

CONSUMER COMPLIANCE OUTLOOK®

THIRD/FOURTH QUARTER 2015

INSIDE

Agencies Issue Final Rule for New Flood Insurance Requirements.....	2
Flood Insurance Compliance Requirements	5
Regulatory Calendar	13
News from Washington	14
On the Docket.....	16
Outlook Live Year in Review	18
Outlook Live Webinars	19
Calendar of Events.....	20

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A NOTE FROM THE EDITORS

“Floods are the most common and costly natural disaster in the United States,” according to the Federal Emergency Management Agency (FEMA).¹ “Between 1980 and 2013, the United States suffered more than \$260 billion in flood-related damages.”² These significant losses translate to a large volume of flood insurance claims. In 2005, for example, Hurricane Katrina resulted in claim payments of \$16.3 billion from the National Flood Insurance Program (NFIP), ranking as the most expensive flood in the U.S. since the NFIP’s inception in 1968. In 2012, Superstorm Sandy resulted in more than \$8 billion in claim payments, ranking as the second most costly flood in the U.S.³

These statistics provide a stark reminder to lenders about the importance of understanding and complying with federal flood insurance laws and regulations. To facilitate compliance, *Consumer Compliance Outlook* has published several articles over the years discussing federal flood insurance requirements. However, flood insurance compliance continues to be a challenge for financial institutions. Federal Reserve data for consumer compliance examinations reveal that several flood insurance requirements regularly appear among the top-cited violations by examiners.

As a result, this issue of *Outlook* is devoted to flood insurance compliance. We review the July 2015 interagency final rule to implement new flood insurance requirements of the Biggert-Waters Flood Insurance Reform Act of 2012 (BWA) and the Homeowner Flood Insurance Affordability Act of 2014 (HFIAA). We also republish a comprehensive article on flood insurance requirements from 2011 titled “Flood Insurance Compliance Requirements” that has been updated to reflect several significant changes in the flood insurance laws, including changes as a result of the passage of the BWA and the HFIAA. Finally, we provide a resource page with helpful flood insurance links.

We hope you find this special flood insurance issue informative.

¹ Federal Emergency Management Agency, “Fact Sheet: National Flood Insurance Program,” May 2011, <http://1.usa.gov/facts-fema>

² Federal Emergency Management Agency, “Federal Flood Risk Management Standard,” February 5, 2015, www.fema.gov/news-release/2015/02/05/federal-flood-risk-management-standard

³ Federal Emergency Management Agency, “Significant Flood Events as of October 31, 2015,” December 15, 2015, www.fema.gov/significant-flood-events

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AGENCIES ISSUE FINAL RULE FOR NEW FLOOD INSURANCE REQUIREMENTS

BY BLESSING CHIMWANDA, SENIOR ASSOCIATE EXAMINER, FEDERAL RESERVE BANK OF BOSTON, AND DANIELLE MARTINAGE, SENIOR ASSOCIATE EXAMINER, FEDERAL RESERVE BANK OF BOSTON

On July 21, 2015, the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (Federal Reserve Board), the Office of the Comptroller of the Currency (OCC), the Farm Credit Administration (FCA), and the National Credit Union Administration (NCUA) jointly published a final rule to implement new flood insurance requirements enacted by the Biggert-Waters Flood Insurance Reform Act of 2012 (BWA) and the Homeowner Flood Insurance Affordability Act of 2014 (HFIAA).¹ The final rule makes four changes to the federal flood insurance requirements:

- Lenders are required to escrow all premiums and fees for flood insurance for loans secured by residential real estate or mobile homes in a special flood hazard area that are made, increased, extended, or renewed on or after January 1, 2016, subject to certain exceptions, including an exception for small lenders. For loans made, increased, extended, or renewed before that date that are still outstanding and not subject to one of the exceptions, lenders must notify borrowers by June 30, 2016, of the option to escrow flood insurance premiums and costs.
- To help reduce the cost of premiums, the rule exempts structures that are part of a residential property but detached from it and that do not serve as a residence (such as a toolshed or pool house) from the mandatory flood insurance purchase requirement, although lenders still have the option to require it to protect the collateral underlying the loan.
- A lender may charge the borrower for the costs of force-placed coverage beginning on the date the borrower's previous coverage lapsed or did not provide sufficient coverage.
- If a lender charges a borrower for force-placed flood insurance but later learns that the borrower actually had sufficient coverage, the lender or its servicer must terminate the force-placed insurance and refund any premiums or fees paid during the period of duplicate coverage.

This article summarizes the final rule.²

ESCROW OF FLOOD INSURANCE PAYMENTS FOR LOANS WITH TRIGGERING EVENTS

A regulated lending institution, or a servicer acting on its behalf, must escrow all flood insurance premiums and fees for loans secured by residential improved real estate or a mobile home in a special hazard area unless the loan or the lending institution qualifies for one of several exceptions. The escrow requirement applies to any nonexcepted loan secured by residential improved real estate or a mobile home that is made, increased, extended, or renewed on or after January 1, 2016.

¹ See the interagency press release, "Agencies Issue Flood Insurance Rule," June 22, 2015, available at www.federalreserve.gov/newsevents/press/bcreg/20150622a.htm. The final rule, 80 Fed. Reg. 43216 (July 21, 2015), is available at www.gpo.gov/fdsys/pkg/FR-2015-07-21/pdf/2015-15956.pdf.

² For the Federal Reserve Board's flood insurance regulation, which includes the changes in the final rule, refer to 12 C.F.R. §208.25.

The rule also states that the escrow provisions of the Real Estate Settlement Procedures Act (RESPA) apply to flood insurance escrows if the loan is subject to RESPA, which applies to “federally related mortgage loans.”³ The escrow provisions of RESPA generally limit the amount that may be maintained in escrow accounts and require escrow account statements discussed below.⁴ The rule also requires lenders to provide the escrow notice for any excepted loan that could lose its exemption during the term of the loan.

Escrow Notice to Affected Borrowers

For loans subject to the escrow requirement or loans that could be subject to it if one of the escrow exceptions discussed in the following section no longer applies, lenders must notify borrowers of the escrow requirement in the Notice of Special Flood Hazards. To facilitate compliance, the agencies updated the model notice form in Appendix A of their regulations to include this information.

Financial institutions should update their Notice of Special Flood Hazard to include the following new text:

Escrow Requirement for Residential Loans

Federal law may require a lender or its servicer to escrow all premiums and fees for flood insurance that covers any residential building or mobile home securing a loan that is located in an area with special flood hazards. If your lender notifies you that an escrow account is required for your loan, then you must pay your flood insurance premiums and fees to the lender or its servicer with the same frequency as you make loan payments for the duration of your loan. These premiums and fees will be deposited in the escrow account, which will be used to pay the flood insurance provider.

Small Lender Exception

The final rule excepts from the flood insurance escrow requirement any financial institution with total assets of less than \$1 billion (as of December 31 of either of the two prior calendar years) that, as of July 6, 2012:

- was not required under federal or state law to deposit taxes, insurance premiums, fees, or any other charges in an escrow account for the entire term of any loan secured by residential improved real estate or a mobile home, and
- did not have a policy of consistently and uniformly requiring the deposit of taxes, insurance premiums, fees, or any other charges in an escrow account for loans secured by residential improved real estate or a mobile home.

Financial institutions are not required to count the assets of other institutions under common ownership with the regulated lending institution when calculating asset size. The final rule also reaffirms that a regulated lending institution that may initially qualify for the exception but later exceeds the \$1 billion asset-size threshold must begin escrowing for any loans made, increased, extended, or renewed on or after July 1 of the first calendar year of changed status.

Loan-Related Exceptions

The rule also excepts several categories of loans from the flood insurance escrow requirement:

- loans with 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 mobile homes that are part of a condominium, cooperative, or other project development when covered by a flood insurance policy that (a) meets the mandatory flood insurance purchase requirement; (b) is provided by the condominium association, cooperative, homeowners association, or other applicable group; and (c) the premium for which is paid by the condominium association, cooperative, homeowners association, or other applicable group as a common expense;
- loans secured by residential improved real estate or a mobile home that is used as collateral for a business, commercial, or agricultural purpose;
- home equity lines of credit;
- nonperforming loans, which the regulation defines as loans that are 90 or more days past due and remain nonperforming until they are permanently modified or until the entire amount past due, including principal, accrued interest, and penalty interest incurred as the result of past due status, are collected or otherwise discharged in full; and
- loans with terms of 12 months or less.

As a general rule, if a lender or its servicer determines during the term of a loan covered by this rule that an exception does not apply, the lender or its servicer shall require the escrow of all flood insurance premiums and fees as soon as reasonably practicable.

