

A photograph of a city street completely flooded with water. In the background, there are several tall skyscrapers and older brick buildings. A white truck is partially submerged in the water, and other cars are visible in the distance. The water is dark and turbulent, with white foam from the waves in the foreground.

Commercial Flood Insurance

*What Could
We Have Missed?*



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JUST WHEN YOU THOUGHT you had the Flood Disaster Protection Act/regulations (Flood) all figured out, you don't. It seems we all have the basics down—any time the bank makes, increases, renews or extends a loan secured by improved real estate located or to be located in an insurable flood zone, flood insurance is required at or before closing.

That is fairly straightforward and has been pounded into our processes and protocols for consumer loans; however, it seems the folks on the commercial lending side might not have as firm a grasp on the requirements. Rather than going on at length about how Flood applies to commercial loans, it might be more helpful to answer some of the questions commercial lenders and commercial compliance officers ask regarding Flood.

If my loan is secured by equipment and not improved real estate do I need to obtain a flood determination and potentially require flood insurance?

Maybe. If the loan is secured *only* by the equipment (and nothing else), the answer is no; but if the loan happens to be cross-collateralized with a loan on improved real estate (located in an insurable flood zone) and the equipment will be housed (kept) in a structure(s) then yes, flood insurance is required. If the equipment loan is a Small Business Administration (SBA) loan, then the answer is yes, regardless of cross collateralization and/or improved real estate being also taken, as SBA guidelines require flood insurance even on the equipment alone.¹

If my loan has improved real estate taken as an abundance of caution, do I need a flood determination?

Yes. The words “abundance of caution” are among the most overused in all of compliance. They mean something only when it comes to underwriting. For flood purposes, it matters not *why* the collateral is taken, it matters only *that* the collateral is taken. So a determination must be obtained, and if it shows the improvements are located in an insurable flood plain, then flood insurance is required at or before closing, just like any other loan.

If my agricultural loan is secured by land located in an insurable flood zone , equipment, and all structures, and one of the structures is not permitted (according to the local ordinances and laws) do I still have to insure it?

No. Per the Interagency Q&As, the insurance require-

ment cannot be waived; however, the structure will not be eligible for National Flood Insurance Program (NFIP) insurance. The bank is required to obtain a determination and provide the Notice of Special Flood Hazards if it's located in a special flood hazard area; however, the decision to require the flood insurance on a non-permitted structure is a safety and soundness risk decision. The structure would be eligible for private insurance per the NFIP Mandatory Purchase of Flood Insurance Guidelines.²

Whose job is it to know where the buildings are located?

It is the lender's responsibility to know where the structures are located. Section 42 of the U.S.C., subsection 40152a sets the ultimate responsibility to place insurance on the applicable lender, yet allows for limited reliance on third parties to the extent that the information they provide is guaranteed. The lender, servicer, or a third-party vendor may conduct the determination of a building's location.³

Is an apartment building or a residential condominium also a commercial building?

Maybe; however, Flood does not distinguish between commercial and consumer situations. All residential structures⁴ have limits of \$250,000 in insurance per structure and \$100,000 for contents and \$500,000 per nonresidential structure and \$500,000 for contents per nonresidential structure. Keep in mind, there is a third category, when the structure appears to be a residential structure; however, the use is for a hotel, motel or temporary housing (six months or less) then the structure would be applicable to the non-residential structure limits for coverage and deductible.⁵

There are, however, “commercial condo” buildings. Think of a strip mall-type shopping center. There is one building, but multiple owners of the different stores. Flood coverage is available on the building, not the individual stores (this is one difference between residential and commercial condos). Therefore the responsibility to maintain flood coverage falls on the building owner; individual unit owners cannot obtain flood insurance covering just their unit.

Are cooperatives insurable for flood?

Yes, these are insured under the Cooperative Association on a General Property form. An individual unit share holder (borrower) may not insure a cooperative unit on their own because they do not own the real estate. Cooperatives are also not eligible for RCBAP (Residential Condominium Building Association Policy) coverage.

Can you renew, extend or increase a loan with force placed flood insurance?

No. Per the FEMA Mandatory Purchase of Flood Insurance Guidelines “force placement of coverage is designed for use at any time during the loan in uninsured and underinsured situations; it is not intended for use at loan origination. If the borrower refuses to obtain the flood insurance coverage as a condition of obtaining the loan, the loan is deficient and may not be made.”⁶

If my customer has a private flood insurance policy, I don't have to worry about FEMA/NFIP requirements, correct?

