Introduction

The 2005 hurricane season was one of the most devastating in history. The Federal Emergency Management Agency (“FEMA”) has estimated that hurricanes Katrina, Rita and Wilma resulted in approximately $23 billion in flood insurance claims — more than the sum of all claims paid since the National Flood Insurance Program (“NFIP”) began in 1968. With the scientific community warning that we are entering a warm Atlantic phase which brings with it an active hurricane era, the great hurricanes of 2005 may be only the beginning of a period of more intense, destructive storms. In future years, the NFIP cannot sustain losses similar to the unprecedented losses of 2005 and continue to function effectively. Critics contend that the need for reform has never been more urgent. The old adage may be that “a rising tide lifts all boats”, but many fear the rising flood waters of an active hurricane era may sink the National Flood Insurance Program unless swift action is taken.

This article reviews the history of the NFIP. It then describes the NFIP as it functions today, with a specific focus on (i) the identification and mapping of flood prone areas, (ii) lender compliance with the mandatory flood insurance purchase requirements, and (iii) regulatory penalties imposed upon non-compliant lenders. This article then examines current problems with the NFIP and concludes by reviewing proposed reforms and their implications for the mortgage lending industry.

National Flood Insurance Program History

Flooding is the most destructive natural disaster in the United States. Magnifying this problem is the fact that flood damage is not covered by standard property insurance. Property insurance policies cover casualties such as wind and fire, but specifically exclude damage from floods.

Prior to 1968, no federal program for flood insurance existed. The federal government attempted to control flooding nationally through the use of dams and levees to restrict the flow of waters. The catastrophic nature of flooding combined with the difficulty of predicting flood losses led private insurers to decline to issue flood insurance. Thus, federal disaster relief was the only financial assistance provided to flood victims. And this relief came at a tremendous cost to taxpayers.

In an effort to halt the mounting costs of flood disasters, Congress, in 1968, passed the National Flood Insurance Act (the “Act”), which created the NFIP. The NFIP provides an opportunity for property owners in
participating communities to insure buildings and their contents from flood losses at reasonable rates.

From 1968 to 1973, the purchase of flood insurance was voluntary. It soon became evident, however, that a relatively small percentage of property owners in participating communities had voluntarily purchased the insurance. To further shift financial responsibility for flood damage from taxpayers to property owners, Congress next passed the Flood Disaster Protection Act of 1973. This amendment to the Act required property owners to purchase flood insurance (sometimes called mandatory flood insurance purchase requirements) by regulating lending institutions. Federally regulated lenders were prohibited from making, extending or renewing any mortgage loan secured by improved property located in a flood zone in a participating community unless the buildings in the flood zone were insured against floods for the term of the loan.

Congress further strengthened these mandatory flood insurance purchase requirements with the National Flood Insurance Reform Act of 1994. The Reform Act attempted to apply greater pressure on lenders to ensure borrower compliance with the mandatory flood insurance purchase requirements. It provides for, among other provisions, the assessment of civil penalties against noncompliant lenders.

The Current Program

FEMA, now a branch of the Department of Homeland Security ("DHS"), administers the NFIP. Recent history aside, the NFIP is intended to be self-supporting. During periods of heavy flooding, however, the NFIP has authority to borrow from the United States Treasury to cover program shortfalls. Prior to September 2005, the NFIP had authority to borrow up to $1.5 billion in this way. Following the 2005 hurricane season, that limit was increased to nearly $21 billion to account for the claims resulting from hurricanes Katrina, Rita, and Wilma.

The NFIP has three central components. These are (1) identifying and mapping flood-prone communities, (2) requiring mortgage lenders to enforce the mandatory flood insurance purchase requirements, and (3) providing regulatory compliance oversight. This article briefly addresses each component below.

Identifying and Mapping Floodplains

FEMA from time to time conducts studies to determine the locations of special flood hazard areas ("SFHAs"). These are areas located at or below the "base-flood elevation". That is, an elevation at which there is a one percent or greater chance of flood waters reaching or exceeding the elevation in any given year. These areas are commonly referred to together as the "100-year floodplain". Property owners located in these areas who obtain mortgage loans must comply with the mandatory flood insurance purchase requirements of the NFIP.

Once a community’s SFHAs are identified, it must decide whether to participate in the NFIP. If a community elects not to participate, property owners within the community will not receive federal flood insurance. Perhaps more importantly, federal disaster assistance is available on only a limited basis for properties in non-participating communities. Communities become eligible to participate in the NFIP by fulfilling the following two requirements:

- Implementing and enforcing floodplain management measures that regulate new construction, and
- Ensuring that substantial improvements to existing structures within identified SFHAs are designed to eliminate or minimize future flood damage.