OPTION TO ESCROW ON OUTSTANDING LOANS

The final rule requires regulated lending institutions to offer and make available to borrowers the option to escrow flood insurance premiums and fees for loans secured by residential improved real estate or mobile homes that are outstanding as of January 1, 2016, subject to the

³ Regulation X, 12 C.F.R. §1024.2(b)

⁴ RESPA's escrow requirements are codified at 12 C.F.R. §1024.17.

exceptions outlined previously. The final rule clarifies that the option to escrow requirement does not apply to an outstanding loan that is already escrowing flood insurance premiums and fees or will be subject to the flood insurance escrow requirement. Furthermore, the rule requires regulated lending institutions that lose the small lender exception to offer the option to escrow to existing

UNDER THE FINAL RULE, FLOOD INSURANCE IS NO LONGER REQUIRED ON STRUCTURES THAT ARE PART OF A RESIDENTIAL PROPERTY BUT ARE DETACHED FROM THE PRIMARY RESIDENTIAL STRUCTURE AND DO NOT SERVE AS A RESIDENCE, SUCH AS A TOOLSHED OR POOL HOUSE.

borrowers with outstanding loans secured by residential improved real estate or mobile homes. Regulated lending institutions have until June 30, 2016, to provide notice to affected borrowers about the option to escrow.

To facilitate compliance with the Option to Escrow notice requirement, the final rule includes a new model clause in Appendix B of the agencies' flood regulations. Using the model clause provides a safe harbor for complying with the notice requirement. The model clause reads as follows:

Escrow Option Clause

You have the option to escrow all premiums and fees for the payment on your flood insurance policy that covers any residential building or mobile home that is located in an area with special flood hazards and that secures your loan. If you choose this option:

- Your payments will be deposited in an escrow account to be paid to the flood insurance provider.
- The escrow amount for flood insurance will be added to the regular mortgage payment that you make to your lender or its servicer.
- The payments you make into the escrow account will accumulate over time, and the funds will be used to pay your flood insurance policy when your lender or servicer receives a notice from your flood insurance provider that the flood insurance premium is due.

To choose this option, follow the instructions below. If you have any questions about the option, contact [Insert Name of Lender or Servicer] at [Insert Contact Information].
[Insert Instructions for Selecting to Escrow]

DETACHED STRUCTURES

Under the final rule, flood insurance is no longer required on structures that are part of a residential property but are detached from the primary residential structure and do not serve as a residence, such as a toolshed or pool house. Previously, detached nonresidential structures had to be insured separately from dwellings (except for detached garages that were covered under dwelling policies up to 10 percent of the policy amount).

According to the final rule, "a structure that is part of a residential property" refers to a structure used primarily for personal, family, or household purposes and

not used primarily for agricultural, commercial, industrial, or other business purposes. In instances in which certain structures are used for both residential and business purposes, the exemption applies only to structures with a primary residential purpose. A structure is "detached" if it stands alone, meaning it is not joined by any structural connection to the residential structure. Furthermore, the detached structure may not "serve as a residence." Because the lender is in the best position to consider all the facts and circumstances surrounding the detached structure, the final rule requires lenders to consider the actual and intended use of a structure and to determine in good faith if the structure serves as a residence. While the rule notes that structures can vary greatly in terms of size, value, purpose, and facilities, the rule explains that a structure could be considered a residence if it includes sleeping, bathroom, or kitchen facilities. The status of a detached structure must be reexamined upon a qualifying "triggering" event, such as making, increasing, extending, or renewing a loan.

Although detached structures are exempt from the mandatory purchase of flood insurance, lenders may nevertheless require flood insurance on a detached structure to protect the collateral securing the mortgage.

FORCE PLACEMENT OF FLOOD INSURANCE

Under the new rule, financial institutions may charge a borrower for the cost of force-placed flood insurance and related fees starting on the date on which flood insurance coverage lapsed or did not provide the proper amount of coverage for the property securing the loan.

It is important to emphasize that a lender is not required to force place flood insurance on the date it learns insurance is required for a property securing an existing loan. A regulated lender must send a force-placed notice

Continued on page 12

FLOOD INSURANCE COMPLIANCE REQUIREMENTS

BY KENNETH BENTON, SENIOR CONSUMER REGULATIONS SPECIALIST, AND MICHAEL SCHIRALDI, FORMER RESEARCH ASSISTANT, FEDERAL RESERVE BANK OF PHILADELPHIA

This article provides an overview of federal flood insurance requirements for federally regulated financial institutions, including a brief history of the federal flood insurance statutes and regulations, a review of general flood insurance requirements, a discussion of specific flood insurance compliance issues, and an examination of enforcement provisions. As noted in the introduction to this issue, this article was originally published in 2011.¹ Because several significant changes to the federal flood insurance laws and regulations have occurred since then, we are republishing this article with updates to reflect these changes.

STATUTORY BACKGROUND: THE NATIONAL FLOOD INSURANCE ACT OF 1968 AND ITS SUBSEQUENT AMENDMENTS

In response to increased flood damage, the escalating costs of disaster relief for taxpayers, and the lack of affordable flood insurance, Congress enacted the National Flood Insurance Act (NFIA) in 1968.² The NFIA established the National Flood Insurance Program (NFIP) to address the economic burdens of floods, encourage protective and preventative measures, and reduce the cost of flood insurance.³ Property located in a flood area where the community participates in the NFIP is subject to the NFIA's requirements. According to the Federal Emergency Management Agency (FEMA), "[a]lmost all of the nation's communities with serious flooding potential have joined the NFIP."⁴

Flood insurance compliance requirements for federally regulated financial institutions began in 1973, when Congress enacted the Flood Disaster Protection Act of 1973 (FDPA).⁵ Section 102(b) of the FDPA amended the NFIA to require the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation

(FDIC), the Office of the Comptroller of the Currency (OCC), and the National Credit Union Administration (NCUA) to issue regulations directing lending institutions under their supervision not to make, increase, extend, or renew any loan secured by improved real estate or mobile homes located, or to be located, in a special flood hazard area (SFHA) where flood insurance is available under the NFIP unless the building or mobile home and any personal property securing the loan are covered by flood insurance for the term of the loan.

Congress subsequently enacted the National Flood Insurance Reform Act of 1994 (Reform Act),⁶ which made comprehensive changes to the NFIA and FDPA. The changes include obligating lenders to escrow all premiums and fees for flood insurance required under the NFIA and its implementing regulations if they require escrows for other loans secured by residential real estate or a mobile home⁷ and applying flood insurance requirements to loans purchased by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.⁸ The Reform Act also brought lenders regulated by the Farm Credit Administration (FCA) within the mandatory flood insurance purchase requirement and directed the Board, FDIC, OCC, NCUA, and FCA (collectively, the agencies) to issue implementing regulations for the institutions they supervise.⁹ In response to the last requirement, the agencies published substantially similar flood insurance regulations to implement the statutory requirements of the federal flood insurance statutes for the institutions they supervise.¹⁰

In part because the NFIP incurred large deficits from paying claims for major floods, Congress enacted the Biggert-Waters Flood Insurance Reform Act of 2012 (BWA)¹¹ to ensure the NFIP's fiscal stability and for other purposes.

¹ Kenneth Benton and Michael Schiraldi, "Flood Insurance Compliance Requirements," *Consumer Compliance Outlook* (Fourth Quarter 2011).

² Pub. Law No. 90-448, 82 Stat. 572 (August 1, 1968). Codified, as amended, at 42 U.S.C. §4001 et seq.

³ See 42 U.S.C. §4001(a).

⁴ National Flood Insurance Program, Answers to Questions About the NFIP, Q. 26, FEMA F-084 (March 2011), www.fema.gov/media-library-data/20130726-1438-20490-1905/f084_atq_11aug11.pdf. The current list of participating communities is available at www.fema.gov/national-flood-insurance-program/national-flood-insurance-program-community-status-book.

⁵ Pub. L. No. 93-234, 87 Stat. 975. (1973)

⁶ Title V of the Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. 103-325 (September 23, 1994)

⁷ Section 523 of the Reform Act (42 U.S.C. §4012a(d))

⁸ Section 522 of the Reform Act (42 U.S.C. §4012a(b)(3))

⁹ See 42 U.S.C. 4012a(b)(1).

¹⁰ The agencies' flood insurance implementing regulations are found at 12 C.F.R. §208.25 (Regulation H) for institutions supervised by the Board, 12 C.F.R. part 22 for institutions supervised by the OCC, 12 C.F.R. part 339 for institutions supervised by the FDIC, 12 C.F.R. part 614 for institutions supervised by the FCA, and 12 C.F.R. part 760 for institutions supervised by the NCUA. This article refers to the flood insurance requirements of the Board's implementing regulation, but the other agencies' regulations are substantially similar.

