



# Regulatory Compliance Bulletin

**Date: July 15, 2019**

## **Agencies Adopt Joint Rule on Private Flood Insurance**

The financial institution regulatory agencies<sup>i</sup> (the "Agencies") have issued their final rule stating the circumstances under which lenders are required to accept private flood insurance in satisfaction of federal flood insurance coverage requirements. The rule became effective July 1, 2019.

The final rule, among other things, mandates that regulated lending institutions accept private flood insurance policies that meet certain regulatory requirements in satisfaction of the requirement that borrowers purchase flood insurance for property located in a special flood hazard area that secures a loan made by the regulated institution.

The concept that lenders are required to accept private flood insurance to satisfy the mandatory purchase requirement for flood insurance originated with the Biggert-Waters Flood Insurance Reform Act of 2012 (the "BWA").<sup>ii</sup>

The BWA directed the Agencies to promulgate implementing regulations concerning the acceptance of private flood insurance. Implementing regulations were first proposed in 2013, then revised and re-proposed in 2016. Eventually, the final rule was released in February 2019 for implementation on July 1, 2019.

### **Background**

The National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973<sup>iii</sup> govern the National Flood Insurance Program ("NFIP"). These laws make federally-subsidized flood insurance available to, and required the purchase of flood insurance by, owners of

property located in a special flood hazard area when the property secures a loan made by a regulated lending institution. The NFIP offers three Standard Flood Insurance Policy ("SFIP") forms. The Federal Emergency Management Agency ("FEMA") administers the NFIP.

The BWA required the Agencies to issue a rule directing lending institutions to accept private flood insurance and to notify borrowers of the availability of such insurance.

### **Requirements of the Final Rule**

Generally, the final rule (1) clarifies the definition of private flood insurance, (2) provides a compliance aid to guide lenders regarding the acceptance of private flood policies, (3) outlines a process for discretionary acceptance of policies that do not meet the statutory definition of private flood insurance, and (4) provides guidelines regarding the acceptance of flood insurance policies issued by mutual aid societies.

### Definition of Private Flood Insurance

Generally, a private flood insurance policy that meets the statutory definition, such that it must be accepted by the lender, will provide coverage as broad as that provided by an SFIP. In particular, an acceptable private policy will:

- *Define a flood to include the same events as an SFIP.* Private policies may actually include a broader definition of flood damage than are typically contained in the NFIP.
- *Have the same types of coverage available as an SFIP;* for instance, building property coverage, personal property coverage,

and increased cost of compliance coverage. Private policies may also include business interruption coverage.

- *Have deductibles that are no higher than SFIP deductibles for policy amounts up to NFIP maximums.* It is unclear how this requirement will be interpreted. If a private policy provides coverage of up to \$1,000,000, in excess of the NFIP maximum of \$500,000 for that type of structure, would the private policy only need to match the SFIP deductible for the first \$500,000 in coverage?

- *Only exclude losses that are excluded in an SFIP, except to the extent those losses apply to coverage that is beyond that provided by an SFIP.*

- *Not contain conditions that narrow the coverage that would be provided in an SFIP; for instance, non-renewal or cancellation provisions that are more restrictive than those provided by an SFIP.*

#### The Compliance Aid

The final rule includes a Compliance Aid to help lenders identify policies that meet the statutory definition of private flood insurance such that the policy must be accepted by the lender. The Compliance Aid reads as follows: "This policy meets the definition of private flood insurance contained in 42 U.S.C. §4012a(b)(7) and the corresponding regulation."

However, lenders must accept policies that adhere to the statutory definition, whether or not the Compliance Aid is present.

#### Discretionary Acceptance

The final rule retains lenders' ability to accept or reject flood insurance policies that do not meet the statutory definition. Discretionary acceptance gives lenders flexibility in the case of, e.g., sophisticated commercial real estate transactions.

Discretionary acceptance of a commercial or residential private policy is acceptable when it:

- *Provides coverage in the amount required, which must be at least equal to the outstanding principal balance of the loan or the maximum limits of coverage available for the applicable type of property under the BWA.*

- *Is issued by an insurer that is licensed to do business in the jurisdiction where the property is located; or, for non-residential commercial property, is issued by a surplus lines insurer recognized in that jurisdiction.*

- *Covers both the mortgagor and mortgagee as loss payees, or is a policy provided and paid for by, e.g., a condominium or homeowners' association.*

- *Provides sufficient protection of the designated loan consistent with general safety and soundness principles, and the lender documents its conclusions in this regard in writing.*

The final rule is not specific as to satisfaction of the documentation requirement in the last bullet point above, but the preamble of the final rule lists several factors that might be considered by a lender to determine whether a policy provides sufficient protection:

- *Are the deductibles reasonable based on the borrower's financial condition?*

- *Does the insurer provide adequate notice of cancellation to permit timely force placement if necessary?*

- *Are the payment limits per loss and in the aggregate sufficient to protect the lender's interest in the collateral?*

- *Does the policy comply with applicable state law?*

- *Is the insurance company financially solvent and able to pay claims?*

#### Mutual Aid Societies

Under the final rule, lenders may accept flood insurance policies written by mutual aid societies, which are defined as organizations that meet the following criteria:

- *Its members share a common religious, charitable, educational or fraternal bond.*

- *The organization and its members have an agreement for the organization to cover losses due to damages to members' property, including flood damage.*

- *The organization has a demonstrated history of fulfilling its obligations with respect to flood damage losses.*

However, policies issued by mutual aid societies must be approved by the lender's regulatory agency before the lender is authorized to accept them. The 2013 iteration of the proposed rules governing private flood insurance stated that the OCC and the Farm Credit Administration would conduct evaluations based on the same statutory criteria that regulated lending institutions are required to consider. The Federal Reserve Board, the FDIC and the NCUA have stated that the cases in which they accept policies issued by mutual aid societies will be rare and limited.

Lenders are not required to accept policies written by mutual aid societies; rather, the final rule only provides a mechanism for lenders to accept them if they choose to.

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<sup>i</sup> The OCC, the Federal Reserve, the FDIC, the Farm Credit Administration and the National Credit Union Administration were the issuers of the regulations.

<sup>ii</sup> The BWA was intended to help expand the private insurance market, but, due to its restrictive provisions, initially had the opposite effect.

<sup>iii</sup> Both statutes are codified at 42 U.S.C. §§4001-4129.

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