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# The National Flood Insurance Program's Mandatory Purchase Requirement: Policies, Processes, and Stakeholders

Richard J. Tobin and Corinne Calfee

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Evaluation of the National Flood Insurance Program

# **The National Flood Insurance Program's Mandatory Purchase Requirement: Policies, Processes, and Stakeholders**

Prepared as part of the Evaluation of  
the National Flood Insurance Program

Richard J. Tobin and Corinne Calfee

American Institutes for Research  
1000 Thomas Jefferson St., NW  
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# EVALUATION OF THE NATIONAL FLOOD INSURANCE PROGRAM

This Evaluation is comprised of a series of reports prepared by the American Institutes for Research (AIR) and selected subcontractors under a contract managed by AIR. These reports assess questions identified and prioritized by a steering committee about the National Flood Insurance Program. Individual reports will be posted on the FEMA website as they are finalized. The website URL is <http://www.fema.gov/nfip/nfipeval.shtm>. The reports in the Evaluation are:

*The Evaluation of the National Flood Insurance Program – Final Report*  
American Institutes for Research and Evaluation Advisory Committee

*Assessing the Adequacy of the National Flood Insurance Program's 1 Percent Flood Standard.* Galloway, Baecher, Plasencia, Coulton, Louthain, and Bagha, Water Policy Collaborative, University of Maryland.

*Assessing the National Flood Insurance Program's Actuarial Soundness.* Bingham, Charron, Messick and Kirschner, Deloitte Consulting.

*Costs and Consequences of Flooding and the Impact of the National Flood Insurance Program.* Sarmiento and Miller, Pacific Institute of Research and Evaluation.

*Developmental and Environmental Impacts of the National Flood Insurance Program: A Review of Literature.* Rosenbaum, University of Florida.

*The Developmental and Environmental Impact of the National Flood Insurance Program: A Summary Research Report.* Rosenbaum, University of Florida.

*An Evaluation of Compliance with the National Flood Insurance Program Part A: Achieving Community Compliance.* Monday, Grill, Esformes, Eng, and Kinney, American Institutes for Research.

*An Evaluation of Compliance with the National Flood Insurance Program Part B: Are Minimum Building Requirements Being Met?* Mathis and Nicholson, Dewberry.

*Evaluation of the National Flood Insurance Program's Building Standards.* Jones, Coulbourne, Marshall, and Rogers, Christopher Jones and Associates.

*Managing Future Development Conditions in the National Flood Insurance Program.* Blais, Nguyen, Tate, Dogan, ABSG Consulting; and Mifflin and Jones.

*The National Flood Insurance Program's Environmental Reviews: An Assessment of FEMA's Implementation of NEPA and Executive Order 11988.* Rosenbaum, University of Florida.

*The National Flood Insurance Program's Mandatory Purchase Requirement: Policies, Processes and Stakeholders.* Tobin and Calfee, American Institutes for Research.

*The National Flood Insurance Program's Market Penetration Rate: Estimates and Policy Implications.* Dixon, Clancy, Seabury, and Overton, RAND Corporation.

*Performance Assessment and Evaluation Measures for Periodic Use by the National Flood Insurance Program.* Miller, Langston, and Nelkin, Pacific Institute of Research and Evaluation.

*State Roles and Responsibilities in the National Flood Insurance Program.* Mittler, Morgan, Shapiro, and Grill, American Institutes for Research.

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## TABLE OF CONTENTS

<b>1. EXECUTIVE SUMMARY .....</b>	<b>iv</b>
<b>2. BACKGROUND .....</b>	<b>1</b>
<b>3. HISTORY OF THE MANDATORY PURCHASE REQUIREMENT.....</b>	<b>4</b>
3.1 National Flood Insurance Act of 1968.....	7
3.2 Flood Disaster Protection Act of 1973.....	8
3.3 Effects of the 1973 National Flood Insurance Act.....	10
3.4 National Flood Insurance Reform Act of 1994.....	11
<b>4. STUDIES OF THE MANDATORY PURCHASE REQUIREMENT.....</b>	<b>14</b>
<b>5. CONTEXT FOR THE MANDATORY PURCHASE REQUIREMENT .....</b>	<b>18</b>
5.1 Flood Insurance.....	18
5.2 The Housing Market.....	21
5.3 The Lending Industry.....	29
<b>6. STATUTORY REQUIREMENTS FOR REGULATED LENDERS .....</b>	<b>32</b>
6.1 Flood Determinations.....	32
6.2 Provide Information on Flood Insurance Requirements.....	40
6.3 Require Flood Insurance at Loan Origination .....	43
6.4 Escrow Funds for Flood Insurance .....	45
6.5 Life-of-Loan Coverage .....	45
6.6 Forced Placement of Flood Insurance.....	46
<b>7. CHALLENGES TO COMPLIANCE .....</b>	<b>50</b>
7.1 Flood Insurance During Construction.....	50
7.2 Letters of Map Change.....	51
7.3 Multiple Loans on a Single Property .....	52
7.4 Multiple Structures Securing a Single Loan.....	53
7.5 Flood Insurance for Condominiums .....	53
7.6 Buildings in Violation of State or Local Laws .....	54
7.7 Selling or Transferring Loans .....	56
7.8 Grandfathering .....	57
7.9 Manufactured Homes.....	60
<b>8. PENALTIES FOR NONCOMPLIANCE.....</b>	<b>62</b>
<b>9. MONITORING LENDERS' COMPLIANCE.....</b>	<b>65</b>
9.1 Farm Credit Administration.....	66
<b>9.1.1 Examination Procedures</b> .....	66
<b>9.1.2 Infractions</b> .....	67
9.2 Federal Deposit Insurance Corporation .....	67
<b>9.2.1 Examination Procedures</b> .....	67
<b>9.2.2 Infractions</b> .....	69
9.3 Federal Reserve Board.....	70
<b>9.3.1 Examination Procedures</b> .....	70
<b>9.3.2 Infractions</b> .....	71
9.4 National Credit Union Administration.....	72
<b>9.4.1 Examination Procedures</b> .....	72
<b>9.4.2 Infractions</b> .....	73

9.5 Office of the Comptroller of the Currency .....	74
<b>9.5.1 Examination Procedures</b> .....	74
<b>9.5.2 Infractions</b> .....	76
9.6 Office of Thrift Supervision.....	77
<b>9.6.1 Examination Procedures</b> .....	77
<b>9.6.2 Infractions</b> .....	78
<b>10. GOVERNMENT-SPONSORED ENTERPRISES .....</b>	<b>80</b>
10.1 Fannie Mae and Freddie Mac .....	80
<b>10.1.1 Flood Insurance Requirements</b> .....	81
<b>10.1.2 Loan Servicing</b> .....	83
<b>10.1.3 Monitoring and Compliance</b> .....	84
10.2 Farmer Mac.....	85
<b>11. FEDERAL AGENCY LENDERS AND GRANTEEES.....</b>	<b>87</b>
11.1 Department of Housing and Urban Development .....	87
<b>11.1.1 Flood Insurance Requirements</b> .....	87
<b>11.1.2 Grants</b> .....	88
<b>11.1.3 Loans</b> .....	89
11.2 Department of Veterans Affairs.....	90
<b>11.2.1 Flood Insurance Requirements</b> .....	91
<b>11.2.2 Loan Guarantees</b> .....	92
<b>11.2.3 Direct Loans</b> .....	93
11.3 Government National Mortgage Association .....	93
11.4 Rural Development, Rural Housing Service.....	94
<b>11.4.1 Flood Insurance Requirements</b> .....	94
11.5 Rural Development, Rural Utilities Service .....	96
11.6 Rural Development, Rural Business and Cooperative Service.....	96
11.7 Small Business Administration.....	97
<b>11.7.1 Flood Insurance Requirements</b> .....	97
<b>11.7.2 Loan Servicing</b> .....	99
<b>11.7.3 Monitoring and Compliance</b> .....	100
<b>12. FEMA’S ROLES AND RESPONSIBILITIES .....</b>	<b>101</b>
<b>13. RECOMMENDATIONS.....</b>	<b>104</b>
13.1 Congress.....	104
<b>13.1.1 Essential Actions</b> .....	104
<b>13.1.2 Other High Priority Actions</b> .....	106
<b>13.1.3 Medium Priority</b> .....	107
13.2 FEMA .....	108
<b>13.2.1 Essential Actions</b> .....	109
<b>13.2.2 Other High Priority Actions</b> .....	110
<b>13.2.3 Medium Priority</b> .....	112
13.3 FEMA and the Federal Entities for Lending Regulation.....	113
<b>13.3.1 High Priority</b> .....	113
13.4 The FFIEC .....	113
13.5 Federal Entities for Lending Regulation.....	113
<b>13.5.1 Essential Actions</b> .....	113
<b>13.5.2 Other High Priority Actions</b> .....	114

**13.5.3 Medium Priority**..... 115

13.6 Federal Agency Lenders ..... 115

13.7 Department of Agriculture..... 115

13.8 Department of Veterans Affairs..... 115

13.9 Farmer Mac..... 115

**14. APPENDICES**..... **116**

**15. ACRONYMS**..... **120**

**16. REFERENCES**..... **121**

## 1. EXECUTIVE SUMMARY

Through the National Flood Insurance Program (NFIP), which was created in 1968 and which the Federal Emergency Management Agency (FEMA) administers, the federal government seeks to reduce the risk, loss, and expense associated with flooding. The program offers flood insurance to property owners and renters in communities that participate in the program by adopting and enforcing ordinances to reduce future flood risks. Certain property owners in Special Flood Hazard Areas (SFHAs) in these communities are required to purchase and retain flood insurance for the life of their mortgage loans, and this is called the mandatory purchase requirement.

Three categories of property owners are required to purchase flood insurance. These include those

- who obtain loans from federally regulated lending institutions and whose loans are secured by improved real estate or a manufactured home.

The federal entities for lending regulation, which include the Board of Governors of the Federal Reserve System, the Farm Credit Administration, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision, are responsible for monitoring compliance with the requirement among regulated lenders. Much of this report discusses the agencies' implementation of their responsibilities.

- whose loans are secured by improved real estate or a manufactured home and whose loans have been purchased by the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac); and,
- property owners who receive federal financial assistance for acquisition or construction purposes in SFHAs in communities that participate in the NFIP.

The Small Business Administration and the Departments of Agriculture, Housing and Urban Development, and Veterans Affairs are the agencies that typically provide such assistance.

The amount of insurance that must be purchased depends on several factors, primarily the amount of financial assistance or the outstanding principal balance of the loan and the maximum amount of insurance available through the NFIP. Homeowners can purchase up to \$250,000 in coverage for their homes through the NFIP; up to \$500,000 in coverage is available for nonresidential buildings. In both instances coverage is also available for the contents of these buildings.

This study focuses on the practices and procedures associated with the purchase requirement and examines each of the mandatory-purchase categories just described. Although the requirement is seemingly straightforward (and statutorily imposed), the interpretation and



application of the requirement varies. Such variation is not unexpected – standards and methods differ from one agency to another as do their approaches to similar issues.

The mandatory purchase requirement has evolved since its inclusion in the Flood Disaster Protection Act of 1973 as have the responsibilities of the agencies charged with monitoring compliance. With the passage of the National Flood Insurance Reform Act of 1994, for example, Congress required regulated lenders to force place flood insurance on property owners who are obligated to purchase flood insurance but who are not adequately insured. Similarly, the 1994 act provides the federal entities for lending regulation with authority to impose civil money penalties on lenders that are found to have a “pattern or practice” of committing violations of the requirement.