¹¹ Pub. L. No. 112-141, 126 Stat. 916 (2012)

To make the program self-sustaining, the BWA phases out both subsidized rates, which apply to approximately 20 percent of policyholders,¹² and grandfathering properties (the practice of providing preferential rates to certain property owners when rates are raised or when a property is newly mapped into an SFHA). In addition, because some of the flood insurance rate maps on which FEMA relies in setting premiums did not fully reflect the actuarial risk of floods, the BWA directs FEMA to implement full-risk pricing for all policies, with some limits on yearly rate increases for certain properties until full-risk pricing is implemented.

The BWA also:

- extends the NFIP through September 30, 2017;
- increases civil money penalties and removes the statutory annual cap on the amount of penalties;
- requires lenders to refund premiums and fees for force-placed flood insurance when the coverage overlaps the borrower's coverage;
- establishes a minimum deductible for property to which construction or substantial improvements occurred on or before December 31, 1974, or before the effective date of an initial flood insurance rate map;
- requires lenders to accept private flood insurance policies that meet certain criteria;
- requires FEMA to conduct a study on flood insurance affordability; and
- requires lenders to escrow flood insurance premiums and fees unless an exception applies.

As FEMA began to phase in full actuarial rates, some policyholders in high-risk areas expressed concerns that the full rates were unaffordable. In addition, real estate sales in some high-risk areas were negatively impacted because the BWA required full-risk pricing for new policies issued on or after July 6, 2012, and some potential property buyers could not afford the full-risk premiums. In March 2014, Congress passed the Homeowners Flood Insurance Affordability Act (HFIAA)¹³ to address these concerns and implement other changes to the NFIP.

To make flood insurance premiums more affordable, the HFIAA limits the extent to which rates can increase in one year. While the HFIAA limits annual rate increases, it does not affect Congress' eventual goal of implementing full-risk

pricing for all policies. Other provisions of the HFIAA also attempt to make rates more affordable, such as permitting lenders to not require flood insurance on structures that are part of a residential property but detached from it and that do not serve as a residence. The agencies issued a final rule in July 2015 to implement the changes under the BWA and the HFIAA for which they have jurisdiction, except for the private insurance requirement, which will be addressed in a separate final rule. The article on page 2 of this issue reviews the July 2015 final rule.

The agencies have provided additional guidance about flood insurance compliance requirements for the institutions they supervise through the Interagency Questions and Answers Regarding Flood Insurance (Interagency Flood Q&As). In July 2009, the agencies updated this guidance and included five new proposed Q&As.¹⁴ In October 2011, the agencies made two of the questions final, withdrew one, and sought additional comments on some of the force-placement questions.¹⁵ On March 29, 2013, the agencies issued the Interagency Statement on the Impact of the BWA, which updated the status of the 2011 proposed questions.¹⁶

GENERAL COMPLIANCE REQUIREMENTS

Flood Hazard Area Determination

Before making a loan secured by a residential or nonresidential building or mobile home, a federally regulated lending institution must determine whether the structure is located, or will be located, in an SFHA for which flood insurance is available under the NFIP.¹⁷ This requirement applies even if a creditor takes a security interest simply out of an "abundance of caution." Interagency Flood Q&A 41 makes it clear that "if the lender takes a security interest in improved real estate located in a[n] SFHA, flood insurance is required." Therefore, lenders must consider these requirements when determining if they will take a security interest in a property located in an SFHA.

Lenders must document the flood hazard determination using FEMA's Standard Flood Hazard Determination Form (SFHDF) and retain a hard or electronic copy of the form throughout the term of the loan.¹⁸ Making a flood determination as early as possible in the loan underwriting process is a good practice because it allows time for the borrower to obtain insurance if it is required and

¹² FEMA, "Changes to the National Flood Insurance Program — What to Expect," available at www.fema.gov/media-library-data/1403633987258-7a504b5b-a12674c0f36adb67fe103ee7/Changes_to_the_NFIP_What_to_Expect.pdf

¹³ Pub. L. No. 113-89; 128 Stat. 1020 (2014)

¹⁴ 74 Fed. Reg. 35,914 (July 21, 2009)

¹⁵ 76 Fed. Reg. 64,175 (October 17, 2011)

¹⁶ "Interagency Statement on the Impact of Biggert-Waters" (March 29, 2013), available at www.federalreserve.gov/bankinforeg/caletters/Attachment_CA_13-2_Interagency_Statement_on_Biggert-Waters.pdf.

¹⁷ See 12 C.F.R. §208.25(f)(1). Regulated lending institution is defined in the NFIA as "any bank, savings and loan association, credit union, farm credit bank, Federal land bank association, production credit association, or similar institution subject to the supervision of a Federal entity for lending regulation." 42 U.S.C. §4003(a)(10).

¹⁸ See 12 C.F.R. §208.25(f)(2).

for the lender to meet all other obligations that such a determination may trigger.

Lenders often inquire whether they may rely on a prior flood hazard determination for the same property. Under Interagency Flood Q&A 68, a lender may rely on its own prior determination when it is increasing, extending, or renewing a loan secured by the property if three conditions are satisfied: 1) the prior determination was made within seven years of the date of the transaction, 2) the SFHDF reflects the basis of the determination, and 3) FEMA has not revised or updated the map affecting the property since the original determination was made.¹⁹ Lenders can determine when the last update was made to a flood map for a particular address from FEMA's website.²⁰ A lender may not rely on a determination made by a different lender.²¹

Required Flood Hazard and Insurance Availability Notice

If a lender determines that property securing the loan is or will be located in an SFHA, the lender must provide a notice to the borrower.²² This borrower notification requirement applies regardless of whether the community participates in the NFIP. The notice must contain a warning that the property is or will be located in an SFHA; a description of the NFIA's flood purchase requirements; a statement, when applicable, that flood insurance is available under the NFIP and from private insurers; and a statement on the availability of federal disaster relief assistance. Use of the sample notice form provided in Appendix A of Regulation H is not mandatory but provides lenders with a safe harbor if used.²³ As discussed in the accompanying article on the new final flood insurance rule on page 2, the agencies revised the model form in Appendix A of their implementing regulations to add language notifying the borrower that the lender or servicer may be required to escrow premiums and fees for flood insurance on a residential building or mobile home that lenders may use when the escrow requirements apply and that flood insurance providing the same level of coverage

as a standard flood insurance policy under the NFIP may also be available from a private insurance company.

If a lender chooses, it may use its own customized notice, but the notice must contain at least the minimum information required by the NFIA and its implementing regulations.²⁴ The lender must provide the notice to the borrower within a reasonable time before the transaction is completed.²⁵ A record (such as a signed copy of the notice or a certified mail receipt) of the borrower's receipt

MAKING A FLOOD DETERMINATION AS EARLY AS POSSIBLE IN THE LOAN UNDERWRITING PROCESS IS A GOOD PRACTICE BECAUSE IT ALLOWS TIME FOR THE BORROWER TO OBTAIN INSURANCE IF IT IS REQUIRED AND FOR THE LENDER TO MEET ALL OTHER OBLIGATIONS THAT SUCH A DETERMINATION MAY TRIGGER.

of the notice must be retained for the term of the loan.²⁶ In a loan transaction involving multiple borrowers, the lender need only provide notice to one of the borrowers in the transaction.²⁷ If a mortgage servicer is used, the lender must provide notice to the servicer "as promptly as practicable" after the notice is furnished to the borrower and no later than when the lender transmits other loan data (such as information concerning hazard insurance and taxes) to the servicer.²⁸

Amount of Coverage

The required amount of flood insurance for a loan secured by property located in a flood hazard area is the lesser of 1) the loan's outstanding principal balance or 2) the maximum amount of coverage available under the NFIA for the particular type of property serving as collateral.²⁹ The maximum coverage available under the NFIA is the lesser of 1) the maximum amount of coverage available under the NFIP for the property type securing the loan (i.e., residential, nonresidential) or 2) the overall property value securing the loan minus the value of the land on which it is located (i.e., the property's "insurable

¹⁹ See Interagency Flood Q&A 68.

²⁰ <https://msc.fema.gov/portal>

²¹ See Interagency Flood Q&A 37.

²² See 12 C.F.R. §208.25(i).

²³ See 12 C.F.R. §208.25(i)(5). The form is in Appendix A of the agencies' regulations.

²⁴ See Interagency Flood Q&A 80.

²⁵ See 12 C.F.R. §208.25(i)(2).

²⁶ See 12 C.F.R. §208.25(i)(3).

²⁷ See Interagency Flood Q&A 73. The bank is permitted to provide each borrower with a notice if it so chooses.