Mortgage Lender Compliance

The Act applies to all federally regulated lenders. The banking regulators charged with implementing the Act
include the Federal Reserve Board, the Office of the Comptroller of Currency ("OCC"), the Office of Thrift Supervision ("OTS"), the Federal Deposit Insurance Corporation ("FDIC"), The National Credit Union Association ("NCUA"), and the Farm Credit Administration ("FCA"). These six agencies (the "Agencies") have issued joint regulations implementing the requirements of the NFIP applicable to mortgage lenders. Under the regulations, five principal obligations are imposed on federally regulated mortgage lenders. Lenders must:

- Determine whether any building included as collateral for a mortgage loan is located in a SFHA and, if so, provide notice to the borrower,
- Document the flood zone determination using the prescribed Standard Flood Hazard Determination Form (a "Standard Flood Form"),
- Require borrowers to obtain flood insurance in the appropriate dollar amount when required by the Act,
- Ensure that any required flood insurance is maintained during the term of the mortgage loan, and
- Force-place flood insurance in appropriate circumstances.

These five obligations will be reviewed below.

Flood Zone Determinations and Notices

Responsibility for determining whether a building lies within a SFHA falls to the lender. The regulations do not permit lenders to shift this burden to the borrower. The NFIP does permit lenders to rely, to a limited extent, on certain third parties (e.g., flood hazard search companies) in determining whether a building lies within a SFHA. Reliance on such parties cannot be used for exculpatory purposes, however, if a lender is faced with a regulatory violation.

Once a lender has determined that a building proposed to secure any mortgage loan to be originated by the lender is located in a SFHA, the lender must provide notice to both the borrower and, if applicable, the loan servicer. This notice is known as a "Notice of Special Flood Hazard and Availability of Federal Disaster Relief Assistance" (a "Flood Notice"). The Flood Notice must include the following items:

- A general warning of the risk of flooding,
- A description of the mandatory flood insurance purchase requirements,
- A discussion of disaster relief eligibility, and
- An explanation of how flood insurance may be obtained in the applicable community.

A Flood Notice must be given in writing within a reasonable period prior to the closing of the transaction. Guidelines released by the Agencies suggest that 10 days prior to closing is a reasonable period.

If the mortgaged property is located in an SFHA, a federally regulated lender must also notify the Director of FEMA’s designee of the identity of the loan servicer at the following times: (i) when the loan is made, (ii) at any time the loan is increased, extended, renewed, sold, or transferred, and (iii) upon any change in the identity of the loan servicer. Information required to be included in this notice includes the following:

- The borrower’s name,
- The flood insurance policy number,
- The property address (including city and state),
- The name of the lender or servicer making the notification,
- The name and address of any new servicer, and
- The name and telephone number of the contact person at any new servicer.
Such notices must be given within 60 days after the effective date of the change that triggers the notice requirement.

**Standard Flood Form**

Independent of the above obligations, the NFIP requires each federally regulated lender to complete a Standard Flood Form for each improved mortgaged property that it finances with a mortgage. The Standard Flood Form documents that a determination was made as to whether a building is located in a SFHA. It also indicates whether flood insurance is required under the NFIP and whether federal flood insurance is available in the community in which the building is located. The form must be completed for all mortgaged properties, regardless of whether flood insurance is ultimately required.10

There are, however, two small exceptions to the mandatory use of a Standard Flood Form. First, a flood determination previously made may be reused for a transaction comprised of the increase, extension, renewal, or purchase of an existing mortgage loan if:

- the previous determination is less than 7 years old,
- no new or revised FIRM has been issued in the interim, and
- the previous determination was documented on a Standard Flood Form.

Second, a new Standard Flood Form need not be obtained when a borrower obtains a second mortgage on a property from the same lender that holds the first mortgage on the property. In that case, the lender may rely upon the original Standard Flood Form so long as no remapping has occurred and the borrower provides evidence that adequate flood insurance is in place for both loans. Notwithstanding these exceptions to the general rule, most lenders do not monitor changes to FIRMs. Thus, the common practice in the industry is to obtain a new Standard Flood Form even where an exception may apply.

**Coverage Limits**

Once a lender determines that flood insurance is required by the NFIP, it must ensure that the borrower obtains the appropriate dollar amount of coverage. Regulations adopted under the Act require the borrower to purchase flood insurance in an amount equal to the lesser of:

- the outstanding principal balance of the loan, or
- the maximum amount of coverage available under the Act.11

The mandatory flood insurance purchase requirements apply only to improved real estate. This means real estate on which a walled and roofed building or a building in the course of construction is located.

**Maintain Life of Loan Coverage**

The Act requires that flood insurance be put in place at the time a mortgage loan is originated or at any other time during the term of the loan that the lender first determines a building included as collateral is located in a SFHA. The NFIP, however, does not require lenders to actively monitor their loan portfolios for compliance purposes. Instead, triggers have been established to alert lenders to any non-compliance with the mandatory flood insurance purchase requirements.