Past studies of the mandatory purchase requirement have found mixed levels of compliance, although compliance appears to have increased considerably since the passage of the 1994 act. In addition to changes in the legislation that have spurred increased levels of compliance, the regulatory agencies have increased the rigor of their examinations of regulated lenders and these lenders have, in turn, increased their familiarity with requirement. In almost one hundred instances, the federal regulatory agencies have imposed civil money penalties on lenders that have violated the requirement. Typical violations include a lender’s failure to determine whether a building or a manufactured home is located in a SFHA, failure to require the purchase of flood insurance when a property is in a SFHA, and failure to escrow premiums for flood insurance when other fees are also placed into escrow.

Although there appears to be widespread familiarity with the procedural requirements among most regulated lending institutions (as well as among nonregulated lenders that also sell loans in the secondary market to Fannie Mae or Freddie Mac), several issues represent challenges to compliance and would benefit from change or clarification, including:

- the time at which flood insurance is required during construction;
- the advisability of exempting some property owners from the mandatory purchase requirement;
- multiple loans on a single property or structure;
- multiple structures securing a single loan;
- insurance requirements for condominiums;
- buildings in violation of state or local laws;
- selling or transferring loans;
- the special characteristics associated with the purchase and placement of manufactured homes; and
- grandfathering, which permits some property owners to pay insurance premiums that are not commensurate with the risk of flooding they face.

These and several other issues can be addressed through changes in the NFIP’s policies, practices, or regulations. Other recommended changes will require revisions to the legislation governing flood insurance. The most desirable changes include:

- an increase in the maximum federal flood insurance available to the same amount as the maximum amount of a conforming loan that Freddie Mac or Fannie Mae can purchase (i.e., \$359,650 in 2005);
- annual automatic adjustments in the maximum coverage available through the NFIP to coincide with changes in the maximum dollar amount of conforming loans that Freddie Mac or Fannie Mae can purchase;
- a requirement that the minimum amount of coverage in place for a loan subject to the mandatory purchase requirement be at least equal to the replacement value of a building or manufactured home or to the maximum limit of coverage made available through the NFIP with respect to the particular type of property, whichever is less, even when the principal balance of a loan is less than the replacement value; and,
- the development of a system that permits a comprehensive and ongoing assessment of the level of lenders' and borrowers' compliance with the mandatory purchase requirement. This system should identify levels of compliance at loan origination as well as when renewal of coverage is required.

This study was completed by the American Institutes for Research (AIR) an independent, not-for-profit corporation contracted by FEMA to lead and manage a comprehensive evaluation of the NFIP. The evaluation is examining many issues related to the NFIP, such as the program's actuarial soundness, its developmental and environmental impacts, and compliance among participating communities with the NFIP's requirements. The evaluation's ultimate goal is to improve the program's effectiveness. The present report's primary audience is the agency, which seeks to improve its understanding of the policies and procedures employed by the agencies and institutions responsible for implementing and monitoring compliance with the mandatory purchase requirement. Although the agency does not have a primary role in enforcing the requirement, FEMA does have a direct interest in high levels of compliance, which promote the program's key objectives.

Thanks are due to the many people who assisted in the study's completion, including representatives of FEMA, the Office of Federal Housing Enterprise Oversight, each of the federal entities for lending regulation, Freddie Mac and Fannie Mac, and several federal agency lenders. These representatives graciously answered many questions, and most thoroughly reviewed two drafts of the present report. All but a few of those invited to review the report did so and provided extensive comments. When appropriate, the text was modified to reflect the comments received. AIR's Kristen Yarber and Jennifer R. Anderson also supported the report's completion.

If industry can successfully flood American homes with overpriced soft drinks with no nutritional value sold primarily on the basis of taste, then the National Flood Insurance Program should be able to market its insurance, which promotes safety and security of life, with relative ease.

Adapted from Buckle and Fleming (2001)

## 2. BACKGROUND

Floods are the most costly and common natural disaster in the United States. They strike in all states and can happen at any time, as too many unfortunate victims have learned. Floods in the United States caused an average of about \$6 billion in damages per year between 1955 and 1999 (University of Colorado 2001). Floods kill about 100 people each year, and all states, save three, experienced flood-related deaths between 1989 and 1999.

Through the National Flood Insurance Program (NFIP), the federal government seeks to reduce the risk, loss, and expense associated with flooding. The program was created with the passage of the National Flood Insurance Act of 1968 and revised in 1973, 1977, 1994, and 2004. The Mitigation Division of the Federal Emergency Management Agency (FEMA), part of the U.S. Department of Homeland Security, administers the program, which has three primary goals. First, the NFIP seeks to indemnify individuals for flood losses through flood insurance. Second, the NFIP attempts to reduce future flood damages through mitigation and states' and communities' implementation of floodplain management regulations. Third, the NFIP's activities seek to reduce federal expenditures for disaster assistance and flood control.

The NFIP offers flood insurance to property owners and renters in communities that participate in the NFIP by adopting and enforcing ordinances to reduce future flood risks. When a community agrees to reduce potential flood losses and participates in the program, the NFIP offers flood insurance to protect community members' buildings and their contents against these losses. The task of identifying and mapping flood-prone areas informs communities and residents within them that they are at risk of flooding (i.e., that they are within Special Flood Hazard Areas or SFHAs).<sup>1</sup> Certain property owners in these areas in participating communities are required to purchase and retain flood insurance for the life of their mortgage loans or federal grants, and this is called the mandatory purchase requirement.

Property owners subject to the requirement include those:

1. Who obtain loans from federally regulated lending institutions and whose loans are secured by improved real estate or a manufactured home.

The National Flood Insurance Reform Act of 1994 defines a regulated lending institution (referred to as a "regulated lender" in this report) as any "bank, savings and loan association, credit union, farm credit bank, federal land bank association, production

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<sup>1</sup> A SFHA defines the area in which there is a 1 percent chance of being flooded in any given year (i.e., the 100-year floodplain). Over a 30-year period, there is at least a 26 percent chance that a SFHA will be flooded to the elevation of the 100-year flood. Flood Insurance Rate Maps (FIRMs) identify areas designated as SFHAs.

credit association, or similar institution subject to the supervision of a federal entity for lending regulation.” These entities include the Board of Governors of the Federal Reserve System (FRB), the Farm Credit Administration (FCA), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). Lenders not subject to regulation by one or more of these entities are referred to as “nonregulated lenders” in this report although another federal agency, such as the Federal Trade Commission, may regulate or supervise them for other purposes.

Loans from regulated lending institutions are deemed to be “designated loans” if they are secured by a building or manufactured home that is located or to be located in a SFHA in which flood insurance is available through the NFIP (U.S. Department of the Treasury et al. 1996). This definition is unique to the agencies’ flood insurance regulations.

2. Whose loans are secured by improved real estate or a manufactured home and whose loans have been purchased by the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac). Although both are private, shareholder-owned companies, Fannie Mae and Freddie Mac are federal agencies for purposes of flood insurance and are often referred to as government-sponsored enterprises (GSEs).
3. In addition to the two categories of loans just noted, property owners who receive federal financial assistance for acquisition or construction purposes in SFHAs in communities that participate in the NFIP are also subject to the mandatory purchase requirement.

According to the 1994 Reform Act, these purposes include “any form of financial assistance which is intended in whole or in part for the acquisition, construction, reconstruction, repair, or improvement of any publicly or privately owned building or mobile home, and for any machinery, equipment, fixtures, and furnishings contained or to be contained therein, and shall include the purchase or subsidization of mortgages or mortgage loans but shall exclude assistance pursuant to the Disaster Relief and Emergency Assistance Act... (other than assistance under such Act in connection with a flood).”

This study focuses on the practices and procedures associated with the mandatory purchase requirements and examines each of the categories just described.

To complete the study, FEMA contracted with the American Institutes for Research (AIR), an independent, not-for-profit corporation. AIR examined applicable legislation and its legislative history as well as reports and guidelines from the government agencies and GSEs with responsibility for or interest in the mandatory purchase requirement. In addition, AIR met with representatives of these agencies and GSEs. When scheduling these meetings, AIR asked to (and did) meet with the agency or GSE staff most knowledgeable about the requirement. A few interviews were conducted by telephone. To ensure the report’s accuracy, detailed notes were taken at each meeting, and summaries then prepared. In many instances these summaries were provided to those interviewed with a request that they review the accuracy of the summary. This

report reflects the notes and agency-reviewed summaries of these meetings and interviews. In addition, each agency was offered an opportunity to review one or more drafts of this report, as was the National Insurance Lenders Council. All but a few of those invited to review the report did so and provided extensive comments. When appropriate, the text was modified to reflect the comments received.

AIR also met with selected staff of federal agencies' regional and district offices, lending institutions in communities that participate in the NFIP and in communities that do not, flood determination companies, sellers of private flood insurance not affiliated with the NFIP, and Write-Your-Own (WYO) companies that sell insurance through the NFIP. The latter are licensed property and casualty companies that also sell other forms of insurance, such as hazard and automobile insurance. Many large insurance companies and their agents write flood insurance. They market flood insurance, sell and issue policies under the company name, and arrange for the adjustment, settlement, payment, and defense of claims. They also retain a portion of the policy premiums to cover their expenses and to compensate their agents but do not assume any financial risk (Office of Inspector General 1993).<sup>2</sup> Data on federal flood insurance policies are from the NFIP's Bureau and Statistical Agent, which operates BureauNet, a web-based database that contains information on all NFIP policies and claims since 1978.

Although the mandatory purchase requirement is seemingly straightforward (and statutorily imposed), the interpretation and application of the requirement varies. This occurs for several reasons. On the one hand, standards and methods can differ from one agency to another as do their approaches to similar issues. As one study (Banking Agency Offices of Inspector General 2002) has noted, differences in the agencies' examination methods arise from different characteristics of the agencies, applicable laws or regulations, relationships with state authorities, and the nature, size, and type of institution being examined. On the other hand, the agencies subject to the requirement do not always coordinate their efforts or share timely information. Each agency is also responsible for its own compliance with the requirement. Some are unaware of how other agencies with similar lending-related functions implement identical mandates. Moreover, no agency or institution has overall responsibility for overseeing or monitoring compliance with the requirement. Although there are agencies, such as FEMA, that might suitably fill a coordinating or monitoring role, none currently do so.

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<sup>2</sup> FEMA also uses some of the premiums to cover the program's operating and administrative expenses.

### 3. HISTORY OF THE MANDATORY PURCHASE REQUIREMENT

Three main legislative efforts have shaped the mandatory purchase requirement. The National Flood Insurance Act of 1968 (P.L. 90-448) created the NFIP and enabled property owners to purchase flood insurance voluntarily. The Flood Disaster Protection Act of 1973 (P.L. 93-234) revised the earlier law to make the purchase of flood insurance mandatory for certain property owners. Finally, the National Flood Insurance Reform Act of 1994 (P.L. 103-325) made adjustments to the requirement in an effort to improve its effectiveness.<sup>3</sup> Table 1 summarizes changes in the requirement.