²⁸ See 12 C.F.R. §208.25(i)(2). See also Interagency Flood Q&A 75. Notice to the servicer may be made electronically or in the form of a copy of the notice received by the borrower, and a copy of the notice must also be retained by the lender for the duration of the loan.

²⁹ See 12 C.F.R. §208.25(c)(1).

value”).³⁰ The maximum coverage caps in an NFIP participating community are \$250,000 for a residential building and \$500,000 for a nonresidential building.³¹ The BWA increased the maximum amount of coverage for a noncondominium residential building designed for use for five or more families from \$250,000 to \$500,000. This change was effective for new policies, renewals, or change endorsements made on or after June 1, 2014.³²

Insurable Value

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. A miscalculation of the property’s insurable value could cause the lender to inadvertently require the borrower to purchase too much or too little flood insurance coverage, resulting in a violation. For example, if the value of the land is not excluded when determining the insurable value of a home or building, the borrower will purchase coverage exceeding the amount the NFIP will pay for a covered loss.³³

To provide greater clarity about insurable value, the agencies issued Interagency Flood Q&A 9 in October 2011. Interagency Flood Q&A 9 explains that while equating the insurable value to replacement cost value (RCV) is appropriate in some cases, RCV should *not* be used as a proxy for insurable value for properties whose insurance loss payout would ordinarily be based on actual cash value:

Strictly linking insurable value to RCV is not practical in all cases. In cases involving certain residential or condominium properties, insurance policies should be written to, and the insurance loss payout usually would be the equivalent of, RCV. However, in cases involving nonresidential properties, and even some residential properties, where the insurance loss payout would normally be based on actual cash value, which is RCV less physical depreciation, insurance policies written at RCV may require an insured to pay for coverage that exceeds the amount the NFIP would pay in the event of a loss. Therefore, it is reasonable for lenders, in determining the amount of flood insurance required, to consider the extent of recovery allowed under the NFIP policy for the type of property being insured.³⁴

The guidance further states that when this occurs, lenders may choose from any reasonable approach to calculate insurable value as long as it can be supported. The guidance provides examples of permissible methods, including appraisal based on a cost-value (not market-value) approach, a construction-cost calculation, and the insurable value used in a hazard insurance policy with appropriate adjustments.³⁵

Escrowing Flood Insurance Premiums and Fees

In the Interagency Flood Q&As, the agencies encourage lenders and servicers to escrow flood insurance premiums. Following this recommendation could result in less force placement of flood insurance. If a creditor requires escrow accounts for loans secured by residential real estate or mobile homes, the creditor must also require the escrow of all premiums and fees for flood insurance required under the NFIA and its implementing regulations.³⁶ The agencies’ regulations authorize regulated lenders, or servicers acting as their agents, to deposit the funds earmarked for flood insurance premiums and fees into the escrow fund on the borrower’s behalf. The lender or its servicer is then required to make payments for the borrower’s flood insurance premiums from the escrow account as they become due.³⁷

The BWA amended these escrow requirements by requiring lenders or servicers to escrow flood insurance premiums and fees for all loans secured by residential property unless an exception applies, including an exception for small lenders meeting certain requirements. The article on page 2 reviews the escrow requirement and its exceptions, as implemented in the agencies’ final rule.

Force Placement of Flood Insurance

The agencies’ flood regulations address the requirements for force placement of flood insurance. If at any time during the term of the loan a lender or its servicer determines that the collateral has less flood coverage than is required by the agencies’ implementing regulations, it must notify the borrower to obtain the required insurance.³⁸ If the borrower has not purchased the necessary flood insurance within 45 days after the notice was sent, the lender must purchase insurance on the borrower’s behalf.³⁹ A lender may comply with the force-placement requirement by purchasing an NFIP

³⁰ See Interagency Flood Q&A 8.

³¹ See Interagency Flood Q&A 7. In participating communities that are under the emergency program phase, the coverage caps are \$35,000 for residential dwellings and \$100,000 for nonresidential structures.

³² For further information, see the “Interagency Statement on Increased Maximum Flood Insurance Coverage for Other Residential Buildings” (May 30, 2014), www.federalreserve.gov/bankinforeg/caletters/Attachment_CA_14-3_Interagency_Increased_Coverage_Guidance_final.pdf.

³³ See Interagency Flood Q&A 8.

³⁴ See Interagency Flood Q&A 9.

³⁵ See Interagency Flood Q&A 9.

³⁶ See 12 C.F.R. §208.25(e).

³⁷ Funds escrowed in connection with designated loans remain subject to the escrow requirements of Regulation X, 12 C.F.R. §1024.17

³⁸ See 12 C.F.R. §208.25(g)(1).

³⁹ See 12 C.F.R. §208.25(g).

Standard Flood Insurance Policy or an appropriate private flood insurance policy in the amount required by the implementing regulations.⁴⁰

The agencies provide guidance on when force-placement insurance must become effective in Interagency Flood Q&A 61, which states that if a borrower fails to obtain insurance within 45 days after notification, the agencies expect the lender to have insurance in effect on the 46th day. If there is a brief delay, for example, because of batch processing, the agencies expect the lender to provide a reasonable explanation for the delay.⁴¹

The BWA made changes to the force-placement flood insurance requirements. In particular, the BWA requires that if a lender force places flood insurance and the borrower already had coverage and notifies the lender and produces the declaration page, the lender must refund the premiums and charges incurred during the period of duplicate coverage. The BWA also authorizes lenders to purchase force-placement flood insurance when they learn that a property has no coverage or insufficient coverage and to pass the cost along to the borrower. These changes are discussed in the flood article on page 2.

SPECIFIC COMPLIANCE ISSUES

Flood Insurance Requirements for Residential Condominiums

Flood insurance is required for loans secured by an individual residential condominium unit, including a unit in a multistory condominium complex, if the condominium is located in an SFHA where flood insurance is available under the NFIP. Loans secured by other condominium property are also covered, such as loans to condominium associations or to condominium developers.⁴²

The NFIP offers a specific insurance policy for a residential condominium complex — defined as a building having 75 percent or more of its floor area in residential use — known as the Residential Condominium Building Association Policy (RCBAP).⁴³ This policy, which can only be purchased by condominium owners' associations, covers all individual units (including improvements) and common

property. Content in the units can also be covered if content coverage is purchased.

The minimum amount of flood insurance for a loan secured by a condominium unit is the lesser of the outstanding principal balance of the loan or the maximum amount available under the NFIP, which is the lesser of:

- the maximum limit for a residential condominium unit; or
- the insurable value allocated to the unit, defined as 100 percent of the RCV of the entire condominium building divided by the number of units.

To facilitate compliance, the Interagency Flood Q&As include a condominium loan example in which a lender makes a \$300,000 loan secured by a residential condominium unit in a 50-unit condominium building that

IF AT ANY TIME DURING THE TERM OF THE LOAN A LENDER OR ITS SERVICER DETERMINES THAT THE COLLATERAL HAS LESS FLOOD COVERAGE THAN IS REQUIRED BY THE AGENCIES' IMPLEMENTING REGULATIONS, IT MUST NOTIFY THE BORROWER TO OBTAIN THE REQUIRED INSURANCE.

is located in an SFHA within a participating community, with a replacement cost of \$15 million and that is insured by an RCBAP with \$12.5 million of coverage.⁴⁴

In this example, additional flood insurance is not required because the RCBAP's \$250,000 per unit coverage ($\$12.5 \text{ million} \div 50 = \$250,000$) satisfies the mandatory flood insurance requirement, which is the lesser of 1) the outstanding principal balance (\$300,000), 2) the maximum coverage available under the NFIP (\$250,000), or 3) 100 percent of the insurable value ($\$15 \text{ million} \div 50 = \$300,000$). Lenders may rely on the RCV and number of units on the RCBAP declaration page when verifying compliance.

If a lender determines that a borrower's unit is not covered by an RCBAP or that the coverage under an RCBAP is below the minimum amount required by the

⁴⁰ See Interagency Flood Q&A 63. A private flood insurance policy may be an adequate substitute for NFIP insurance if it meets the criteria set forth by FEMA. FEMA set forth the criteria in its Mandatory Purchase of Flood Insurance Guidelines. However, on October 9, 2014, FEMA rescinded the guidelines. See www.fema.gov/media-library/assets/documents/11705. The BWA largely codified FEMA's criteria for a private policy that lenders must accept. This provision of the BWA will not become effective until the agencies issue implementing regulations. The agencies issued a proposal to implement this and announced in the July 2015 final rule that they will address private flood insurance in a separate, later rulemaking.

⁴¹ See Interagency Flood Q&A 61. 76 Fed. Reg. 64,175, 64,182 (October 17, 2011).

⁴² See Interagency Flood Q&A 26.