No. First the bank must comply with the technical requirements, i.e.; (1) obtain the flood determination; (2) notify the applicant that the property is located in a special flood hazard area and that NFIP flood insurance is or isn't available; and (3) determine that insurance coverage is sufficient.

Second, if the applicant has private flood insurance, the bank must ensure the policy meets FEMA requirements. Specifically, Mandatory Purchase of Flood Insurance Guidelines provides six elements of compliance for all private flood insurance policies: Licensure of the issuer, Surplus Lines Recognition (Non-Residential Commercial), Required 45-Day Notice of Cancellation/Non-Renewal Notice, Breadth of Policy Coverage, Strength of Mortgage Interest Clause, and Legal Recourse.⁷ Most so-called “gap” or “blanket” policies (issued through private insurance companies) that cover many risks won't cover all six elements for flood. Compliance with these insurance requirements can sometimes be difficult to ascertain; it's more an insurance issue than a banking compliance issue, but it nevertheless must be done.

If the improved real estate securing my loan is in an insurable flood zone, but has no value or nominal value, do I still have to obtain flood insurance?

Yes. The FEMA Mandatory Purchase of Flood Insurance Guidelines specifically states, “... if the land has a building on it, and the lender has a security interest in that building, the lender must require the purchase of flood insurance to protect its security interest.” When you get down to it, even if the structure has no market value, there is still value there.

Think of it this way: The purpose of the flood insurance rules is to protect

the federal government from paying out excessive disaster relief assistance payments, not to protect borrowers or lenders (even though they clearly benefit when there is a flood). So if there is a flood, the owner of a “no value” building will still likely apply for some amount of disaster relief assistance. For this reason, the structure must be insured.

If I do not escrow my commercial loans, including my small dollar business loans, do I have to set up an escrow account for flood insurance on these?

No. The requirement to escrow for flood insurance is only applicable if the loan is secured by residential real estate (or a mobile home), not to commercial real estate. Even then, flood insurance premiums must only be escrowed if lender requires the escrow.⁸ If the escrow account is a voluntary service, flood insurance premiums need not be added.

If we have a guidance line of credit (GLOC) for the purpose of purchasing and rehabilitating residential homes, do we have to obtain flood insurance for each purchase?

It depends. If you are taking a security interest (deed of trust/mortgage) in each property using the proceeds from the GLOC, for each property that is located in an insurable flood zone you would need flood insurance before you advanced the funds to make the purchase.


It's all about two things: (1) is there a loan; and (2) is there a security interest in improved real estate? In this situation the answer to each question is yes, so the flood insurance rules apply.

Do I have to limit deductibles for flood insurance?

Yes. The Mandatory Purchase Guidelines clearly outline the deductible requirements, as follows: the “... standard deductible is \$500.00 for new construction, for all buildings ... post FIRM, and or buildings rated in Zones A99, B, C, D or X.” The guidelines also provide that, “... pre-FIRM is \$1,000.00 applied separately to buildings and again to contents.”⁹ There is an optional maximum deductible of \$5,000 for a single family residence building and \$50,000 for non-residential buildings. In addition, the optional deductibles are not available on Preferred Risk Policies (PRP).

My loan is over 10 years old. FEMA has remapped the property and now my borrower is located in a special flood hazard area. Do I have to tell my borrower to obtain flood insurance?

Yes. If or when the bank is aware that the structure now lies in an insurable flood zone, the borrower must obtain the appropriate flood insurance or the



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bank will be required to force place the insurance. For instance, if a triggering event occurs (the loan is increased, renewed, or extended), the bank would discover the remapping. Or if the bank had life-of-loan coverage, it would also discover the remapping. Even though the loan is seasoned, the mandatory purchase requirements are very clear regarding the Lender Responsibilities (keep in mind most regulatory agencies will expect some form of due diligence monitoring for remapping if you do not have life of loan services with your determinations).¹⁰

Do I have to obtain flood insurance on a pole barn?