**TABLE 1: Summary of Legislative Changes, 1968-1994**

Topic	Legislation		
	National Flood Insurance Act of 1968	Flood Disaster Protection Act of 1973	National Flood Insurance Reform Act of 1994
<b>Availability of Flood Insurance</b>	Available in participating communities.	Available in participating communities.	Available in participating communities.
<b>Purchase of Flood Insurance</b>	Voluntary.	Mandatory for certain property owners: a) building or manufactured home in or to be located in a SFHA in a participating community and receiving a loan from a regulated lender.; b) building for which any federal financial assistance is used for acquisition or construction of a building or a manufactured home in a SFHA of a community participating in the NFIP	Mandatory for certain property owners: a) building or manufactured home in or to be located in a SFHA in a participating community and receiving a loan from a regulated lender; b) building or manufactured home in or to be located in a SFHA in a participating community and whose loan is purchased by Fannie Mae or Freddie Mac; c) building for which any federal financial assistance is used for acquisition or construction of a building or a manufactured home in a SFHA of a community participating in the NFIP;

<sup>3</sup> The Flood Insurance Reform Act of 2004 (P.L. 108-264) does not contain any provisions directly affecting the mandatory purchase requirement.

**TABLE 1: Summary of Legislative Changes, 1968-1994**

Topic	Legislation		
	National Flood Insurance Act of 1968	Flood Disaster Protection Act of 1973	National Flood Insurance Reform Act of 1994
<b>Amount and Length of Coverage Required</b>	<p>Elective amount up to the replacement cost of improvements on the structure or the maximum amount of flood insurance available, whichever is lower.</p> <p>Elective length of coverage.</p> <p>Coverage of contents not required.</p>	<p>Replacement cost for the structure having received nonloan federal financial assistance for the life of the structure.</p> <p>Amount of loan outstanding on structures having received federal financial assistance in form of a loan, for the life of the loan.</p> <p>Amount of loan outstanding on structures having received loan from a regulated lender, for the life of the loan.</p> <p>Coverage of contents not required unless used as collateral for the loan.</p>	<p>Replacement cost for the structure having received other federal financial assistance for the life of the structure.</p> <p>Amount of loan outstanding on structures having received federal financial assistance in form of a loan, for the life of the loan.</p> <p>The lesser of the principal loan balance outstanding or the maximum amount of flood insurance available on structures secured by a loan from a regulated lender, for the life of the loan.</p> <p>Coverage of contents not required unless used as collateral for the loan.</p>
<b>Coverage limits available</b>	<p>Residential coverage under premiums subsidized by the federal government limited to \$17,500 per single-family residence and \$30,000 for per two-to-four-family residence.</p> <p>Nonresidential coverage under premiums subsidized by the federal government limited to \$30,000 plus \$5,000 for each small business occupant of a commercial structure. Additional coverage at actuarial rates available for total coverage up to twice the subsidized limits.</p>	<p>Coverage limited to \$35,000 for single-family residences (and \$10,000 for contents) in communities in the NFIP's Emergency Program in the 48 adjacent states and \$185,000 for such residences (and \$60,000 for contents) in the NFIP's Regular Program.<sup>1</sup></p> <p>Nonresidential coverage limited to \$100,000.</p> <p>Coverage for churches limited to \$100,000 and \$100,000 aggregate liability for contents related to any single structure.</p>	<p>Residential coverage limited to \$250,000 for single-family and multifamily dwelling units. Coverage for contents limited to \$100,000 per building or unit.</p> <p>Nonresidential coverage, including that for churches, limited to \$500,000 per building. Coverage for contents limited to \$500,000.</p>
<b>Nonparticipating Communities</b>	<p>Ineligible for flood insurance.</p>	<p>Ineligible for federal flood insurance.</p> <p>Ineligible for federal financial assistance for construction or acquisition in a SFHA.</p> <p>Ineligible for loans in SFHAs from regulated lenders.<sup>2</sup></p>	<p>Ineligible for federal flood insurance.</p> <p>Ineligible for federal financial assistance for construction or acquisition in a SFHA.</p> <p>Eligible for loans in SFHAs from regulated lenders. Such lenders must notify borrower whether the structure will be eligible for disaster assistance due to a flood (P.L. 95-128, 1977).</p>

TABLE 1: Summary of Legislative Changes, 1968-1994

Topic	Legislation		
	National Flood Insurance Act of 1968	Flood Disaster Protection Act of 1973	National Flood Insurance Reform Act of 1994
<b>Responsibilities of Regulated Lenders</b>	Not applicable.	Require flood insurance for buildings or manufactured homes located in the SFHA of a participating community.  Ensure that flood insurance is maintained on such structures for the life of the loan.	Determine whether the building or manufactured home is, or will be, located in a SFHA.  Complete a hazard determination form.  Provide notice of availability of flood insurance to borrower, lending institution, and loan servicer.  Require flood insurance for structures located in SFHAs of a participating community.  Ensure that flood insurance is maintained for the life of the loan.  Escrow for flood insurance if other mortgage-related expenses are required to be escrowed.  Force place flood insurance in the event of nonrenewal or insufficient coverage.
<b>Federal Banking Regulators</b>	Not applicable.	Board of Governors of the Federal Reserve System (FRB)  Federal Deposit Insurance Corporation (FDIC)  Office of the Comptroller of the Currency (OCC)  National Credit Union Administration (NCUA)  Federal Home Loan Bank Board  Federal Savings and Loan Insurance Corporation	FRB  FDIC  OCC  NCUA  Office of Thrift Supervision (OTS) <sup>3</sup>  Farm Credit Administration (FCA)
<b>Lender Examination Process</b>	Not applicable.	None specified.	Federal regulators must develop “substantially similar” examination processes through collaboration and cooperation with the Federal Financial Institutions Examination Council (FFIEC).
<b>Sanctions for Noncompliance</b>	Not applicable.	None specified.	Civil money penalties against regulated lenders and government-sponsored enterprises.
<b>Federal Agencies Providing Financial Assistance</b>	None specified.	Financial assistance for acquisition or construction purposes prohibited in SFHAs unless the building or manufactured home and any personal property to which such financial assistance relates is covered by flood insurance for the life of the loan.  Financial assistance for acquisition or construction purposes prohibited in SFHAs in nonparticipating communities after July 1, 1975.	Federal agencies that make direct loans cannot make, increase, extend, or renew any loan secured by improved real estate or a manufactured home in a SFHA in a participating community unless the building of manufactured home and any personal property securing the loan has flood insurance for the term of the loan.



**TABLE 1: Summary of Legislative Changes, 1968-1994**

Topic	Legislation		
	National Flood Insurance Act of 1968	Flood Disaster Protection Act of 1973	National Flood Insurance Reform Act of 1994
<b>Involvement of Fannie Mae and Freddie Mac</b>	None specified. (Freddie Mac not established until 1970).	None specified (although both Fannie Mae and Freddie Mac required flood insurance on properties in SFHAs in participating communities at least from the early 1990s).	Secondary-market purchases subject to the mandatory purchase requirement.  Purchase of mortgages on structures in SFHAs in nonparticipating communities prohibited.
<b>FEMA Responsibilities<sup>4</sup></b>	Administer the NFIP.	Administer the NFIP.  Issue regulations “as may be necessary” to implement the purpose of the legislation.	Administer the NFIP.  Issue regulations “as may be necessary” to implement the purpose of the legislation.  Create standard flood hazard determination form.  Notify borrower, loan servicer, and mortgagee 45 days before a flood insurance policy expires.  Collect information from lenders about changes in loan servicing and mortgage agreements. <sup>5</sup>

<sup>1</sup> The Emergency Program, created in 1969, provides limited amounts of subsidized flood insurance during the period prior to completion of a community’s Flood Insurance Study, which serves as the basis for the development of a Flood Insurance Rate Map.

<sup>2</sup> The Housing and Community Development Act of 1977 (P.L. 95-128) removed this prohibition.

<sup>3</sup> The OTS assumed the responsibilities of the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation in 1989.

<sup>4</sup> The Department of Housing and Urban Development (HUD) administered the NFIP until FEMA was created in April 1979.

<sup>5</sup> FEMA has assigned responsibility for this function to the WYO companies that sell NFIP insurance.

SOURCE: National Flood Insurance Act of 1968 (P.L. 90-448), Flood Disaster Protection Act of 1973 (P.L. 93-234), Housing and Community Development Act of 1977 (P.L. 95-128), and National Flood Insurance Reform Act of 1994 (P.L. 103-325).

### 3.1 National Flood Insurance Act of 1968

With the passage of the National Flood Insurance Act of 1968, the Congress changed the federal government’s role in flood disasters. Before 1968, the federal government provided funds for flood control projects and disaster assistance to flood victims. Flood control projects divert the flow of water away from development and control water for use in irrigation and hydroelectric plants. Despite these efforts, flood losses escalated, and the government paid increasing sums in disaster assistance.

The 1968 act moved from flood control to a policy of interdependent mitigation and insurance programs. The new policy, which the Department of Housing and Urban Development (HUD) would implement, was meant to promote insurance to indemnify individuals against flood loss, reduce future flood losses by effective floodplain management, and reduce federal expenditures for disaster assistance and flood control.

The mitigation effort sought to encourage communities to develop floodplain management ordinances that reduce the impact of flooding. When communities adopt and

implement ordinances that are compliant with the NFIP's requirements, they are eligible to participate in the program. The act also grants the NFIP authority to provide insurance for improved real estate or manufactured homes (and for their contents) in such communities.

The federal government offered flood insurance because such insurance had been unavailable at a reasonable price in the private market due to the geographic concentration and the catastrophic nature of floods. The government had also determined that supporting such an insurance program (through subsidies and insurance claims) would be less expensive than continuing to pay for disaster assistance. The government thus initiated an effort to map flood hazards to provide geographical data for floodplain management and actuarial data for flood insurance rates.

The act provided authority for the federal government to offer both subsidized and unsubsidized flood insurance, which property owners could purchase voluntarily. Subsidized insurance is available to property owners of structures in SFHAs constructed before the publication of Flood Insurance Rate Maps (FIRMs) and the delineation of SFHAs on the assumption that these owners did not have sufficient information before building or purchasing their properties to know that they would be located in flood-prone areas. The actuarial rates for many of these flood-prone structures would have been prohibitively expensive, thus discouraging the purchase of insurance by highly vulnerable property owners and similarly deterring communities' participation in the NFIP. In contrast, owners of buildings constructed or improved on or after the effective date of the FIRM or after December 31, 1974 (whichever is later) are eligible only for unsubsidized insurance. Congress determined that these property owners have sufficient information at their disposal (through flood hazard mapping) to know that they are assuming greater flood risk by purchasing or building in a SFHA.

### **3.2 Flood Disaster Protection Act of 1973**

In the four years following the implementation of the National Flood Insurance Act, few communities joined the NFIP, and few property owners purchased flood insurance.<sup>4</sup> By 1973, about 2,200 of an estimated 21,000 flood-prone communities had joined the NFIP, and about 95,000 flood policies were in force.<sup>5</sup> The properties covered by these insurance policies comprised a small proportion of the eligible buildings in identified SFHAs in participating communities. The Congress and HUD consequently concluded that "voluntary participation...yields too few subscribers."

Congress noted that federal expenditures on flood disaster assistance continued to increase at an "alarming" rate after the 1968 act because of ongoing development in floodplains. Congress also determined that the availability of nondisaster federal assistance contributed to

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<sup>4</sup> The 1973 Act defines community as "a state or a political subdivision thereof which has zoning and building code jurisdiction over a particular area" that has been identified as having SFHAs.