⁴³ The FEMA flood manual, updated in November 2015, provides more specific details about the RCBAP, available at www.fema.gov/media-library-data/1444063407536-ba0719a500727e372693442dfd8f1ee8/06_condo_508_nov2015.pdf.

⁴⁴ See Interagency Flood Q&A 28.

NFIA, the lender must ensure that the borrower obtains sufficient coverage.⁴⁵ The lender should first request that the borrower ask the condominium association to obtain coverage or obtain additional coverage sufficient to meet the regulation's requirements. If the association fails to comply, the lender must require the borrower to purchase a FEMA dwelling policy for supplemental coverage or force place the policy if necessary.⁴⁶ When both the RCBAP and a dwelling policy cover the same unit, the RCBAP is considered primary insurance. The maximum amount of coverage for a residential condominium unit is \$250,000; therefore, when both an RCBAP and dwelling policy are in place, the policies are coordinated such that the maximum payout is capped at \$250,000.

Nonresidential Condominium Associations

For a nonresidential building (a building with less than 75 percent residential square footage) that includes condominiums, the condominium association must purchase FEMA's general property policy. Both building and contents coverage are available separately, in amounts up to \$500,000 per nonresidential building.

Home Equity Loans or Lines of Credit

A home equity loan (closed-end credit) or home equity line of credit (open-end credit) secured by a building or mobile home located in an SFHA community that participates in the NFIP is subject to the flood insurance requirements, regardless of lien priority.⁴⁷ Therefore, when a lender makes, increases, extends, or renews a designated home equity loan or line of credit, it must ensure adequate flood insurance is in place, taking into account the liens of other creditors on the property.

For home equity loans with multiple lienholders, the required minimum coverage is determined by the same formula used for single-lien designated loans, except that the outstanding principal balance of the designated home equity loan is calculated by adding together the principal balances of each existing loan. Therefore, when the outstanding principal balance of all loans is less than the property's insurable value, a lender making a home equity loan on a property with multiple liens cannot comply with the minimum coverage requirement by simply ensuring that flood coverage for the collateral is at least equal to the outstanding principal balance of its loan to the borrower.

The lender must calculate both the total principal balance of all of the outstanding liens on the property and the total amount of flood insurance on the other senior and junior lien(s) securing the property.⁴⁸ Interagency Flood Q&A 36 provides several examples to facilitate compliance. Lenders may obtain a borrower's current credit report to determine the current amounts owed to other lienholders.⁴⁹

For home equity lines of credit, a flood determination must be made before the consummation of the loan, but draws against an approved line of credit do not require additional determinations.⁵⁰ However, a borrower's request to increase the credit limit on the line of credit may trigger a new flood insurance determination depending on whether the requirements in Interagency Flood Q&A 68 for relying on a previous flood insurance determination are satisfied.

Construction Loans

The Interagency Flood Q&As 19 through 23 provide detailed guidance on the flood insurance requirements for construction loans. If a loan is secured only by land that will later be developed into a buildable lot, flood insurance is not required because the insurance requirements apply only to a loan secured by a building or mobile home.⁵¹ On the other hand, a loan secured by a building in the course of construction is subject to flood insurance requirements, even if the building is not yet walled and roofed, as long as the construction has not been halted for 90 days or longer or the lowest floor used for rating purposes is not below the base flood elevation (BFE).⁵² When insurance is obtained for a building in the course of construction, materials or supplies used in construction or repair are not insurable unless they are in an enclosed building located on or adjacent to the premises.

The Interagency Flood Q&As offer two compliance options for a lender making a loan secured by a building to be constructed. A lender may require the borrower to acquire a flood insurance policy at the time of origination. Alternatively, a lender may allow a borrower to defer the purchase of flood insurance until either 1) a foundation slab has been poured or an elevation certificate has been issued or 2) the building is walled and roofed, provided the building to be constructed will have its lowest floor below the BFE.⁵³ But before the lender disburses funds for

⁴⁵ See Interagency Flood Q&A 28.

⁴⁶ See Interagency Flood Q&A 30. While supplementing a borrower's RCBAP coverage with a dwelling policy of the statutorily required amount will satisfy the minimum purchase requirement, the lender and the borrower/unit owner may still be subject to risk of loss. Specifically, the dwelling policy does not extend the RCBAP's maximum coverage limits. The dwelling policy may also not cover the individual unit owner's share of the coinsurance penalty. Lenders are encouraged to inform borrowers of this risk.

⁴⁷ See Interagency Flood Q&A 34.

⁴⁸ See Interagency Flood Q&A 34.

⁴⁹ See Interagency Flood Q&A 36.

⁵⁰ See Interagency Flood Q&A 35.

⁵¹ See Interagency Flood Q&A 19.

⁵² See Interagency Flood Q&A 21.

⁵³ See Interagency Flood Q&A 22.

construction (except for pouring the slab or preliminary site work), it must require the borrower to have flood insurance in place.

A lender that elects to allow the borrower to defer the purchase of flood insurance until after origination must have adequate internal controls in place to detect whether either of the above two mandatory purchase triggers has occurred. When either of these triggering conditions occurs, the lender must require the borrower to purchase flood insurance or, if necessary, prepare to force place the insurance.⁵⁴

Regulated Lender Responsibility for Designated Loans Serviced by Third Parties

When a regulated lender originates a designated loan and later transfers or sells the servicing rights to a nonregulated party but retains ownership of the loan, the regulated lender remains ultimately responsible for fulfilling the flood insurance compliance requirements. The regulated lender must take adequate steps to ensure that the loan servicer will comply with all flood insurance requirements. Such steps include notifying FEMA or its designee of the identity of the new servicer.⁵⁵

ENFORCEMENT: CIVIL MONETARY PENALTIES

Under the NFIA, a regulated lender demonstrating a “pattern or practice” of violating any of the following statutory requirements is subject to civil monetary penalties (CMPs): 1) purchasing flood insurance where available, 2) escrowing flood insurance premiums when required, 3) force placing flood insurance after providing the requisite notice to the borrower, 4) providing notice of special flood hazards and the availability of federal disaster relief assistance, and 5) providing notice of the identity of the loan’s servicer and any change of that servicer to the regulatory entity.⁵⁶

The NFIA does not define “pattern or practice.” In determining whether a lender has engaged in a pattern or practice of flood insurance violations, Interagency Flood Q&A 82 states that the following factors may be considered whether:

- the conduct resulted from a common cause or source within the financial institution’s control;
- the conduct appears to be grounded in a written or unwritten policy or established practice;
- the noncompliance occurred over an extended period of time;

- the instances of noncompliance are related to one another (for example, whether the instances of noncompliance occurred in the same area of a financial institution’s operations);
- the number of instances of noncompliance is significant relative to the total number of applicable transactions (depending on the circumstances, however, violations that involve only a small percentage of an institution’s total activity could constitute a pattern or practice);
- a financial institution was cited for violations of the federal flood insurance statutes or the agencies’ regulations at prior examinations and the steps taken by the financial institution to correct the identified deficiencies;
- a financial institution’s internal or external audit process had not identified and addressed deficiencies in its flood insurance compliance; and
- the financial institution lacks generally effective flood insurance compliance policies and procedures or a training program for its employees.

While “[i]solated, unrelated, or accidental occurrences” will not be deemed a pattern or practice, “repeated, intentional, regular, usual, deliberate, or institutionalized practices will almost always constitute a pattern or practice.”⁵⁷

The BWA increased the maximum amount of CMPs for a “pattern or practice” of violating certain flood insurance requirements from \$385 to \$2,000 for each violation and removed the \$135,000 statutory cap on the amount of CMPs that may be assessed against an individual financial institution in a single calendar year.⁵⁸

The agencies assess CMPs for violations when required by the statute. In addition to imposing a substantial financial penalty, CMPs can cause reputational damage to financial institutions because the CMP orders are often reported by local media outlets and are tracked on websites.⁵⁹

CONCLUSION

Congress enacted the NFIA to reduce the costly burden of floods. In recent years, major flooding has caused devastating property losses, making the NFIA and its amendments even more crucial. It is important that financial institutions have strong flood insurance compliance programs. Specific issues and questions about consumer compliance matters should be raised with your primary regulator.

⁵⁴ See Interagency Flood Q&A 22.

⁵⁵ See Interagency Flood Q&A 44. The issue of third-party servicing compliance obligations is also discussed in Interagency Flood Q&As 45 through 50.

⁵⁶ See 42 U.S.C. 4012a(f). See also Interagency Flood Q&A 81.

⁵⁷ See Interagency Flood Q&A 82.

⁵⁸ See 42 U.S.C. §4012a(f)(5).