The increase, extension, or renewal of a loan is one such trigger. Upon any of these events, the lender must take steps to ensure that the property securing the loan complies with NFIP requirements. Note that the assignment or sale of a lender’s interest in a loan does not, in and of itself, trigger the mandatory flood insurance purchase requirements.

As a practical matter, following loan origination there are very few triggers that will alert lenders to whether a
loan fails to comply with the mandatory flood insurance purchase requirements. Two examples, however, should be kept in mind. First, a known FIRM change that places a building serving as collateral for a mortgage loan in a SFHA will trigger a NFIP compliance review of the loan. This trigger, however, appears to have little practical effect. Neither the Act nor the Agencies’ regulations require lenders to actively monitor changes to FIRM. Thus, FIRM changes are unlikely to be “known” to lenders and therefore lenders may often be unaware of a non-compliant borrower.

Second, receipt by a lender of notice that payment of a flood insurance policy premium is past due is another compliance review trigger. Federally regulated lenders must require that their borrowers maintain flood insurance coverage on each building located in a SFHA for the entire term of the loan. This trigger is somewhat more effective than the previous one, in that mortgage lenders are generally well equipped to monitor a borrower’s compliance with loan document insurance covenants.

Forced Placement of Flood Insurance

The NFIP places the responsibility to force-place flood insurance on federally regulated lenders in instances where the borrower either fails to obtain flood insurance or has obtained insufficient coverage. In such cases, the Act authorizes a lender to purchase flood insurance and pass the premium on to the borrower.

The Agencies’ regulations provide that a mortgage lender must force-place insurance only after determining that required flood insurance is absent or that a property is underinsured. In contrast, if a flood insurance deficiency exists at the time of loan origination, the lender is barred from making the loan at all.

Prior to force-placing flood insurance, the lender must notify the borrower of its failure to comply. The notice must state that the borrower is required, at the borrower’s expense, to obtain flood insurance in the required amount. Should the borrower fail to comply with the notice, then it is the responsibility of the lender to force-place the appropriate amount of flood insurance.12

There are, however, instances in which flood insurance is not federally mandated, even for structures located in a SFHA. Examples include:

- small loans (less than $5,000),
- loans by lenders that are not federally regulated,
- loans secured by unimproved real estate, and
- loans secured by properties in non-participating communities.

Although the mandatory flood insurance purchase requirements are not applicable to unregulated lenders, such lenders ignore the NFIP’s provisions at their own peril. Future loan syndicate members or assignees (many of whom may be regulated lenders themselves) may require evidence of compliance with the NFIP even if the agent or lead lender is not federally regulated.

Regulatory Penalties

Under the 1994 Reform Act, Congress authorized the assessment of civil penalties when a lender fails to place insurance, comply with the notice requirements described above, or force-place flood insurance in a manner that constitutes a “pattern or practice of committing violations”. The penalties are currently $350 per violation. At no time, however, can the aggregate amount of penalties per year for a single federally regulated lending institution exceed $100,000.

The ill will of regulators is often more problematic for a regulated lender than any regulatory fine. Unsatisfactory audit results and, in extreme cases, cease and desist orders may be a greater deterrent to non-compliant lenders than any NFIP penalty.
Problems with the Current Program

Critics complain that the NFIP is a complex program that is currently failing to achieve its objectives. This article next highlights three of the major deficiencies in the NFIP that experts have asked Congress to address.

Weak Regulatory Compliance Scheme

Although federally regulated mortgage lenders must ensure that improved properties in SFHAs are covered by flood insurance, critics maintain that there is no effective compliance scheme to ensure that such coverage is maintained throughout the term of each mortgage loan. Although available data on the degree of lender compliance with the NFIP is inconclusive, studies have suggested that compliance levels could be improved. The root of the problem may be a general lack of accountability under the NFIP. Nothing in the Act or the Agencies’ regulations beyond the few triggers discussed above would require lenders to actively monitor and track loans to ensure that adequate flood insurance is maintained. In support of this criticism, critics point to the fact that after each major flooding disaster damaged properties are identified that were uninsured or underinsured in contravention of the Act’s requirements.

Low Participation Rates

A common criticism of the NFIP is that participation rates remain low. One reason for persistently low participation may be a general misunderstanding of the 100-year floodplain. The 100-year floodplain is often interpreted to mean that a community within the floodplain will flood once every 100 years. In fact, there is a greater than 25% chance of flooding in the 100-year floodplain over any 30-year period. Similarly, the risk of flooding outside of the 100-year floodplain may be much higher than property owners believe. Nationwide, nearly 25% of flood insurance claims relate to properties located outside the 100-year floodplain. These misperceptions impede the voluntary purchase of flood insurance, even for properties at high risk of flooding.