<sup>5</sup> These data come from FEMA, but Kunreuther (1978) stated that "fewer than 275,000 homeowners [had] voluntarily bought a [flood] policy" in the first four years of the NFIP's operation. The difference in data may be attributable to slightly different reporting periods or to the difference between the total number of policies ever purchased and the number of existing policies (other data suggest that nonrenewal rates for flood insurance were, and continue to be, higher than for homeowner's insurance). In any case, only a small proportion of property owners elected to purchase federal flood insurance after it initially became available.

undesirable patterns of land use, as did the availability of funds from lending institutions. Finally, Congress also expressed concern about the vulnerability of federally funded development in the floodplain and for the assets of regulated lenders whose portfolios contained loans secured by properties in the floodplain.

The Flood Disaster Protection Act of 1973 addressed the low participation rates by establishing the mandatory purchase requirement and prohibited regulated lenders from making, increasing, extending, or renewing any loan secured by improved real estate or personal property located in a SFHA unless the secured building and any personal property securing the loan are covered by flood insurance for the term of the loan.<sup>6</sup> The amount of coverage required must be at least equal to the lesser of the loan's outstanding principal balance or the maximum limit of coverage available through the NFIP. The requirement was not retroactive: flood insurance was not required on properties for which loans were made prior to March 1, 1974 unless such loans were increased, extended, or renewed.

Congress included six regulatory agencies in its definition of "federal instrumentalities responsible for the supervision, approval, regulation, or insuring of banks, savings and loan association, or similar institutions": the FRB, the FDIC, the OCC, the NCUA, the Federal Home Loan Bank Board, and the Federal Savings and Loan Insurance Corporation.<sup>7</sup>

The 1973 act also utilized the existing structure of federal financial assistance to increase the number of flood policies covering properties in SFHAs. The act imposed the mandatory purchase requirement on properties for which any federal financial assistance is used for acquisition or construction of a building or a manufactured home in a SFHA of a community participating in the NFIP.

Congress encouraged community participation in the NFIP with indirect incentives: it improved opportunities for property owners in participating communities relative to those in nonparticipating communities. The law disqualified property owners in *nonparticipating* communities from receiving federal financial assistance for acquisition or construction purposes in a SFHA.<sup>8</sup> The law also prohibited regulated lenders from making, increasing, extending, or renewing any loan secured by improved real estate or a manufactured home in a SFHA in nonparticipating communities. These prohibitions supposed that a community would act in its

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<sup>6</sup> Prior to August 1996, federal regulatory agencies responsible for overseeing lenders' compliance with the 1973 Act differed in their interpretation of what constitutes the "making" of a loan. For example, the FRB and the OCC did not consider the purchase of a loan to be an event that triggered an obligation to obtain a flood hazard determination. In contrast, the OTS (and its predecessor, the Federal Home Loan Bank Board) considered the purchase of a loan to be equivalent to making a loan. The FDIC did not have a position on this issue. With the issuance of joint regulations by the federal regulatory agencies in 1996 (U.S. Department of the Treasury et al. 1996), these agencies, plus the FCA and the NCUA, agreed that a loan purchase is not an event that triggers lenders' obligation to obtain a flood hazard determination.

<sup>7</sup> The Office of Thrift Supervision (OTS) replaced the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation in 1989. The 1973 Act did not include the Farm Credit Administration (FCA). As a result, farm credit banks, federal land bank associations, and production credit associations were not initially subject to the mandatory purchase requirement.

<sup>8</sup> The FFIEC (1997) and the OTS (2001) incorrectly declare that government-guaranteed or insured loans are not permitted in nonparticipating communities. Such loans are not permitted *in SFHAs* in nonparticipating communities but are permitted outside of SFHAs in nonparticipating communities.

residents' best interests by enacting and enforcing floodplain management ordinances to join the NFIP and thereby qualify its property owners for federal funding and regulated lending.

Congress divided authority for implementing the 1973 act among the secretary of the Department of Housing and Urban Development, the directors of the federal agencies administering relevant financial assistance, and federal bank regulatory agencies.<sup>9</sup> The act authorized the secretary to issue regulations “as may be necessary to carry out the purpose of this Act” and the heads of the other federal bank regulatory agencies to issue rules and regulations “to govern the carrying out of the agency’s responsibilities under this Act.”

### **3.3 Effects of the 1973 National Flood Insurance Act**

As FEMA has since noted, because flood insurance was available only in communities participating in the NFIP, the result of the 1973 act was a “great increase” in the number of participating communities and in the number of policies in force. Indeed, by 1977, about 15,000 of the estimated 21,000 flood-prone communities were participating in the NFIP and approximately 1.2 million policies were in force at the end of that year.

In that year, however, Congress removed one of the indirect incentives for community participation in the NFIP through the so-called Eagleton Amendment (P.L. 95-128). The amendment eliminated the prohibition against regulated lenders issuing loans in nonparticipating communities and replaced it with a requirement that regulated lenders notify purchasers or lessees of property located in a SFHA whether federal disaster relief assistance would be available in the event of a flood disaster.<sup>10</sup> Removing the prohibition against regulated lending in nonparticipating communities initiated the situation that now exists in which regulated lenders may make conventional loans in nonparticipating communities and may do so without requiring flood insurance.<sup>11</sup> Nonetheless, lenders retain the option to require their borrowers in nonparticipating communities to obtain flood insurance, which must be issued by private insurers. The NFIP cannot provide flood insurance in communities that do not participate in the program.

The 1977 legislation did not remove the prohibition against federal financial assistance in nonparticipating communities, but it did amend the definition of “financial assistance for acquisition or construction purposes” to exclude all disaster assistance unless flood-related. The exclusion of nonflood-related disaster assistance from the definition meant that flood insurance would no longer be required as a condition for a federal loan to repair damage in a community

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<sup>9</sup> Federal agencies include “any department, agency, corporation, or other entity or instrumentality of the executive branch of the federal government and...the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.” Unlike the federal agencies that regulate lending institutions, Fannie Mae and Freddie Mac have no regulatory authority.

<sup>10</sup> If a property is located in a SFHA in a participating community, the property owner may be eligible for disaster assistance. If the property is in a nonparticipating community that has one or more SFHAs that have been identified for at least one year, the property owner is not eligible for federal disaster assistance in the event of a presidentially declared flood disaster.

<sup>11</sup> A conventional loan is one that is neither insured nor guaranteed by a federal agency.

that suffered a disaster unrelated to flooding.<sup>12</sup> The Federal Insurance Administration (FIA) issued further clarification of the definition in 1978. Through a notice in the *Federal Register*, the FIA (1978a) indicated that “financial assistance for acquisition or construction purposes means any form of financial assistance which is intended in whole or in part for the acquisition, construction, reconstruction, repair, or improvement of any publicly or privately owned building or mobile home, and for any machinery, equipment, fixtures, and furnishings contained or to be contained therein.” A separate notice (FIA 1978b) stated that federal financial assistance includes “loans, grants, guarantees, and similar forms of direct and indirect assistance from Federal agencies.”

Congress revisited the NFIP in the late 1980s, largely because FEMA reported that only 14 percent of structures in SFHAs were covered by flood insurance and because more than 20 percent of flood insurance policies were not renewed annually (U.S. House of Representatives 1990). These numbers suggested but did not confirm noncompliance with the mandatory purchase requirement because the uninsured structures may have had neither mortgages from regulated lenders nor received federal financial assistance for acquisition or construction.

### **3.4 National Flood Insurance Reform Act of 1994**

In response to concerns about compliance with the Flood Disaster Protection Act, the Congress passed the National Flood Insurance Reform Act in 1994. The legislation clarified and strengthened the mandatory purchase requirement to increase compliance, which would in turn better indemnify individuals for flood losses through insurance and reduce federal expenditures for disaster assistance. The 1994 act also imposed additional responsibilities on regulated lenders and secondary market entities involved in mortgage loan transactions.

First, the definition of “federal entities for lending regulation” was expanded to include the Farm Credit Administration, thereby increasing the number of lending institutions subject to the requirement. Also, Fannie Mae’s and Freddie Mac’s purchases of mortgages in the secondary market became subject to the revised requirement as of September 23, 1995.<sup>13</sup>

With two exceptions, lenders are also still required to ensure that flood insurance is maintained during the life of the loan. The 1994 law exempts regulated lenders from requiring flood insurance on: a) loans with an original principal balance of \$5,000 or less and with a repayment term of one year or less; and, b) on state-owned properties covered by self-insurance satisfactory to FEMA’s director. Thirteen states, including Florida, Georgia, Iowa, Kentucky, Maine, New Jersey, New York, North Carolina, Oregon, Pennsylvania, South Carolina, Tennessee, and Vermont, have approval to self-insure their buildings and contents.

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<sup>12</sup> As the *Mandatory Purchase of Flood Insurance Guidelines* (FEMA 1999) observe, the 1977 change “benefited developers who now can obtain federally guaranteed money for floodplain development.” This statement is imprecise and suggests an inaccurate conclusion. The 1977 law maintained the prohibition against federal financial assistance for construction or acquisition of property in a SFHA of a nonparticipating community. Federally guaranteed money, which is considered to be one form of federal financial assistance, for acquisition or construction would therefore *not* be available to developers. (Federally guaranteed money for other purposes may be available to developers, but this is beyond the scope of the mandatory purchase requirement.)

<sup>13</sup> Fannie Mae and Freddie Mac had both required flood insurance for buildings in SFHAs prior to this date, so the practical effect of the statutory change is unclear.

Several lender responsibilities did not change in the 1994 act. Regulated lenders must still require flood insurance for improved real estate or manufactured homes in or to be located in a SFHA in participating communities. The minimum amount of required coverage is still the lesser of the amount of the loan principal outstanding or the maximum coverage available under the NFIP.<sup>14</sup>

Second, Congress also gave lenders and servicers of loans the authority to purchase flood insurance on behalf of the owners of properties in SFHAs in communities that participate in the NFIP for which, at the time of loan origination or any time during the term of the loan, the property is not adequately insured. This change is important because it provides regulated lenders with the legal authority to purchase flood insurance on behalf of recalcitrant borrowers who are required to have flood insurance for the life of their loans.<sup>15</sup>

Third, and in a further significant change, Congress provided for enforcement of the purchase requirement by specifying the role of the federal entities for lending regulation. The act mandates that the agencies examine lending institutions' compliance with the act as part of existing examination processes. As a result of this mandate, the agencies developed uniform flood-related examination procedures after consultation and coordination with the Federal Financial Institutions Examination Council (FFIEC).<sup>16</sup> The application of these procedures is discussed below.

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<sup>14</sup> The NFIP does not insure land. As a consequence, in determining the amount of insurance coverage required under the mandatory purchase requirement, lenders can assess the portion of the loan that is associated with improved real estate and exclude the appraised value of the land. The Federal Reserve Board notes that the amount of federal flood insurance available is limited to the overall value of the property securing the loan minus the value of the land on which the property is located. Although the law imposes a minimum amount that each loan must have and establishes a per-loan maximum, the law does not prevent lenders from requiring that each loan be insured up to the maximum coverage available through the NFIP (although some states prohibit requiring insurance beyond replacement costs). In no instance, however, will the NFIP provide coverage for a building for more than its insurable value, even if the loan value, exclusive of the land, exceeds the insurable value of the building.