⁵⁹ See, e.g., Flood Civil Money Penalties, available at www.bankersonline.com/penalty/penalty-type/flood-civil-money-penalties.

to the borrower on that date but is permitted to wait until 45 days after sending the notice before force placing insurance. When determining whether to force place on the date a lender learns flood insurance is required, a lender may consider in the case of a lapsed policy that the National Flood Insurance Program provides a grace period during which an expired policy remains in effect for 30 days after its expiration date as long as the overdue premium is paid within 30 days. Therefore, a lender's greatest risk for a lapsed policy is the period after the grace period expires and before the lender is required to force place on the 46th day if the borrower does not comply.⁵

The final rule also requires a lender to refund any premiums and fees for the period during which a lender force placed flood insurance and the borrower already had coverage. The rule requires the lender to contact the insurer to terminate the force-placed insurance and refund any overlapping premiums and fees charged within 30 days of receiving proof of a borrower's existing flood insurance coverage. For purposes of confirming existing flood insurance coverage, a financial institution

or servicer must accept from the borrower an insurance policy declarations page that includes the existing flood insurance policy number, the identity of the insured, and contact information.

EFFECTIVE DATES

The mandatory escrow of flood insurance premiums provisions and the escrow option provisions becomes effective on January 1, 2016. The force-placement provisions became effective on July 6, 2012, when the BWA was enacted, and the detached structure exemption became effective on March 21, 2014, when the HFIAA was enacted.

CONCLUSION

It is important for financial institutions to become familiar with these new flood insurance regulatory requirements. Financial institutions should update their policies and procedures and provide training to their staffs to ensure compliance with these new flood insurance rules by the applicable effective dates. Specific issues and questions should be raised with the consumer compliance contact at your Reserve Bank or with your primary regulator.

Additional Resources

- Outlook Live webinar, "Interagency Flood Insurance Regulation Update," October 22, 2015, <https://consumercomplianceoutlook.org/outlook-live/2015/interagency-flood-insurance-regulation-update>
- "FDIC Banker Teleconference Series: Update on Mandatory Flood Insurance Purchase Requirements," December 9, 2014, www.fdic.gov/news/news/financial/2014/fil14059a.html
- FEMA's "Flood Insurance Manual," www.fema.gov/flood-insurance-manual
- FEMA's Flood Insurance Regulation, 44 C.F.R. Part 61
- FEMA's Flood Map Service Center, <http://msc.fema.gov/portal>

⁵ The grace period does not apply when a building or mobile home securing an existing loan is remapped into a special flood hazard area or when the borrower has an insufficient amount of insurance. (In the case of an insufficient amount of insurance, the grace period would apply only to the amount of the lapsed insurance policy, which is insufficient to protect the lender's security interest in the property.)

REGULATORY CALENDAR*

Effective Date	Implementing Regulation	Regulatory Change	Outlook Live Webinar
1/1/18 (most provisions)	Reg. C	Final rule implementing Dodd-Frank Act changes to the Home Mortgage Disclosure Act	
1/1/16	Reg. H	Final rule implementing provisions of the Homeowner Flood Insurance Affordability Act and the Biggert-Waters Flood Insurance Reform Act	10/22/15
1/1/16	Reg. Z	Final rule expanding definitions of <i>small creditor</i> and <i>rural</i> for purposes of certain mortgage rules with reduced regulatory requirements for small creditors and small creditors operating primarily in rural areas	
10/3/15	Regs. Z and X	Final rule extending integrated disclosure timing requirements for rate locks and requiring placement of the Nationwide Mortgage Licensing System and Registry ID on the Truth in Lending Act and Real Estate Settlement Procedures Act (TILA-RESPA) integrated disclosures	6/17/14 8/26/14 10/1/14 11/18/14 5/26/15
8/31/15	N/A	Final rule defining larger nonbank participants in the automobile financing market	
8/10/15	Reg. Z	Final rule implementing the Dodd-Frank Act requirements for appraisal management companies	
7/21/15	Reg. E	Final rule extending temporary provision allowing use of estimates for foreign remittance transfer pricing disclosures until July 21, 2020	
12/1/14	Reg. E	Final rule defining larger nonbank participants in international money transfer market	
11/3/14	Reg. Z	Final rule providing cure procedure for points and fees errors for qualified mortgage	
10/28/14	Reg. P	Final rule streamlining privacy notices	
†	Regs. Z and X	Proposal to make nine changes to mortgage servicing rules under the TILA and the RESPA	
†	Regs. E and Z	Proposal to provide consumer protection for prepaid cards	

* Links to the regulatory changes are available in the online version of *Outlook* at tinyurl.com/calendar-cco.

† Rulemaking proposals generally do not have an effective date.

NEWS FROM WASHINGTON: REGULATORY UPDATES*

The Consumer Financial Protection Bureau (CFPB) issues a report on electronic mortgage closings. On August 5, 2015, the CFPB published a report titled “Leveraging Technology to Empower Mortgage Consumers at Closing: Learnings from the eClosing Pilot.” The CFPB conducted a pilot research program with lenders and technology vendors to evaluate whether consumers benefit from eClosings, defined as mortgage closings that rely on technology for borrowers to view and sign closing documents electronically. Key findings in the report include the following: eClosings were associated with higher perceived consumer empowerment, efficiency, and understanding than paper closings; consumers who received and reviewed documents before closing felt more empowered in the closing process and had higher scores when quizzed about their actual understanding, relative to those who did not review documents before the closing meeting; and eClosing meetings were shorter than paper closings.

The CFPB issues a bulletin on the compliance requirements for private mortgage insurance (PMI). On August 4, 2015, the CFPB published a compliance bulletin to assist mortgage servicers in complying with the Homeowners Protection Act of 1998 (HPA), which governs when PMI must be canceled or terminated. The CFPB, which has observed industry confusion with the HPA’s requirements, published the bulletin to facilitate compliance.

The U.S. Department of Housing and Urban Development (HUD) seeks comment on proposed revisions to addendum to uniform residential loan application. On May 15, 2015, HUD published a notice seeking public comment on proposed revisions to the HUD Addendum to the Uniform Residential Loan Application. The changes would:

- differentiate between the initial and final Uniform Residential Loan Application;
- revise mortgagee certification on debarment and suspension to be loan specific;
- remove references to handbooks no longer in use by single-family housing;
- update language regarding acceptable sources of funds;
- provide current nondiscrimination language; and
- update terminology reflected in the new Federal Housing Administration’s Single Family Housing Policy Handbook (HUD Handbook 4000.1).

The public comment period closed on July 14, 2015.

The U.S. Department of Education (DOE) proposes consumer protections for student financial accounts. On May 18, 2015, the DOE issued a rulemaking proposal to provide new consumer protections for student financial accounts. Many colleges and universities have partnered with financial account providers to disburse financial aid, usually through debit or prepaid cards. The DOE issued the proposal to address consumer protection issues that have arisen with some account providers, such as charging recipients unavoidable fees to access their student aid funds and prioritizing disbursements to account providers’ own affiliated accounts over aid recipients’ preexisting bank accounts. The proposed regulations would, among other things, do the following:

- prohibit educational institutions from requiring students or parents to open specific accounts into which their credit balances are deposited;
- mitigate fees incurred by student aid recipients by requiring reasonable access to surcharge-free ATMs;
- prohibit point-of-sale fees and overdraft fees for T1 accounts (financial accounts used for disbursing Title IV funds) and allow students and parents to access Title IV funds without paying fees for up to 30 days after the funds are disbursed;
- require an institution to provide a list of account options from which a student may choose to receive credit balance funds, with each option presented in a neutral manner and the student’s preexisting bank account listed as the first, most prominent, and default option; and
- require institutions to ensure electronic payments made to a student’s preexisting account are treated the same as payments made to accounts marketed through the institution.

The DOE estimates the proposal would affect 9 million students receiving \$25 billion in Pell Grants and Direct Loan program funds through debit or prepaid cards. *Update:* On October 30, 2015, the DOE issued a final rule that largely adopted the proposed changes, which is available at www.gpo.gov/fdsys/pkg/FR-2015-10-30/pdf/2015-27145.pdf.

Agencies issue final rule on minimum requirements for appraisal management companies. On April 30, 2015, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the CFPB, the Federal Housing Finance Agency (FHFA), and the National Credit

* Links to the announcements are available in the online version of *Outlook* at www.consumercomplianceoutlook.org.



