A. INTRODUCTION

The 1994 National Flood Insurance Reform Act (the Reform Act) is part of Title V of the Riegle Community Development and Regulatory Improvement Act of 1994 and amended 42 U.S.C. §4001 et seq. The Reform Act imposes significant new obligations on lenders and servicers and tightens the requirements on the receipt of disaster assistance.

1. Brief Description of the National Flood Insurance Program

Prior to 1968, the Federal Government attempted to control coastal and riverine flooding on a national scale through re-channeling, using dams and levees to restrict the flow of waters, as well as through development of hydroelectric power and irrigation. But the increasing costs of these projects and high annual totals of flood-related damage influenced the Government to explore the possibility of decreasing disaster relief payments through flood insurance.

In spite of all these actions, vast sums of money continued to be expended through the response mechanism of Federal disaster assistance. From the standpoint of the Federal Government, the question to be decided was through which mechanism Federal funds would be made available most effectively after a flood, i.e., disaster assistance or flood insurance payments.

In 1968, flood insurance coverage was virtually unavailable in the private sector. The private insurance industry was then, and remains now, largely unwilling to underwrite and bear the risk of flood because of its catastrophic nature. Moreover, the risk of flood is subject to adverse selection, a situation in which only the less desirable risks with higher expected losses choose to insure, thereby giving rise to underwriting losses. Consequently, Congress decided to provide coverage through a Federal flood insurance program to help reduce the costs of expensive disaster relief payments.

Through the National Flood Insurance Act of 1968, Congress authorized the National Flood Insurance Program (NFIP), which provided an opportunity for property owners to purchase flood insurance protection for structures and contents from the Federal Government. The NFIP combines the concepts of insurance protection and hazard mitigation. This Program provides an incentive for communities to adopt floodplain management ordinances to mitigate the effects of flooding upon new or existing construction. (Citations referring to the statutory authority of the Program can be found in Appendix 1.)

The 1968 Act made federally subsidized flood insurance available to owners of improved real estate or mobile homes located in a floodplain if their community participated in the NFIP. The Act defines improved real estate as real estate upon which a building is located. Under the NFIP, this means a walled and roofed building or a building in the course of construction, qualifying for insurance coverage. The term "improved real estate," as used throughout these guidelines, includes mobile homes, unless otherwise stated.

A community establishes its eligibility to participate in the NFIP in two ways:

- By adopting and enforcing floodplain management measures to regulate new construction, and

- By ensuring that substantial improvements to existing structures within its Special Flood Hazard Areas (SFHAs) are designed to eliminate or minimize future flood damage.

An SFHA is an area within a floodplain having a 1 percent or greater chance of flood occurrence in any given year. SFHAs are delineated on maps issued by the Federal Emergency Management Agency (FEMA) for individual communities. These flood zones are represented on the flood maps by the darkly shaded areas with zone designations that include the letter A or V.

Federal flood insurance was initially available only through insurance agents who dealt with the Federal Insurance Administration (FIA). This "direct" policy program has been supplemented since 1983 with a program known as "Write Your Own (WYO)," through which more than 90 insurance companies, based on an arrangement with the FIA, issue policies and adjust flood claims under their own names. The insurers receive an expense allowance and remit premium income in excess of claims to the Federal Government. The FIA pays losses in excess of premiums and sets the rates, coverage limitations, and eligibility requirements. The premium charged for NFIP flood coverage by a WYO Company is the same as that charged by the Federal Government through the direct program.

2. The Mandatory Flood Insurance Purchase Requirement

a. Flood Disaster Protection Act of 1973

From 1968 until the adoption of the Flood Disaster Protection Act of 1973, the purchase of flood insurance was voluntary. Property owners could make their own decisions whether to purchase flood insurance. However, the 1973 Act mandated NFIP coverage for many properties. For the first time, regulated lending institutions could not make, increase, extend, or renew any loan secured by improved real estate or located in an SFHA in a participating community unless the secured property and any personal property securing the loan was covered for the life of the loan by flood insurance. This measure was necessary because, after major flooding disasters, it became evident that relatively few individuals who sustained flood damage had purchased flood insurance. Although nearly all the eligible communities are now in the Program, fewer than 25 percent of the eligible structures are actually covered by flood policies. Market penetration is highly variable from community to community. As shown by past disasters, coverage has been as low as 10 percent or less in some communities and as high as 75 percent in certain coastal communities.