Lenders can also require that personal property within a structure located in a SFHA be insured if the property secures all or part of a loan. From a lender's perspective, requiring insurance on a building's contents may be prudent when the property, real or personal, represents collateral for the loan.

<sup>15</sup> Lenders that originate loans using standard forms from Fannie Mae and Freddie Mac, which are commonly used in the industry even for loans not sold on the secondary market, have had legal authority at least since 1990 to require flood insurance and to force place this insurance if borrowers fail to obtain or renew coverage when it is required.

<sup>16</sup> The Federal Financial Institutions Examination Council Act of 1978 (Title X of P.L. 95-630) created the FFIEC. It is an interagency body that prescribes uniform principles, standards, and report forms for the federal examination of financial institutions by the FRB, FDIC, NCUA, OCC, and OTS and makes recommendations to promote uniformity in the supervision of financial institution (FFIEC 2002). The National Flood Insurance Reform Act of 1994 (P.L. 103-325) requires the FFIEC "to consult with and assist federal entities for lending regulation...in developing and coordinating uniform standards and requirements for use by regulated lending institutions under the national flood insurance program." Title XII of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (P.L. 104-208) requires the FFIEC and each federal banking agency represented on the FFIEC to conduct, "not less frequently than once every 10 years...a review of all regulations prescribed by the Council or by any such appropriate Federal banking agency, respectively, in order to identify outdated or otherwise unnecessary regulatory requirements imposed on insured depository institutions." The chairman of the FCA has been a nonvoting member of the FFIEC since 1985, and the FCA coordinates its policies with those the FFIEC establishes.

Fourth, the 1994 law also created a Flood Insurance Interagency Task Force to ensure compliance among federally regulated lenders, GSEs, and federal agencies providing financial assistance for construction or acquisition of property in SFHAs. The Task Force included representatives from FEMA, HUD, the VA, the FCA, the FFIEC, Freddie Mac, Fannie Mae, the Rural Housing Service, the Small Business Administration (SBA), and the Office of Federal Housing Enterprise Oversight (OFHEO).<sup>17</sup> The Task Force, which submitted its final report to the Congress in September 1998, had five duties: a) to recommend standardized enforcement procedures; b) to study possibilities for federal entities to assist in ensuring compliance with the mandatory purchase requirement; c) to study compliance among federal agencies; d) to recommend enforcement and compliance procedures for federal agencies; and, e) to study fees paid to companies for determining whether a property is located in a SFHA.

The Task Force (1998) report was notably modest in its recommendations related to the mandatory purchase requirement. The Task Force developed a list of enforcement best practices and recommended that the GSEs and the federal regulatory agencies consider implementing these practices.

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<sup>17</sup> OFHEO, which was created in 1992 as an independent entity within the Department of Housing and Urban Development, oversees the safety and soundness of Fannie Mae and Freddie Mac.

## 4. STUDIES OF THE MANDATORY PURCHASE REQUIREMENT

Prior research has sought to reconcile the number of flood insurance policies written each year with much higher estimates of the number of properties that are presumed to be subject to the requirement. This research has identified several core debates about mandatory purchase without resolving the central issue: what are the rates of compliance with the requirement and how well does it achieve its objectives?

In the first of these studies, the General Accounting Office (GAO) reported on the mandatory purchase requirement in 1990 and concluded that FEMA's perception of substantial noncompliance differed from lenders' and federal regulatory agencies' belief that compliance was not a problem. As an illustration, FEMA estimated that there were 11 million households in SFHAs that could be covered by flood insurance in 1987, though not necessarily through mandatory purchase, but that there were only 1.4 million policyholders among them (U.S. House of Representatives 1990).<sup>18</sup> The GAO (1990) described federal regulatory agencies and lenders reporting several factors that "impede[d] full compliance with the requirement." According to the GAO, the lack of readability, lack of accuracy, and the expense of maintaining FIRMs complicated lenders' compliance. In the GAO's opinion, the expense of flood insurance discouraged borrowers from renewing their coverage. Finally, complying with the mandatory purchase requirement allegedly put regulated lenders at a competitive disadvantage to nonregulated lenders (such as private mortgage companies) who were not subject to the requirement or the expenses associated with it.

The GAO also described postdisaster studies from Maine and Texas that examined why flood-disaster victims who owned personal residences and had applied for disaster assistance had not previously been covered by flood insurance. Among the 147 properties located in SFHAs in Maine, the GAO found that 78 percent were in compliance with the mandatory purchase requirement. In contrast, only 9 of 43 properties in SFHAs in Texas that should have had flood insurance did so.

It is of corollary interest that over 75 percent of all the property owners who applied for federal disaster assistance in the two states were *not* subject to the requirement primarily because the owners had mortgages from nonregulated lenders. These data indicate that fewer than one in four properties that flooded were subject to the requirement. There are no accurate, comprehensive data indicating the proportion of properties that are subject to the requirement, but data like these from Maine and Texas suggest that compliance could have been high but that the number of flood insurance policies purchased as a result of the requirement was far lower than the number of structures located in SFHAs.

The study had several weaknesses. The GAO excluded loans for which a lender was unable to provide data so the proportion of properties that should have been covered by flood insurance may have been greater than reported. The GAO also noted that it conferred only with FEMA and lenders about the loans in its sample. Thus, the GAO did not know whether

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<sup>18</sup> In a study conducted for FEMA, PricewaterhouseCoopers (1999) estimated that 6.6 million structures, including 6.2 million residential structures, were located in SFHAs in 1997. FEMA currently estimates that there are about 7.9 million structures in SFHAs.



applicants for disaster assistance had received federal financial assistance to acquire or construct their homes. Property for which such federal financial assistance had been obtained would also be subject to the mandatory purchase requirement and was clearly not covered by flood insurance because the owners of such property were applying for disaster assistance.

A second GAO study examined compliance after floods occurred in New York and New Jersey in 1992. Data on mortgages were obtained from 752 homeowners without flood insurance in SFHAs who applied for disaster assistance in the two states (GAO 1993). Of these homeowners, 31 percent had mortgages from federally regulated lenders and were required to have flood insurance. The remainder, who were not required to have flood insurance, either did not have a mortgage (65 percent) or had a mortgage from a nonregulated lender (4 percent). Although the GAO's analysis was preliminary, it explained that erroneous flood determinations and poor enforcement were the primary causes of the noncompliance.

To determine the extent of compliance, FEMA examined applications for disaster assistance from 1,549 victims of a flood in August 1998 in northern Vermont (FEMA Region I 1999). Only 2 percent of the applicants had flood insurance, but most were not in SFHAs. Of those in SFHAs, 84 percent did not have flood insurance. More important, of those with no insurance, 45 percent had mortgages from a federally regulated lender and should have had insurance. These noninsured property owners received nearly \$500,000 in federal disaster assistance.

Geotrac, a flood determination company, found in 1999 that one-quarter to one-third of flood-damaged properties in Grand Forks, North Dakota required to have flood insurance were not covered. In fact, however, a re-analysis of the Geotrac data indicates that more than one-third of the properties either did not have flood insurance or had an inadequate amount of flood insurance. Thus, more than one-third of the properties were likely to have been noncompliant with the mandatory purchase requirement at the time of the study. Another privately funded study examined data from two counties in Kentucky after flooding in 1999 (GAO 2003a). Among homes with mortgages issued after 1994, 52 percent had flood insurance. Again, however, it is not clear what percentage of all the homes in the study were subject to the requirement.

FEMA's Office of Inspector General (2000) studied opportunities to enhance compliance with the mandatory purchase requirement in 16 communities in ten states in 2000. The inspector general (IG) found that many structures in floodplains in these communities did not have flood insurance, but that many of these structures were exempt from the requirement because they had no mortgage or ones from nonregulated lenders.<sup>19</sup> The study found an overall noncompliance rate of 10 percent, but this rate was affected by a sampling procedure that included a disproportionate number of structures in coastal areas, which typically have high rates of compliance. As a consequence of this biased sample, the IG declared its expectation that the national level of noncompliance would be "much greater" than found in its sample.

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<sup>19</sup> The report did not indicate whether any of the loans had been sold to Fannie Mae or Freddie Mac. Such loans would be subject to the requirement.

Further, the IG did not determine whether property owners had received federal financial assistance for construction or acquisition on the flood-prone properties. The IG subtracted the number of properties securing mortgages from nonregulated lenders and the number of properties without mortgages, assuming that these properties were not subject to the mandatory purchase requirement. In fact, these properties would be subject to the requirement if their owners had received federal financial assistance for construction or acquisition.

The GAO (2002) revisited the mandatory purchase requirement and determined that differences in the types of data collected accounted for the differences in perspective on compliance between FEMA and the federal agencies. These agencies routinely gather nonstatistical (and, therefore, not necessarily representative) samples from which they have found few violations with the requirement. Conversely, FEMA routinely gathers data on originations and expirations of flood insurance policies and receives anecdotal evidence from individuals with knowledge of the program.

Analyzing data on new mortgages, new flood insurance policies, and from the 1990 census, the GAO (2002) concluded that major noncompliance at loan origination is not a problem. The GAO focused on 471 census tracts in which almost all of the properties are located in SFHAs. For most of these flood-prone areas, more insurance policies were purchased than mortgages originated in 1999. Although the overall pattern of compliance appeared to be high in the communities studied, the GAO did find some communities in which the number of new mortgages exceeded the number of new flood insurance policies issued in the same year. This finding suggests localized problems with compliance.

The methodology in this GAO report did not assess compliance directly because it compared the number of new mortgages with the number of new insurance policies. The study did not match the new mortgages with the new insurance policies to determine whether they covered the same properties. For example, a concerned property owner not subject to the requirement who nonetheless purchased flood insurance in 1999 would “cancel” the noncompliant action of a property owner who did not acquire flood insurance for a loan subject to the mandatory purchase requirement. Only overlaps that mask noncompliance are possible under this methodology, so the study may have underestimated noncompliance. It is unclear whether the study included loans insured privately, loans from nonregulated lenders for which federal financial assistance had been provided, or properties covered by lender- or force-placed insurance, which is discussed below.

The GAO also discussed the challenges inherent in a definitive compliance study. The GAO observed the difficulty associated with collecting accurate, nationwide, property-specific data on mortgages, flood zone determinations, and flood insurance policies. The GAO noted the ongoing disagreement about which entities have authority and responsibility for addressing compliance, requiring information, and managing information. The report combined the activities and authority necessary for comprehensive, ongoing compliance assessment with those necessary for a one-time compliance assessment. The resources and information management systems required for the two options are different.

Although the GAO's 2002 assessment concluded that noncompliance with the mandatory purchase requirement at loan origination is not a problem, the GAO relied on the same data a year later (GAO 2003a) to conclude that the extent of noncompliance is unknown. The GAO cited several regional studies that found low overall participation rates, namely low proportions of eligible properties in SFHAs covered by flood insurance. As suggested above, low participation rates do not necessarily translate into low compliance because not all property owners in SFHAs are required to have flood insurance.