Union Administration (NCUA) (all inclusive: the agencies) issued a final rule to implement a provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act that mandated the agencies to establish minimum requirements for state registration and supervision of an appraisal management company (AMC). AMCs provide services to creditors or principals in the secondary mortgage market, including the hiring of licensed and certified appraisers to perform appraisals. The rule does not compel states to establish an AMC registration system. However, there is a consequence if a state does not establish an AMC registration system that applies the rule's minimum requirements for AMCs within 36 months of the effective date of the rule: Nonfederally regulated AMCs in that state will be prohibited from providing appraisal management services for federally related transactions until the state adopts a regulatory structure for AMCs that incorporates the rule's minimum requirements. Regarding the minimum requirements, AMCs must verify that 1) only state-certified or state-licensed appraisers are used for federally related transactions and 2) appraisals comply with the Uniform Standards of Professional Appraisal Practice and valuation independence standards in the Truth in Lending Act and implementing regulations. The

final rule became effective on August 10, 2015. AMCs that are subsidiaries of insured depository institutions do not have to register with a state but must comply with the minimum requirements by August 10, 2016.

Regulators release guidance on private student loans with graduated repayment terms at origination. On January 29, 2015, the Board, the OCC, the FDIC, the NCUA, and the CFPB, in partnership with the State Liaison Committee of the Federal Financial Institutions Examination Council, issued guidance for financial institutions on private student loans that have graduated repayment terms at origination. This guidance provides principles that financial institutions should consider in their policies and procedures for originating private student loans with graduated repayment terms — that is, those that are structured to provide for lower initial monthly payments that gradually increase. The guidance also states that financial institutions that originate private student loans with graduated repayment terms should underwrite the loans in a manner consistent with safe and sound lending practices and provide disclosures that clearly communicate the timing and the amounts of payments to facilitate a borrower's understanding of the loans' terms and features.

2015 Federal Reserve Board Consumer Affairs Letters

Consumer Affairs (CA) letters address significant policy and procedural matters related to the Federal Reserve System's consumer compliance supervisory responsibilities. CA letters are numbered sequentially by year.

CA 15-10	Supervisory Expectations for Supervised Institutions Regarding the TILA-RESPA Integrated Disclosure Rule
CA 15-9	Examinations of Insured Depository Institutions Prior to Membership or Merger into a State Member Bank
CA 15-8	Expansion of the Federal Reserve's Emergency Communications System
CA 15-7	Revised Interagency Examination Procedures for Regulation P
CA 15-6	Revised Interagency Examination Procedures for Regulation Z and Regulation X
CA 15-5	Transfer of SAFE Act Supervisory Responsibilities and Publication of SAFE Act Examination Procedures
CA 15-4	Expiration of the Protecting Tenants at Foreclosure Act
CA 15-2	Guidance to Encourage Financial Institutions' Youth Savings Programs and Address Related Frequently Asked Questions
CA 15-1	Guidance on Private Student Loans with Graduated Repayment Terms at Origination

ON THE DOCKET: RECENT FEDERAL COURT OPINIONS*

FAIR HOUSING ACT (FHA) — 24 C.F.R. §100.500

The U.S. Supreme Court rules that disparate impact claims are cognizable under the FHA. *Texas Department of Housing and Community Affairs v. Inclusive Communities Project, Inc.*, 135 S. Ct. 2507 (2015). The FHA prohibits discrimination in housing and mortgage lending, but legal challenges have raised questions about whether it solely allows disparate treatment claims or also permits claims of disparate impact (when neutral policies or practices have a disproportionately adverse effect on a prohibited basis). The plaintiffs asserted both types of claims against a Texas housing agency that allocated federal tax credits for low-income housing predominately to areas with high minority populations, allegedly perpetuating segregated housing. The district court rejected the disparate treatment claim but ruled in favor of the plaintiffs on the disparate impact claim. On appeal, the Fifth Circuit affirmed this part of the district court's ruling, and the agency appealed to the Supreme Court.

The Supreme Court affirmed that disparate impact claims are cognizable under Sections 804 and 805 of the FHA, based on the “results-oriented language” of the FHA and “the Court’s interpretation of similar language in Title VII and the ADEA [Age Discrimination in Employment Act], Congress’ ratification of disparate-impact claims in 1988 against the backdrop of the unanimous view of nine Courts of Appeals, and the statutory purpose.” The court first noted that “antidiscrimination laws should be construed to encompass disparate-impact claims when their text refers to the consequences of actions and not just to the mindset of actors” The court said this principle applies to Section 804(a) of the FHA because it makes it unlawful “[to] refuse to sell or rent ... or otherwise make unavailable or deny, a dwelling to a person because of race’ or other protected characteristic” The court also found that Section 805, concerning discrimination in residential real estate-related transactions, applies to disparate impact claims because the court had construed another statute with language similar to Section 805 to apply to disparate impact claims. In addition, when Congress amended the FHA in 1988, nine federal appeals courts had already upheld disparate impact claims under the FHA, and Congress did not disturb this interpretation. Finally, the court noted that disparate impact claims further the FHA’s policy against housing discrimination, stating, “[R]ecognition of disparate-impact liability under the FHA plays an important role in uncovering discriminatory intent: it permits plaintiffs to counteract unconscious prejudices and disguised animus that escape easy classification as disparate treatment.”

The court also clarified the three-step legal framework used to analyze disparate impact claims. First, the plaintiff must establish a prima facie case by identifying a specific policy that caused the disparity. The court explained that a disparate impact claim based solely on a statistical disparity fails if the plaintiff cannot identify the policy or policies causing that disparity. The court further noted that a “robust causality requirement ensures that ‘[r]acial imbalance ... does not, without more, establish a prima facie case of disparate impact’ and thus protects defendants from being held liable for racial disparities they did not create.” With respect to the second step in the framework, the court noted that “housing authorities and private developers [must] be allowed to maintain a policy if they can prove it is necessary to achieve a valid interest.” The court stated: “This step of the analysis is analogous to the business necessity standard under Title VII and provides a defense against disparate-impact liability.” The court stated that without the safeguards of the burden-shifting framework, disparate-impact liability “might displace valid governmental and private priorities, rather than solely ‘remov[ing] ... artificial, arbitrary, and unnecessary barriers.’” Third, with respect to the final step in the framework, the court quoted a previous opinion holding that a court must determine that a plaintiff has shown that there is “‘an available alternative ... practice that has less disparate impact and serves the [entity’s] legitimate needs.’” Finally, the court stated that when violations are found, the remedies should concentrate on eliminating the offending practice and, if additional measures are adopted, that those measures should strive to eliminate the racial disparities through race-neutral means. In light of the Supreme Court’s decision, the case was remanded to the Fifth Circuit for further consideration.

Federal court dismisses class-action lawsuit alleging FHA disparate impact violations. *City of Los Angeles v. Wells Fargo & Co.; Wells Fargo Bank, N.A.*, 2015 WL 4398858 (C.D. Cal. 2015). In 2013, the City of Los Angeles filed suit against Wells Fargo & Co. and Wells Fargo Bank, N.A. (collectively, “Wells Fargo”), alleging both FHA disparate treatment and disparate impact violations on the basis of race and national origin. Los Angeles alleged the disparate impact violations in connection with Wells Fargo’s supposed disproportionate origination to minority borrowers of loans classified as higher-priced mortgage loans under the Home Mortgage Disclosure Act (the court referred to the same as “high-cost loans” in its decision) and United States Federal Housing Authority (USFHA) loans. The case is one of the first to apply disparate impact analysis following the Supreme Court’s recent *Inclusive Communities* decision.



With respect to the 16 higher-priced mortgage loans (defined as loans with an annual percentage rate that is 1.5 or more points higher than the average prime offer rate [APOR] for first-lien loans and 3.5 or more points higher than the APOR for subordinate-lien loans), the court found that the disparity in Wells Fargo originations was statistically insignificant: Hispanic borrowers had a 0.0033 percent likelihood of receiving higher-priced mortgage loans, similarly situated African American borrowers had a 0.0067 percent likelihood of receiving higher-priced mortgage loans, and similarly situated non-Hispanic white borrowers had a 0.0008 percent likelihood of receiving higher-priced mortgage loans. The court noted that a disparate impact violation requires proof of a “significantly adverse” effect on minorities and observed that these negligible disparities did not meet that standard: “The City must provide evidence of a *significantly* disproportionate effect on minorities, and comparing thousandths of a percentage fails to meet the minimum threshold” The court further noted that, under *Inclusive Communities*, Los Angeles was required to identify a “robust causality” — that is, a Wells Fargo policy or policies that caused the alleged disparate impact — which it could not do.