Maybe. The regulation applies to eligible buildings and an eligible building must be affixed to the ground, have a roof and two rigid (load-bearing) walls. In many cases there are no rigid walls with regard to a pole barn.¹¹ The same would apply to a gazebo, for example. But a silo would qualify (FEMA won't buy the argument that is only one wall albeit as round one, but effectively is the same as four.)

Flood compliance does not apply to banks in a Participation unless the bank is the lead/agent bank; correct?

No. The Interagency Q&As (#4) states, "... although the agreement among the lender may assign compliance duties to a lead lender or agent and include clauses in which the lead lender or agent indemnifies participating lenders against flood losses, each participating lender remains individually responsible."¹² Not only is flood compliance applicable, each participating bank has a duty to ensure the insurance is accurate and correct and reconciles to the determination(s) obtained. It's a due diligence requirement. In addition, a renewal, increase or extension of a participation loan is a triggering event, just as with any other loan subject to the flood compliance requirements.

My loan renews every 90 days and the collateral includes a structure in an insurable flood zone. Do I have to give my borrower the flood notice they just signed 90 days ago again?

Yes. The bank must provide the notice of SFHA (Standard Flood Hazard Area) each time the bank makes, increases, renews or extends the loan to borrower and to the servicer if the bank is not servicing the loan. There is no allowance for reliance on a previous SFHA notice,¹³ no matter how recently it was provided.

How can my good customer get out of flood insurance requirements?

Flood insurance requirements can never be waived, even for your best customers, and even if they threaten to pull their business or claim the bank down the street will make the loan without flood insurance. The only way to release flood insurance for an improvement located (or to be located) on properties currently located in zones A and/or V is to obtain a Letter of Map Change (LOMC). These take the form of either a LOMA (Letter of Map Amendment) or LOMR (Letter of Map Revision).

In either case, the borrower must seek the change from FEMA on their own, there is usually a cost associated with them, and the documents take time to obtain from FEMA. In the meantime, the borrower would have to maintain flood insurance on the improvements at the required amount until the LOMA or LOMR are received from FEMA. The final point regarding a LOMA or LOMR revolves around its findings—a LOMA and/or LOMR does not automatically mean the improvement(s) will be removed from the A or V zone—the document may simply adjust the zone risk by amending it from a V to A (as an example).¹⁴

We have a flood zone discrepancy and the insurance agent refuses to change his/her position; what do we do?

First of all, be clear on whether or not you actually have a discrepancy that requires action. The Interagency Q&As state "... a lender should only be concerned about a discrepancy on the Standard Flood Hazard Determination Form (the SFHDF) and the one on the flood insurance policy if the discrepancy is between a high-risk zone (A or V) and a low- or moderate-risk zone (B, C, D, or X). In other words, a lender need not be concerned about subcategory differences between flood zones on these two documents."¹⁵

If there is a discrepancy requiring action, the lender should check to see if it was the result of a mistake (by rechecking the determination or petitioning FEMA for a review, if done within days of the borrower notification), or because of the grandfather rule or a Preferred Risk Policy (both or which allow the lower-rated zone to control).

If neither of these are the case, "... the lender should notify the insurance agent about the insurer's duty pursuant to FEMA's letter of April 16, 2008 (W-08021), to write a flood insurance policy that covers the most hazardous flood zone. When providing this notification, the lender should include its zone information and it should also notify the insurance company itself."

If even this is unsuccessful, the only solution left is to find a new insurance agent.

Can I close my loan and make the flood insurance a condition of funding?

No. The regulation is very specific, it says you may not make, increase, renew or extend a loan without flood insurance.¹⁶

My collateral is located in two zones, A and C. Can I just use the C zone and not worry about the flood insurance?

No. In a case where a structure sits in multiple zones, if the bank's vendor does not perform "split zone" determinations, then the vendor will cite the high-risk zone on the determination (in this case, the A zone). The borrower will be required to obtain appropriate flood insurance coverage on the entire structure or obtain a LOMA or LOMR.¹⁷

Land is not insurable against flood peril; only improvements (structures) on the land. It doesn't matter whether any land taken as collateral sits in a non-special flood hazard area; in fact, it doesn't matter whether land is taken as collateral at all.

OK, I understand that, but let's say the land securing the loan lies in both zones A and C, but the structure lies in zone A. In that case, can I just use the C zone and not worry about the flood insurance?