## 5. CONTEXT FOR THE MANDATORY PURCHASE REQUIREMENT

Providing context for the mandatory purchase requirement assists in understanding its scope and potential impact. For example, most NFIP policies cover residential property and most mortgages are liens against residential property. This report thus focuses on the requirement as it relates to residential rather than commercial property. Further, the structure of the housing market means that although most homes were built before the requirement became effective, most residential properties are subject to it because most are mortgaged and most mortgages originated after the requirement was amended in 1994. Finally, the majority of homeowner debt for properties in SFHAs is subject to the requirement due to the lending structure and secondary market for home loans.

### 5.1 Flood Insurance

About 4.56 million federal flood insurance policies were in force as of December 31, 2004 (see Table 2). Ninety-five percent of these policies covered residential properties. Within the residential category, nearly 69 percent of policies covered single-family residences and 20 percent covered condominiums. Given this overwhelming preponderance of residential policies, the most appropriate context for the mandatory purchase requirement is the residential housing market.

More than two-thirds of all policies cover properties in A zones, which designate areas subject to the 1 percent annual chance flood. A zones are typically adjacent to rivers, streams, and lakes although such zones are also designated in coastal areas, landward of V zones, which are coastal areas subject to high velocity wave action. Less than 2 percent of NFIP policies cover properties in V zones. A and V zones comprise the SFHAs covered by the mandatory purchase requirement.<sup>20</sup> In contrast and in most instances, policies covering properties in B, C, and X zones are purchased voluntarily.<sup>21</sup>

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<sup>20</sup> Some buildings in A and V zones are not subject to the mandatory purchase requirement because, for example, their owners do not have a mortgage. The owners of such buildings may elect to purchase flood insurance voluntarily. The proportion of policies in A and V zones purchased voluntarily is not known.

<sup>21</sup> B, C, and X zones represent areas of moderate and low risk and are outside the SFHA. As discussed below, some policyholders are administratively grandfathered. Due to a change in the boundaries of a SFHA, a property may be remapped into a SFHA but be allowed to retain the rates associated with the property's former location in a B, C, or X zone. Such "grandfathered" properties may be subject to the mandatory purchase requirement.

**TABLE 2: Number and Percentage Distribution of NFIP Policies in Force, by Selected Characteristics, as of December 31, 2004**

Selected characteristics	Number in force	Percent
Overall	4,558,696	100.0
Zone		
A Zone <sup>1</sup>	3,126,364	68.6
V Zone <sup>1</sup>	83,946	1.8
B, C, and X Zones	1,320,108	29.0
Other <sup>2</sup>	28,278	0.6
Occupancy		
Residential	4,347,131	95.4
Single-family	3,129,856	68.6
2-4 family	156,977	3.4
Other residential	138,274	3.0
Condominium <sup>3</sup>	922,175	20.2
Nonresidential	211,414	4.6

<sup>1</sup> Not all flood insurance policies for properties located in A and V zones are purchased to comply with the mandatory purchase requirement; policies can be purchased voluntarily.

<sup>2</sup> Includes policies sold through the Emergency Program, records on which the zone code is missing or invalid, and in D zones, which are areas in which FEMA has not made an assessment of a flood hazard but where flooding is considered possible.

<sup>3</sup> Residential Condominium Building Association Policies.

SOURCE: FEMA, BureauNet. Data accessed on March 9, 2005.

Table 3 provides selected median housing costs for owner-occupied units. In mid-2004, the median annual cost of flood premiums for residences in an A zone was \$424 while the median annual cost for homes in a V zone was \$1,182. The A zone premium was about \$100 less than the median hazard insurance premium (as of 2003), each of which comprised about 4 and 5 percent of total housing costs, respectively. The V zone premium represented about 11 percent of total housing costs, when the increased total cost was considered.

In addition, it is important to note that the rates shown in Table 3 reflect the composite of annual average rates for pre-FIRM and post-FIRM structures. The latter include those built in compliance with the NFIP's building requirements, typically after a community's entry into the NFIP and after completion of a FIRM. Rates for compliant, post-FIRM structures are significantly lower than for comparable pre-FIRM structures, which are those constructed before base flood elevations were determined for a community and often without knowledge that a building was in a floodplain.<sup>22</sup>

<sup>22</sup> The base flood elevation (BFE) represents the estimated water surface elevation resulting from the 1 percent annual chance flood.

**TABLE 3: Comparison of Selected Annual Housing Costs for Owner-Occupied Units, 2003**

Expense	Percent of Total	
	Dollars	Housing Costs
Total	\$10,840	
Median annual residential mortgage payment for principal and interest	8,508	78.5
Median annual real estate tax burden	1,368	12.6
Median annual hazard insurance premium	540	5.0
Average annual residential NFIP policy premium <sup>1</sup>	424	3.9
A Zone <sup>2</sup>	446	4.1
V Zone <sup>2</sup>	1,182	10.9

<sup>1</sup> Includes policies in flood zones other than A and V. Most of these policies are purchased voluntarily because the mandatory purchase requirement usually applies only to properties in A and V zones.

<sup>2</sup> Not all flood insurance policies for properties located in A and V zones are purchased to comply with the mandatory purchase requirement; they can be purchased voluntarily. Annual average policy premiums are from 2004.

SOURCE: U.S. Department of Commerce (2004c), Table 2-13 and FEMA, BureauNet, accessed August 2, 2004.

The data in Table 4 demonstrate that several variables affect premiums for flood insurance. The average premium for structures in V zones, where the velocity of floods can damage these structures, is significantly higher than those for structures in A zones, which are likely to experience rising water without the same velocity. Property owners in B, C, and X zones, all of which are *outside* of SFHAs, have the highest amounts of coverage for buildings and their contents, perhaps because it is also the least expensive. In other words, property owners who seemingly have the least need for flood insurance have the most coverage.

Average premiums for residential buildings and their contents are lower than for nonresidential buildings: \$394 versus \$1,299 in November 2004 (the amount of coverage available for residential buildings is lower than the amount available for nonresidential buildings). Single-family homes in A zones have average premiums of \$460 whereas condominium units have average premiums of \$136 for similar coverage, although policyholders in condominiums typically purchase significantly lower amounts of coverage for their contents. Coverage amounts vary as well. The average residential policy provides \$129,529 in building coverage whereas the average nonresidential policy provides \$223,123.

**TABLE 4: Comparison of Average NFIP Premiums and Coverage Amounts, November 2004**

<b>Selected Characteristics</b>	<b>Average Premium<sup>1</sup></b>	<b>Average Building Coverage</b>	<b>Average Contents Coverage</b>
Overall	\$459	\$133,882	\$28,900
Zone <sup>1</sup>			
A Zone <sup>2</sup>	488	130,246	22,939
V Zone <sup>2</sup>	1,285	134,494	19,109
B, C, and X Zones	339	144,381	44,127
Other <sup>3</sup>	470	34,121	2,845
Occupancy			
Residential	394	129,529	26,855
Single-family	460	139,212	35,415
2-4 family	493	126,353	18,174
Other residential	503	97,699	20,698
Condominium <sup>4</sup>	136	102,029	2,447
Nonresidential	1,299	223,123	70,821

<sup>1</sup> Includes the federal policy fee, which is used to defray some of the NFIP's administrative expenses.

<sup>2</sup> Not all flood insurance policies for properties located in A and V zones are purchased to comply with the mandatory purchase requirement; policies can be purchased voluntarily.

<sup>3</sup> Includes policies sold through the Emergency Program, records on which the zone code is missing or invalid, and in D zones, which are areas where FEMA has not made an assessment of a flood hazard where flooding is considered possible.

<sup>4</sup> Residential Condominium Building Association Policies.

SOURCE: FEMA, BureauNet. Computed from data accessed on January 25, 2005.

## 5.2 The Housing Market

Americans can choose from many housing options. People can buy or rent their homes, live in detached houses or large apartment buildings, and choose between old and new residences. The housing choices that individuals make shape the housing market on which the mandatory purchase requirement depends.

Table 5 shows the percentage distribution of total occupied housing units, by type of housing. In mid-2004, the homeownership rate among Americans was 68 percent. In other words, almost seven in ten residences are owner-occupied. Seventy percent of homes are single-unit residences, 23 percent are part of multi-unit residences, and 6 percent are manufactured homes.

As of 2003, more than half of American residential units had been constructed before 1975 (see Table 6), meaning that many residential units were constructed before FIRMs were completed and before the adoption of building codes emphasizing flood safety and protection.

**TABLE 5: Total Occupied Housing Units, by Type of Housing, 2003**

	Total		Owner-Occupied	Renter-Occupied	Homeownership Rate
	Number	Percent			
Total	105,842,000	100	72,238,000	33,604,000	68.0
Type of structure and number of units					
Detached, single unit	67,753,000	64.0	59,642,000	8,111,000	88.0
Attached, single unit	6,272,000	5.9	3,679,000	2,593,000	58.7
2 to 4	8,474,000	8.0	1,426,000	7,048,000	16.8
5 to 9	5,135,000	4.9	501,000	4,634,000	9.8
10 to 19	4,468,000	4.2	485,000	3,983,000	10.9
20 to 49	3,294,000	3.1	389,000	2,905,000	11.8
50 or more	3,592,000	3.4	601,000	2,991,000	16.7
Manufactured home or trailer	6,854,000	6.5	5,514,000	1,340,000	80.4
Select other categories (may be included above)					
Cooperative	558,000	0.5	378,000	180,000	67.7
Condominium	4,722,000	4.5	3,416,000	1,305,000	72.3

NOTE: Detail may not sum to totals due to rounding.

SOURCE: U.S. Department of Commerce (2004c), Table 1A-1.

**TABLE 6: Total Occupied Housing Units, by Year of Construction, 2003**

	Number	Percent
Total	105,842,000	100.0
2000 to 2004 <sup>1</sup>	5,228,000	4.9
1995 to 1999	7,922,000	7.5
1990 to 1994	6,344,000	6.0
1985 to 1989	7,936,000	7.5
1980 to 1984	6,641,000	6.3
1975 to 1979	10,876,000	10.3
1970 to 1974	9,598,000	9.1
1960 to 1969	13,781,000	13.0
1950 to 1959	11,933,000	11.3
1940 to 1949	7,098,000	6.7
1930 to 1939	5,432,000	5.1
1920 to 1929	4,750,000	4.5
1919 or earlier	8,304,000	7.8
Median year constructed	1971	

<sup>1</sup>The survey used the category "2000-2004" even though it was performed in 2003.

NOTE: Detail may not sum to totals due to rounding.

SOURCE: U.S. Department of Commerce (2004c), Table 1A-1.

The mandatory purchase requirement utilizes the market for home mortgages to reach property owners who may be at risk for flooding. Table 7 demonstrates the scope of the home



mortgage market. At least 63 percent of all owner-occupied residences in 2003 were mortgaged or had a home equity loan on them.<sup>23</sup> A smaller proportion, 42 percent, of manufactured homes had liens against them. These data do not include nonowner-occupied residences, which comprise about 32 percent of the total housing units and which may also be subject to the mandatory purchase requirement.

Of these mortgages, the majority were originated after the effective date of the mandatory purchase requirement: more than 98 percent of mortgages existing in 2003 were originated in 1974 or later (see Table 8). A negligible proportion of mortgages on manufactured homes were originated before the requirement became effective. Further, at least half of the existing mortgages were originated after 1994, when the present purchase requirement became effective. More than 85 percent of mortgages on manufactured homes originated after 1994.