With respect to the USFHA loans — of which Wells Fargo originated 625 to Hispanic borrowers, 140 to African American borrowers, and 385 to white borrowers — the court noted that *Inclusive Communities* required evidence of a practice that has a “disproportionately adverse effect on minorities.” Although the USFHA loans had some drawbacks compared with conventional mortgage loans, the court found that both the federal government (and, in prior years, Los Angeles) touted the virtues of USFHA loans, and an expert witness for Los Angeles acknowledged the “benefits of USFHA loans.” The court found that, when compared with conventional mortgages, USFHA loans were beneficial: “When the benefits and purpose of USFHA loans are considered, the Court fails to see how minority borrowers are adversely affected. USFHA loans allow low-income families, who could otherwise not qualify for a loan, to buy a home. ... Minority borrowers with poor credit and little money for a down payment can put their family in a home through a USFHA loan.” Additionally, regarding high-cost loans, the court noted that Los Angeles again was unable to identify a Wells Fargo policy or policies relating to USFHA loans that produced the alleged disparate impact. Accordingly, the court granted Wells Fargo’s motion for summary judgment.

PREEMPTION

Second Circuit holds that the National Bank Act (NBA) does not preempt a borrower’s home state usury law after a national bank lender assigns the loan to a creditor that is not a national bank. *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015). The NBA permits national banks to charge interest rates on loans to the extent permitted by the laws of the state where they are incorporated and preempts other states’ laws that are contrary. 12 U.S.C. §85. Here, the Second Circuit ruled that the NBA’s preemption of a state usury law does not apply after a national bank assigns a loan to a creditor that is not a national bank.

Midland Funding, a debt purchaser, bought charged-off consumer credit card debts, including the plaintiff’s credit card account, from Bank of America, a national bank. An affiliate of Midland Funding then contacted the plaintiff, a New York resident, to obtain payment and stated, under the cardholder agreement, the interest rate on the debt was 27 percent per year. The plaintiff filed a class-action lawsuit alleging that the interest rate violated New York’s usury law, which prohibits interest rates in excess of 25 percent per year. Midland Funding argued that it was entitled to charge a higher rate based on the laws of Delaware, where the assignor national bank was incorporated. The Second Circuit rejected this argument, finding that NBA preemption could only apply to such a creditor if it were an agent or a subsidiary of a national bank or was otherwise acting on behalf of a national bank or if the application of the challenged state law significantly interferes with a national bank’s ability to exercise its powers under the NBA. The court found that appropriately applying the usury law of a borrower’s home state to an assignee that is not a national bank would not limit the assignor national bank’s activities unless the new creditor was acting on behalf of the national bank: “To apply NBA preemption to an action taken by a non-national bank entity, application of state law to that action must significantly interfere with a national bank’s ability to exercise its power under the NBA.” In this case, however, Midland Funding owned the debt and was collecting it on its own behalf. Midland Funding also argued that a Delaware choice-of-law provision applied pursuant to the change in terms notice. The Second Circuit reversed the district court’s finding of NBA preemption and vacated its judgment for the defendants, returning the case to the district court for further proceedings consistent with its opinion — including Delaware choice-of-law provision, class certification, and Fair Debt Collection Practices Act claims that were dependent in part on the NBA preemption clause.

* Links to the announcements are available in the online version of *Outlook* at www.consumercomplianceoutlook.org.

OUTLOOK LIVE YEAR IN REVIEW

As 2016 is beginning, we would like to wish all of you a happy new year! Since Outlook Live covered most of the hot topics throughout the year in the Interagency Fair Lending Hot Topics and Common Violations and Hot Topics sessions, we did not host our annual Year-in-Review webinar; however, we want to provide a year-end recap to highlight recent regulatory developments and to direct you to some additional resources. While this list is not all-encompassing, we hope you will find it useful.

- **TILA-RESPA Integrated Disclosure (TRID) Rule** — In coordination with the Consumer Financial Protection Bureau (CFPB), we have hosted five Outlook Live webinars on TRID, which went into effect on October 3, 2015. All five events are archived and are available for playback through our archives page. For easy access to the information covered during the webinars, we have compiled an index of questions discussed during the webinar to help you locate and access information more quickly. For additional information and resources related to TRID, please refer to the CFPB's Regulatory Implementation page.
- **Flood Insurance Rule** — On October 22, 2015, we hosted an Outlook Live session titled Interagency Flood Insurance Regulation Update, in which the agencies discussed the recent updates to the flood insurance regulations. The topics included:
 - escrow of flood insurance premiums and fees;
 - force-placed flood insurance; and
 - detached structures exemption.

Consistent with all of our events, this one has been archived and is available for replay. We have also posted an event transcript for easier access to both the discussion and the Q&As covered during the event. Because we received a large number of questions during the event, we will also be publishing a *Consumer Compliance Outlook* article to address the more common questions that we received.

- **Home Mortgage Disclosure Act (HMDA) Final Rule** — On October 15, 2015, the CFPB issued a final rule that updates the reporting requirements of the HMDA regulation. To facilitate bankers' understanding of the rule, the CFPB has released numerous resources, including the HMDA Executive Summary, HMDA Key Dates Timeline, HMDA Compliance Guide, Summary of Reportable Data, and Institutional Coverage Charts for 2017 and 2018, all of which are posted to the CFPB's Regulatory Implementation page.
- **CFPB's Future Rulemaking** — For those of you who are interested in the CFPB's rulemaking activity, the CFPB posted its fall 2015 rulemaking agenda on November 20, 2015. The semiannual rulemaking agenda provides an overview of the CFPB's major rulemaking initiatives in prerule, proposed rule, final rule, long-term, and completed stages. Among its shorter-term initiatives, the CFPB expects to issue a final rule related to prepaid accounts in spring 2016 and a proposal related to payday, auto title, and similar products in the first quarter of 2016.

We are constantly trying to improve our outreach and guidance efforts and to address topics of interest to the industry, so if there are any topics you would like us to cover, please send your suggestions to fedwebinar@sf.frb.org.

The Federal Reserve System regularly conducts Outlook Live webinars on consumer compliance topics. Here are the archived webinars from 2014 and 2015, which are available for replay free of charge. You can view the webinars and presentation slides on the Outlook Live archive page at www.consumercomplianceoutlook.org/outlook-live/archives.

Date	Webinar	Description
10/22/15	Interagency Flood Insurance Regulation Update	Presenters from the banking agencies explain the new flood insurance final rule.
10/15/15	2015 Interagency Fair Lending Hot Topics	Presenters from the federal agencies charged with enforcing the Equal Credit Opportunity Act and/or the Federal Housing Administration discuss a number of hot topics.
7/29/15	Common Violations and Hot Topics	Presenters from the Federal Reserve System discuss common violations involving Regulation C, Regulation B — Spousal Signatures, Flood Disaster Protection Act of 1973, and Unfair and Deceptive Acts or Practices Act.
5/26/15	TILA-RESPA Integrated Disclosures, Part 5 — Implementation Challenges and Questions	This session reviewed implementation challenges and questions.
12/4/14	Consumer Compliance Hot Topics — 2014 Year in Review	This session discussed significant 2014 compliance changes and previewed changes for 2015.
11/18/14	FAQs on the TILA-RESPA Integrated Disclosures, Part 4 — Completing the Closing Disclosure	This session focused on issues related to completing the closing disclosure.
10/22/14	2014 Federal Interagency Fair Lending Hot Topics	This session focused on the expectations for compliance management systems, fair lending risk assessments, real estate owned properties, maternity leave discrimination, mortgage pricing risks, and auto lending enforcement. The presenting agencies were the U.S. Department of Justice, Consumer Financial Protection Bureau, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Federal Reserve System, U.S. Department of Housing and Urban Development, and National Credit Union Association.
10/1/14	FAQs on the TILA-RESPA Integrated Disclosures Rule, Part 3 — Completing the Loan Estimate	This session focused on questions related to rule interpretation and implementation challenges for loan estimates.
8/26/14	FAQs on the TILA-RESPA Integrated Disclosures, Part 2 — Various Topics	This session covered application, scope, record retention, timing for delivery, tolerance, and basic form contents for the disclosures.
7/17/14	Interagency Questions and Answers Regarding Community Reinvestment	This session covered revisions to the Interagency Q&As Regarding Community Reinvestment Act (CRA) issued in November 2013 and the revised interagency Large Institution CRA Examination Procedures issued in April 2014.
6/17/14	TILA-RESPA Integrated Disclosures, Part 1 — Overview of the Rule	This session provided an overview of the integrated disclosure final rule and addressed compliance questions.
4/10/14	Consumer Compliance Management Program — Common Concerns and Best Practices	This session discussed concerns commonly seen at Federal Reserve-supervised institutions and highlighted various components of a successful compliance program.

CONSUMER COMPLIANCE OUTLOOK

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CALENDAR OF EVENTS 2016

February 7–10

Pathways to Economic Opportunity

2016 National Interagency Community Reinvestment Conference
Federal Reserve Bank of San Francisco, FDIC, OCC, CDFI Fund
JW Marriott at L.A. Live
Los Angeles, CA

March 11–17

ABA National Compliance School

Doubletree Mission Valley
San Diego, CA