A second possible explanation for low participation rates is that the NFIP does not require flood insurance for buildings that lie in floodplains where man-made structures, such as levees and dams, have been constructed to prevent flooding. Such was the case for many of the New Orleans properties devastated by Hurricane Katrina. Critics contend that it is unrealistic of the NFIP to ignore the possibility that levees and dams may be breached by a hurricane.

Subsidized Insurance Rates

For many of the riskiest properties flood insurance is provided under the NFIP at subsidized rates that are not actuarially sound. Two types of properties qualify for subsidized rates: (1) structures built prior to the mapping and implementation of the NFIP floodplain management requirements (known as pre-FIRM structures) and (2) structures entitled to an “administrative grandfather”. The first category consists of structures that have been located in SFHAs for many years. The second category consists of structures that, while not originally included in a SFHA, are subsequently remapped into a SFHA because of base-flood elevation changes. The administrative grandfather permits such structures to retain the flood insurance rates associated with their former designation.

On average, subsidized policyholders pay only 40% of a full risk-based premium. The rationale for these subsidies is twofold. First, the detailed information about risks that FIRMS provide was not available when pre-firm structures were constructed. Second, premiums based on actual flood risk may be high enough to discourage participation in the NFIP.

Defenders of the subsidies note that historically the NFIP has collected premiums sufficient to cover all claims made in a typical year. In a catastrophic year like
2005, however, the NFIP has reserves that are not sufficient to pay for the devastating losses incurred.

Possible Reforms
The remainder of this article discusses possible reforms that could be implemented and the implications, both positive and negative, of such reforms for regulated lenders. These reforms are currently being considered by federal lawmakers. It is unlikely, however, that decisive action will be taken in an election year.

Improve Compliance
To improve compliance with the NFIP, critics have suggested that Congress amend the Act to require (rather than recommend) life-of-loan portfolio tracking by lenders, including the active monitoring of FIRM changes. The goal of such a change would be to more effectively ensure that lenders will require their borrowers to obtain and maintain flood insurance as and when required by the NFIP.

Requiring on-going map monitoring or adding remapping as a trigger event for the mandatory flood insurance purchase requirements could increase loan administrative costs for lenders. Query whether this burden could be effectively off-loaded onto borrowers.

Expand Participation
Critics have suggested that one method of expanding participation in the NFIP would be to expand mandatory flood insurance purchase zones from the 100-year floodplain to the 500-year floodplain. The 500-year floodplain is not a SFHA but is comprised of areas often prone to catastrophic flood losses when particularly disastrous hurricanes make landfall. Critics have similarly proposed that the mandatory flood insurance purchase requirements be amended to apply to areas protected by man-made levees or dams.

Implementing the foregoing expansion proposals would be a significant challenge given that current FIRMs do not show the 500-year floodplain. These reforms would, therefore, require a reworking of FIRMs at a substantial cost to taxpayers. The impact of an extension of NFIP mandatory flood insurance purchase requirements on development, operating and occupancy costs for businesses should also be considered before action is taken. Commentators point out that such increased costs could contribute to more frequent mortgage loan delinquencies and foreclosures and a corresponding reduction in property values. It is fair to conclude that the cost/benefit analysis of these proposals requires further study.

Eliminate Subsidies
Critics point out that amending the NFIP so that actuarial premiums are charged would eliminate the financial imbalances attributable to the current subsidized rates. Such a reform, however, could create new problems for the program. Many policyholders may respond by cutting their levels of coverage. Other policyholders may drop coverage altogether. Thus, overall levels of compliance with the NFIP could fall if subsidies are eliminated or reduced.

Consider the numbers. It has been estimated that the NFIP collects about 60% of the premiums that it would be required to collect to achieve actuarial balance. The shortfall leaves an annual burden on taxpayers of approximately $1.3 billion. Query whether this figure would exceed the expenditures made by the federal government each year on disaster assistance for flood victims who become uninsured or underinsured as a result of higher insurance rates.

Conclusion
The 2005 hurricane season ignited a debate regarding the government’s role in flood disaster relief. Catastrophic flood losses sustained by property owners
have spurred Congress to re-evaluate the NFIP. Members of Congress are currently reviewing proposed legislation aimed at reshaping the program. Although the NFIP has provided property owners with the ability to obtain flood insurance, critics contend that too many properties remain uninsured or underinsured. With the dawn of a new active hurricane era, more flood disasters are likely in the coming years. Fears persist that unless the NFIP is reformed, these disasters will come at a significant price to taxpayers. Further expert analysis of the costs and benefits of proposed reforms should be undertaken before changes are implemented. Whatever the result, however, one thing is clear: mortgage lenders may be asked to play a larger role in ensuring that properties at risk of flooding are properly insured.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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