It is useful to consider how many home sales occur each year according to the types of financing homebuyers opt to use because the origination of mortgages for home sales are a primary trigger of the mandatory purchase requirement. (Refinancing, second mortgages, and home equity loans also trigger the requirement.) Nearly 7.2 million new and existing homes were sold in 2003. This represents an increase since 1988, particularly between 1994 and 2003. In fact, among all owner-occupied housing units, 24 percent were acquired in 2000 or later, and another 24 percent were acquired between 1995 and 1999 (U.S. Department of Commerce 2004c).

**TABLE 7: Number and Percentage Distribution of Owner-Occupied Residences, by Ownership Status and Type of Residence, 2003**

Ownership Status	Total Owner-Occupied Units <sup>1</sup>		Manufactured Homes	
	Number	Percent	Number	Percent
Total	72,238,000	100	5,514,000	100
No mortgage, owned free and clear	25,020,000	34.6	3,100,000	56.2
Regular and/or home-equity mortgage and reverse mortgage	45,471,000	62.9	2,319,000	42.1
Line of credit not reported	1,700,000	2.4	95,000	1.7

<sup>1</sup> Includes manufactured homes.

NOTE: Detail may not sum to totals due to rounding.

SOURCE: U.S. Department of Commerce (2004c), Table 3-15.

<sup>23</sup> Two percent of respondents did not report a line of credit. These nonrespondents could fall into either category.

**TABLE 8: Number and Percentage Distribution of Mortgages, by Year of Mortgage Origination, 2003**

Year of Origination	Total Owner-Occupied Units <sup>1</sup>		Manufactured Homes	
	Number	Percent	Number	Percent
Total	43,677,000		2,290,000	
2000 to 2004 <sup>2</sup>	23,739,000	54.3	1,016,000	44.3
1995 to 1999	10,343,000	23.7	939,000	41.0
-----Changes to mandatory purchase requirement became effective-----				
1990 to 1994	4,595,000	10.5	231,000	10.1
1985 to 1989	2,249,000	5.1	61,000	2.7
1980 to 1984	889,000	2.0	24,000	1.0
1975 to 1979	1,013,000	2.3	13,000	0.6
-----Mandatory purchase requirement initiated-----				
1970 to 1974	486,000	1.1	2,000	0.1
1960 to 1969	363,000	0.8	4,000	0.2
Median	2000+		1999	

<sup>1</sup> Includes manufactured homes.

<sup>2</sup> The survey used the category “2000-2004” even though it was performed in 2003.

NOTE: Detail may not sum to totals due to rounding.

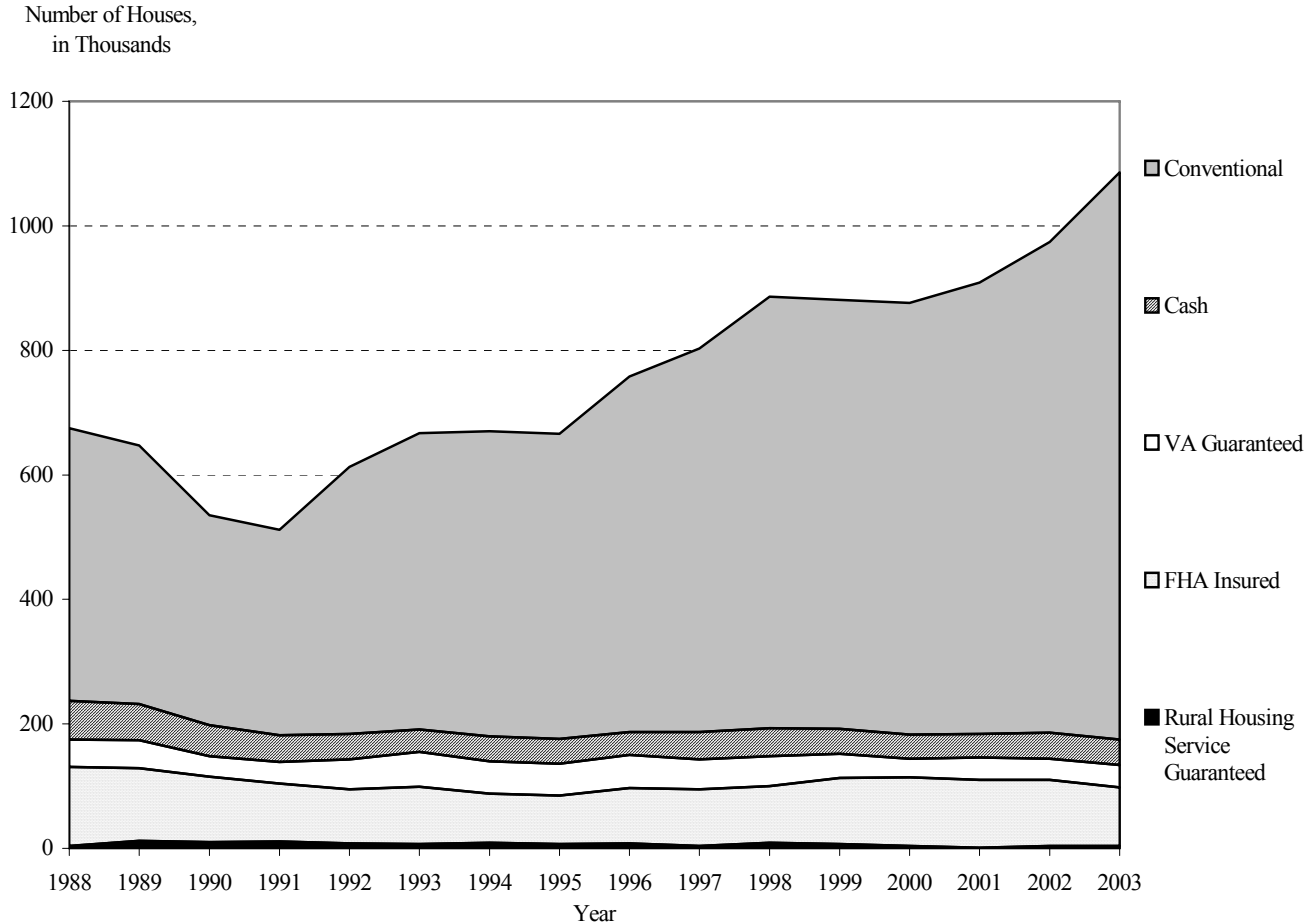
SOURCE: U.S. Department of Commerce (2004c), Table 3-15.

Between 1988 and 2003, conventional loans were used to finance the majority of home sales (see Figure 1).<sup>24</sup> Further, conventional loans represented an increasing proportion of the housing market during the same period. It is difficult to know how many conventional loans are subject to the mandatory purchase requirement because the Bureau of the Census does not collect data on the number of mortgages made by regulated versus nonregulated lenders or ask homebuyers whether their mortgages have been sold in the secondary market. Indeed, most homeowners probably do not know whether their loans have been sold; at most, they will know whether the servicing has been transferred, which may or may not be concurrent with a sale of the loan. Even if the Census Bureau had such data, it would not know which loans are subject to the purchase requirement without corresponding information about which structures are or are not in SFHAs.

<sup>24</sup> In 2003, as an example, conventional loans were used to finance the purchase of 84 percent of new homes. Loans from the Department of Veterans Affairs, the Federal Housing Administration, and the Rural Housing Service were used to finance the purchase of an additional 12 percent. Cash was used for 4 percent.

Other financing options include cash payment, which is not subject to the mandatory purchase requirement, and federal financial assistance for acquisition or construction, which is. The proportion of loans sold via federal financial assistance from the Department of Veterans

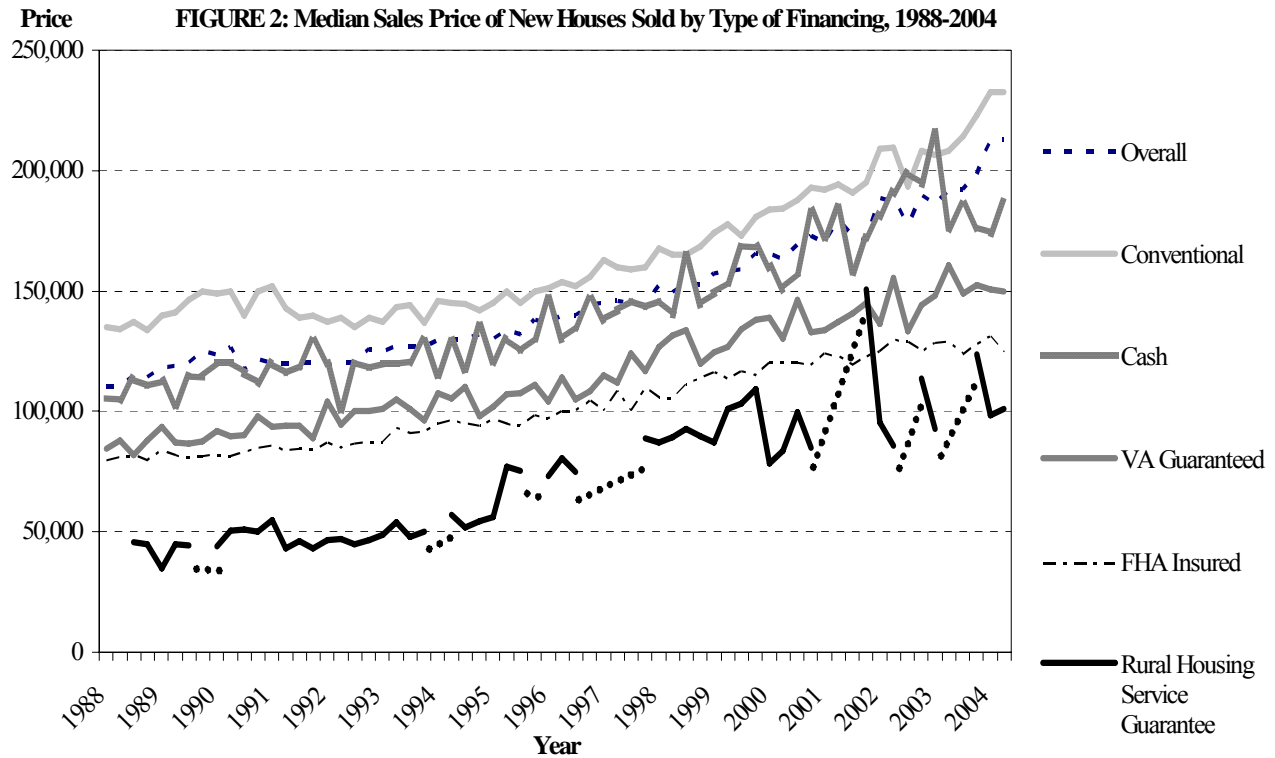
**FIGURE 1: Number of New Houses Sold by Type of Financing, 1988-2003**



SOURCE: U.S. Department of Commerce (2004a).

Affairs (VA), the Federal Housing Administration (FHA), or the Rural Housing Service (RHS) diminished between 1988 and 2003 (see Figure 1). Loans associated with federal financial assistance for structures in SFHAs are always subject to the mandatory purchase requirement whereas conventional loans are subject to the requirement only if they are originated by a regulated lender or purchased by Fannie Mae or Freddie Mac. As a consequence, the proportion of loans subject to the mandatory purchase requirement decreased. The number of loans that the government was required to monitor (i.e., loans for which federal financial assistance was issued) diminished whereas the number of loans required to be monitored by private industry, which is supervised and examined by the government, grew.<sup>25</sup>

<sup>25</sup> See the discussion below on monitoring the mandatory purchase requirement for a fuller description of the variety of monitoring processes that exist among federal agencies.