Overall, history has proven that voluntary participation, as well as a mandatory

program with weak sanctions, yields too few subscribers.

b. National Flood Insurance Reform Act of 1994

Following the multi-billion dollar flood damage in the Midwest during the summer of 1993, Congress revisited the mandatory purchase law and enacted the 1994 Reform Act. The reasons for the Reform Act included the NFIP's low reserves, resulting from a series of storms, as well as a low level of participation among eligible property owners. At that time it was estimated that fewer than 2 million of the 11 million structures in SFHAs were covered by flood insurance. This low level of coverage persisted for several reasons:

- Some homeowners believed that they simply could not afford the cost of flood insurance in addition to mortgage payments and homeowners' insurance.

- Federally regulated lending institutions often were relaxed in enforcing the mandatory purchase provision without the sanction of a penalty.

- Homeowners who purchased flood insurance at the origination of their mortgages often allowed their policies to lapse.

A combination of these factors led to a low percentage of eligible homeowners purchasing flood insurance and kept disaster relief payments high. Congress recognized that the proper response was to bring more property owners into the Program by creating more inducements to purchase coverage.

Congressional activity culminated with the passage of H.R. 3474, which was enacted as 103 P.L. 325, Title V, 108 Stat. 2160, 2255-87 (Sept. 23, 1994), generally referred to as the 1994 Reform Act. The Conference Committee's report that accompanies the legislation at H.R. Conf. Rep. No. 652, 103rd Cong. 2d Sess. 195 (1994) (Conference Report) describes the reasons for the amendments to the Act.

As stated in the report, the legislation contains important reforms to improve the financial condition of the NFIP. A primary purpose of the legislation is to improve compliance with the mandatory purchase requirements of the NFIP by lenders, servicers, and secondary market purchasers. Improved program compliance will increase participation nationwide by those individuals who have mortgaged homes or businesses in SFHAs, but have not purchased or maintained flood insurance coverage. Increasing compliance and participation in the NFIP is also designed to provide added income to the insurance fund and decrease the financial impact of flooding to the Federal Government, to taxpayers, and to citizens in areas prone to flooding.

The law requires Federal agency lenders and regulators to develop regulations to direct their federally regulated lenders not to make, increase, extend, or renew any loan on applicable property unless flood insurance is purchased. The proposed regulations were jointly issued in the October 18, 1995, Federal Register at Vol. 60, No. 201, p.53962; the final regulations appeared in the August 29, 1996, Federal Register at Vol. 61, No. 169, p.45683. A version of the regulations is attached as Appendix 2. Most of the final regulations have an effective date of October 1, 1996. Exceptions are the implementation of the Farm Credit Administration regulations, with an effective date of October 4, 1996, and the National Credit Union Administration regulations, with an effective date of November 1, 1996.

In response to numerous requests for additional information, the agencies will issue informal guidance to address technical issues after the promulgation of the joint final regulations.

The centerpiece of the mandatory purchase requirements is found in the statute at 42 U.S.C. §4012a(b) (see Appendix 3). Certain notice requirements that complement these substantive requirements are found at 42 U.S.C. §4104a and §4104b (see Appendix 4). These sections address the responsibility of regulated lending institutions, as well as Government-Sponsored Enterprises (GSEs), in providing notice of and requiring flood coverage for the term of the loan on property located in any SFHA in participating communities.

The 1994 Reform Act significantly tightens the 1973 Act by imposing important new obligations on both mortgage originators and servicers, including mandatory escrow requirements for flood insurance and mandatory provisions for "forced placement" of flood insurance.

Although the intent of the statute is to require borrowers to purchase flood insurance, the Act's directives and prohibitions are directed to federally regulated primary lenders and to secondary market entities involved in loan transactions. The flood insurance requirements do not apply to lenders or servicers that are not federally regulated and that do not sell loans to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (Fannie Mae and Freddie Mac) or other GSEs. The 1994 Reform Act indirectly impacts regulated as well as unregulated lender security, because borrowers who have received certain disaster assistance and then fail to obtain flood coverage are barred from receiving future disaster aid.