Nice try, but again no. Land is not insurable against flood peril; only improvements (structures) on the land. It doesn't matter whether any land taken as collateral sits in a non-special flood hazard area; in fact, it doesn't matter whether land is taken as collateral at all. It's all about the improvements. Here, if the building sits in the A zone, flood insurance is required.

A related issue is where multiple structures secure the loan, and the various structures are located in different zones (say A and C again). A determination must be obtained for each individual structure to determine whether each is located in an A or C zone. The bank is required to insure only those structures that lie in an A zone.

When force placing flood insurance coverage, must the policy be in force on the morning of day 46? What if there is the occasional delay?

Ideally, 45 days means 45 days—the policy should be in force on day 46. But the agencies recognize this might not be possible in every instance. The most recent Interagency Q&As comment on this is "... where there is a brief delay in force placing required insurance, the Agencies will expect the lender to provide a reasonable explanation for the delay, for example, where a lender uses batch processing to purchase force-placed flood insurance policies."

"Brief" is not defined, but it likely wouldn't be good practice to wait a weeks; more than a couple days would likely not be considered brief. But whatever the timeframe, make sure the "reasonable explanation" is well-documented.

How do we determine replacement cost value (RCV)? On many commercial loans, especially on those where we only take the structures as an abundance of caution, we don't have an appraisal showing this or anything close to it—what do we do?

The most recent Interagency Q&As define RCV as the "cost to replace property with the same kind of material and construction without deduction for depreciation." The agencies do recognize the difficulties, however: "... strictly linking insurable value to RCV is not practical in all cases."

Alternatives are allowed: lenders "... may choose from a variety of approaches or methods to establish the insurable value. They may use an appraisal based on a cost-value (not market-value) approach, a construction-cost calculation, the insurable value used in a hazard insurance policy ..., or any other reasonable approach, so long as it can be supported."

The key word here is "supported," so make sure the conclusion is properly documented.

Obviously it is not possible to answer every question a commercial lender may have or to even contemplate every scenario; however, these are a few of the key questions that linger out there day after day.

In closing, it is prudent to advise all compliance officers to keep up with FEMA/NFIP changes. Register for their email updates on training and regulatory changes. Contact your NFIP regional director—get that person on your speed dial and in your email contacts. Prepare to spend a great deal of time explaining flood insurance requirements and needs to insurance agents. Be patient; keep in mind that insurance agents typically work with hazard, auto, and life insurance far more often than flood insurance. And, just when you think you have the lenders and the agents trained—it will change. ■

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Endnotes

- ¹Page 209 (c), SOP 20105(C) Lender Development Company Loan Programs.
- ²Pages 19–22, NFIP Mandatory Purchase of Flood Insurance Guidelines FEMA F-083/August 2008.
- ³Page 11, NFIP Mandatory Purchase of Flood Insurance Guidelines FEMA F-083/August 2008.
- ⁴Page GLS 9–10, NFIP Mandatory Purchase of Flood Insurance Guidelines FEMA F-083/August 2008 describe residential structures.
- ⁵Page GLS 9, NFIP Mandatory Purchase of Flood Insurance Guidelines FEMA F-083/August 2008.
- ⁶Page 40, NFIP Mandatory Purchase of Flood Insurance Guidelines FEMA F-083/August 2008.
- ⁷Page 58, NFIP Mandatory Purchase of Flood Insurance Guidelines FEMA F-083/August 2008.
- ⁸Interagency Q&As 2009 #53.
- ⁹Page 29, NFIP Mandatory Purchase of Flood Insurance Guidelines FEMA F-083/August 2008.
- ¹⁰Page 5, NFIP Mandatory Purchase of Flood Insurance Guidelines FEMA F-083/August 2008.
- ¹¹Page GR 7 of the October 2011 NFIP Flood Insurance Manual.
- ¹²Interagency Q&As 2009 #4.
- ¹³12 CFR 339.9(a).
- ¹⁴Pages 17–18, NFIP Mandatory Purchase of Flood Insurance Guidelines FEMA F-083/August 2008.
- ¹⁵Interagency Q&As 2009 #71.
- ¹⁶12 CFR 339.9(a) and page 5 of the NFIP Mandatory Purchase of Flood Insurance Guidelines FEMA F-083/August 2008.
- ¹⁷Page GR 14 of the October 2011 NFIP Flood Insurance Manual.