust lines of defense (e.g. quality assurance and quality control) to self-identify, report and correct misconduct, gaps and other issues.
- Implementing data analytics in support of transactions testing and monitoring programs to help identify data anomalies and predict patterns and trends over flood practices.
- Strengthening and improving the financial institution's risk data aggregation, systems, and reporting capabilities to enable leadership to have a view of the flood processes across the institution as well as its ties to key data elements and associated linkages amongst obligations, risks, controls, and testing.
- Conducting monitoring and oversight of third-party service providers heavily relied upon for flood processes.

Responsive elements

- Addressing changes to regulatory obligations and expectations, like new escrow requirements, in a proactive manner integrating the solution into strategic objectives in order to avoid redundancy and rework for a more practical and efficient process;
- Creating an efficient and effective issue management process that applies an enterprise wide approach to remediating issues.

Additionally, based on the industry's shift towards digitizing labor intensive processes, compliance leaders should be incorporating digital labor as much as possible to support further automation of business processes. Specific applications in the flood insurance context include flood-specific compliance monitoring and testing activities such as identifying accounts with overlapping flood coverage that require cancellation and identifying accounts that experienced flood zone changes that result in changes to flood requirements.

KPMG's Compliance Transformation Framework provides multiple options that can incorporate and tailor digital labor to suit specific financial institution needs in the flood insurance context. By digitizing flood monitoring and testing processes, as among others, financial institutions will enhance the scope, robustness, and efficiency of their compliance programs while simultaneously ensuring that those programs are both risk based and driven by key cross-enterprise data.

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