In recognition of those recipients of Federal disaster assistance who continue to remain uninsured, thereby increasing the chances they will need Federal disaster assistance again, the 1994 Reform Act makes it clear that the requirement to purchase flood insurance is not to be waived for any purpose. Removing the availability of disaster assistance thus encourages individuals to purchase flood insurance rather than have no funds available when a loss occurs. Disaster assistance for temporary housing and for purposes other than repairing or rebuilding structures is not affected by this new provision.

A key clarification of the 1994 Reform Act is that flood insurance must be obtained and maintained during the term of the loan. This provision also applies to Fannie Mae and Freddie Mac on any "covered loan" they buy. Flood insurance will be required even if the SFHA designation is first identified after settlement, but during the term of the loan. This requirement is designed to combat coverage lapses allowed to occur by individuals who believe they will not be flooded, and therefore discontinue payment of flood insurance premiums during the term of the loan.

It is a prerequisite that a designated loan have flood insurance as a condition of closing. If a borrower will not voluntarily obtain coverage and a lender is unable to force place coverage, the lender must deny the loan or exercise the sanction provisions of the loan document if the loan already has been made. A lender cannot accept a borrower's assurance that he or she will obtain coverage in the future or grant the lender indemnity while seeking coverage. Closing a designated loan without coverage in place constitutes a violation of the regulation.

The 1994 Reform Act is designed to strengthen compliance with mandatory

purchase requirements. The Act is applicable when a lien is taken as security for a loan transaction on improved real estate or a mobile home. Under the new law, lenders' responsibilities include the following actions:

- Determine whether the structure offered as security for a loan is, or will be, located in an SFHA;
- Document the determination of flood hazard status;
- Require that flood insurance to the appropriate limit is obtained when necessary; and
- During the term of the loan, ensure that flood insurance is maintained or added if the lender becomes aware that the property involved subsequently becomes part of an SFHA.

While the mandatory purchase requirement applies only to properties located in SFHAs of participating communities, NFIP flood insurance is available in all areas of participating communities. This is especially significant because, historically, one-third of the NFIP claims paid have actually been outside of SFHAs. Lenders and property owners may wish to exercise additional caution in areas subject to flooding due to storm water, in areas where the NFIP has used approximate methods to map flood hazard areas, or in remote locations where no flood hazard areas have been designated by FEMA. In January 1989, to facilitate the purchase of flood insurance outside of SFHAs, the NFIP began offering a low-cost "preferred risk" policy for structures located in Zones B, C, and X.

Some properties in a participating community may be ineligible for flood insurance because of statutory restrictions or NFIP underwriting rules. See Section B.2.d for a discussion of the consequences of the unavailability of flood insurance in such instances.

As detailed later in these guidelines, the 1994 legislation's mandatory purchase requirement applies to any loan made, increased, extended, or renewed since September 23, 1994. The Conference Committee, in its report on the legislation, states its view that the making, increasing, extending, or renewing of a loan serves as a "tripwire" of sorts for compliance with the flood insurance purchase requirements. In the modern mortgage marketplace, this approach makes compliance by lenders increasingly more likely, as borrowers obtain new loans on existing structures or refinance existing loans. At each designated "tripwire" in the mortgage process, the legislative intent is for a lender or servicer to ensure that flood insurance is purchased and maintained.

As stated in the Supplementary Information section of the final regulation, a requirement for flood insurance on secured property that is not subject to the Federal flood insurance statutes is a matter of contract between the lender and borrower.

B. COVERAGE AVAILABILITY

1. Participating Communities

a. Community Ordinances

FEMA conducts studies throughout the United States to determine the location of Special Flood Hazard Areas (SFHAs) in each community. Based on these studies, FEMA issues Flood Hazard Boundary Maps (FHBMs) and Flood Insurance Rate Maps (FIRMs) showing the location of these areas and notifies each community of the determination.

Following notification, if a community decides to participate in the NFIP, it enters