..... : Data withheld because estimate did not meet publication standards on the basis of response rate, associated standard error, or a consistency review.

SOURCE: U.S. Department of Commerce (2004b).

Home prices vary in relation to the type of financing used at purchase. The median price of new homes purchased with conventional loans is higher than that of new homes purchased with cash, which is higher than the median price of new homes purchased with federal financial assistance. Figure 2 illustrates that home prices rose between 1988 and mid 2004. In 1995, the median price of new homes purchased with conventional loans was \$145,000. This median price was significantly below \$250,000, the maximum amount of coverage available through the NFIP for residential properties since 1994. In other words, for the half of all new homes sold with conventional loans that cost more than \$145,000, it is likely that many were still under the \$250,000 ceiling. In 2004, however, the median sales price of new homes with conventional loans had increased to \$237,200, revealing that many homes are worth more than the \$250,000 ceiling.<sup>26</sup> This is less of an issue for home owners that received federal financial assistance. The median price for new homes purchased with VA-guaranteed loans was \$149,400 in 2004. The comparable amounts for FHA-insured loans and RHS-guaranteed loans were \$128,800 and \$102,100, respectively.

<sup>26</sup> Readers should remember, however, that mortgages typically cover the structure and the land, whereas flood insurance covers only structures and not land, so the shortfall is not as large as it appears. The median prices also disguise differences among regions. The Bureau of the Census estimated that 53 percent of new homes sold in the Northeast and 45 percent of those sold in the West had a sale price, including the value of the improved lot, of \$300,000 or more in 2004. During the same period, according to the Bureau, the median sales price of homes was \$312,000 in the Northeast, \$203,400 in the Midwest, \$178,500 in the South, and \$279,300 in the West.

According to the Bureau of the Census, nearly 17 million owner-occupied residential housing units, or almost 24 percent of the total, had an estimated value of \$250,000 or more in 2003 (Table 9).<sup>27</sup> Although these units can meet the mandatory purchase requirement, some portion of these units cannot be insured adequately unless a supplemental flood policy is purchased from a private insurer. Table 9 outlines the distribution of owner-occupied residential units by purchase price and their estimated value in 2003. The data in the table reflect a significant difference between purchase price and value, with the latter much higher. Mortgages are based on the purchase price of homes, so that data also suggest that some of the value in Americans' homes is underinsured should they be damaged by floods.

**TABLE 9: Distribution of Owner-Occupied Residential Units by Purchase Price and Value, 2003**

Owner-Occupied Residential	Purchase Price		Value	
	Number	Percent	Number	Percent
<i>Total</i> <sup>1</sup>	64,154,000	100.0	72,238,000	100.0
Up to \$29,999	14,270,000	22.2	4,714,000	6.5
\$30,000 to \$59,999	12,013,000	18.7	6,049,000	8.4
\$60,000 to \$99,999	13,068,000	20.4	13,867,000	19.2
\$100,000 to \$149,999	10,187,000	15.9	14,266,000	19.7
\$150,000 to \$199,999	6,246,000	9.7	9,989,000	13.8
\$200,000 to \$249,999	3,116,000	4.9	6,358,000	8.8
<i>Under NFIP coverage limit, subtotal</i>	58,900,000	86.1	55,243,000	76.5
-----NFIP flood insurance coverage limit-----				
\$250,000 to \$299,999	1,785,000	2.8	4,561,000	6.3
\$300,000 or more	3,469,000	5.4	12,434,000	17.2
<i>At or above NFIP coverage limit, subtotal</i>	5,254,000	8.2	16,995,000	23.5

<sup>1</sup> For purchase price only, total excludes units with no purchase price reported.

NOTE: Detail may not sum to totals due to rounding.

SOURCE: U.S. Department of Commerce (2004c), Table 3.14.

Regulated lenders must require that borrowers subject to the mandatory purchase requirement retain flood insurance to the lesser of the balance of the loan outstanding or to the maximum coverage available (\$250,000). The balance of the loan outstanding (current value of the loan) often represents only a portion of a mortgaged property's value.<sup>28</sup> Borrowers reduce their mortgage balances while property typically appreciates in value. Inflation exacerbates the difference in loan amount and property value. Table 10 illustrates the distribution of homes by the current amount of the home loan as a percentage of their total value. Eighty-seven percent of loans secured by owner-occupied home were for less than 90 percent of the property value in 2003. Sixty-eight percent of loans secured by owner-occupied manufactured home were for less than 90 percent of the property value. Due to the considerable equity that many homeowners

<sup>27</sup> The U.S. Department of Commerce (2004c) defines a housing unit as a "house, apartment, group of rooms, or single room occupied or intended for occupancy as separate living quarters." Living quarters include structures intended for residential use, such as a house, apartment, boarding house, or manufactured home.

<sup>28</sup> Data comparing current loan value to replacement cost are not available, and the reader is again reminded that property values typically include the value of land, which cannot be insured.

have, the minimum amount of required flood insurance may be less than the value of the structure, thus exposing many equity-rich homeowners in SFHAs to significant risk.

**TABLE 10: Number and Percent of Mortgages, by Current Value of Loan as Percent of Value, 2003**

Current Value of Loan as Percent of Total Value	Total Owner-Occupied Units <sup>1</sup>		Manufactured Homes	
	Number	Percent	Number	Percent
Total	43,680,000	100.0	2,289,000	100.0
Less than 39 percent	12,802,000	29.3	465,000	20.3
40 to 79 percent	20,868,000	47.7	618,000	27.0
80 to 89 percent	4,365,000	10.0	185,000	8.1
90 to 99 percent	3,097,000	7.1	227,000	9.9
100 percent or more	2,548,000	5.8	794,000	34.7
Median percentage	58.7		83.3	

<sup>1</sup> Includes manufactured homes.

NOTE: Detail may not sum to totals due to rounding. Mortgages include home-equity loans.

SOURCE: U.S. Department of Commerce (2004c), Table 3-15.

Lenders must also require that borrowers subject to the mandatory purchase requirement retain flood insurance for the life of the loan. Table 11 shows the distribution of home loans by the term of the loan at loan origination. Mortgages are generally long term: nearly 64 percent of home loans for owner-occupied units are originated with terms of 28 years or more. Mortgages on manufactured homes are of a shorter duration: almost 60 percent of such loans are for 22 or fewer years.

**TABLE 11: Number and Percent of Primary Mortgages by Term of Loan at Origination or Assumption, 2003**

	Total Owner-Occupied Units <sup>1</sup>		Manufactured Homes	
	Number	Percent	Number	Percent
Total	43,677,000	100.0	2,289,000	100.0
Less than 8 years	1,197,000	2.7	192,000	8.4
8 to 12 years	1,521,000	3.5	225,000	9.8
13 to 17 years	8,979,000	20.6	589,000	25.7
18 to 22 years	2,824,000	6.5	364,000	15.9
23 to 27 years	1,113,000	2.5	151,000	6.6
28 to 32 years	27,048,000	61.9	754,000	32.9
33 years or more	806,000	1.8	11,000	0.5
Variable	189,000	0.4	3,000	0.1
Median (in years)	29		20	

<sup>1</sup> Includes manufactured homes.

NOTE: Detail may not sum to totals due to rounding.

SOURCE: U.S. Department of Commerce (2004c), Table 3-15.

FIGURE 3: Median Age of Refinanced Mortgages, 1997-2004



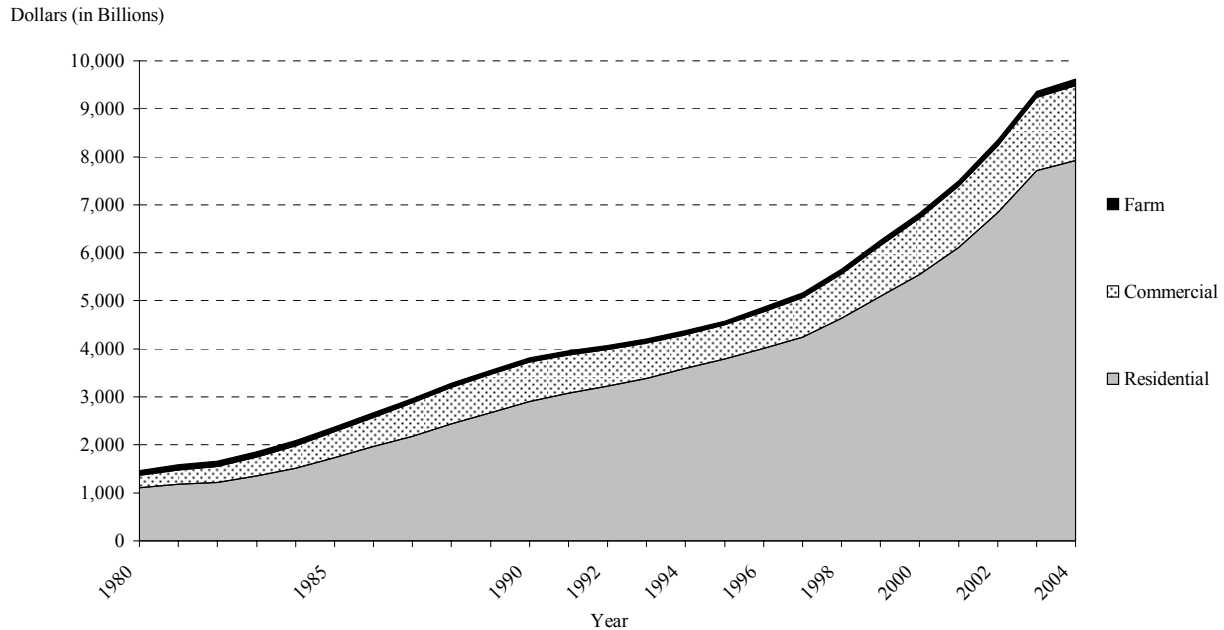
SOURCE: Freddie Mac (2004a).

Despite the length of home loans at origination, the actual duration of most mortgages is much shorter. As interest rates declined to near-record lows in recent years, millions of Americans refinanced their mortgages. Refinancing represented more than two-thirds of the value of all mortgage obligations in 2003. The median age of refinanced home loans decreased to less than two years in the second quarter of 2004 from about four years in 1997 (see Figure 3). Actual loan lengths are short because many borrowers relocate or refinance their properties frequently.

### 5.3 The Lending Industry

Mortgage lending is a fast-growing industry. As shown in Figure 4, the total mortgage debt in the United States increased to \$9.4 trillion in 2003 from \$3.8 trillion in 1990. Residential mortgage debt grew to \$7.7 trillion from \$2.9 trillion over the same period. Commercial mortgage debt grew to \$1.5 trillion from \$821 billion. Farm mortgages increased to \$132 billion during the same period. Clearly, residential mortgage lending is a large industry. Such lending represents more than 80 percent of all mortgage debt in the United States.

FIGURE 4: Mortgage Debt Outstanding, by Type of Mortgage, 1980-2004



Several kinds of lending institutions issue these mortgages (see Figure 5). For the purposes of mandatory purchase, there are two categories – regulated and nonregulated institutions. Regulated institutions are monitored by one or more of the federal entities for lending regulation and include commercial banks, savings institutions, credit unions, and farm credit system institutions.

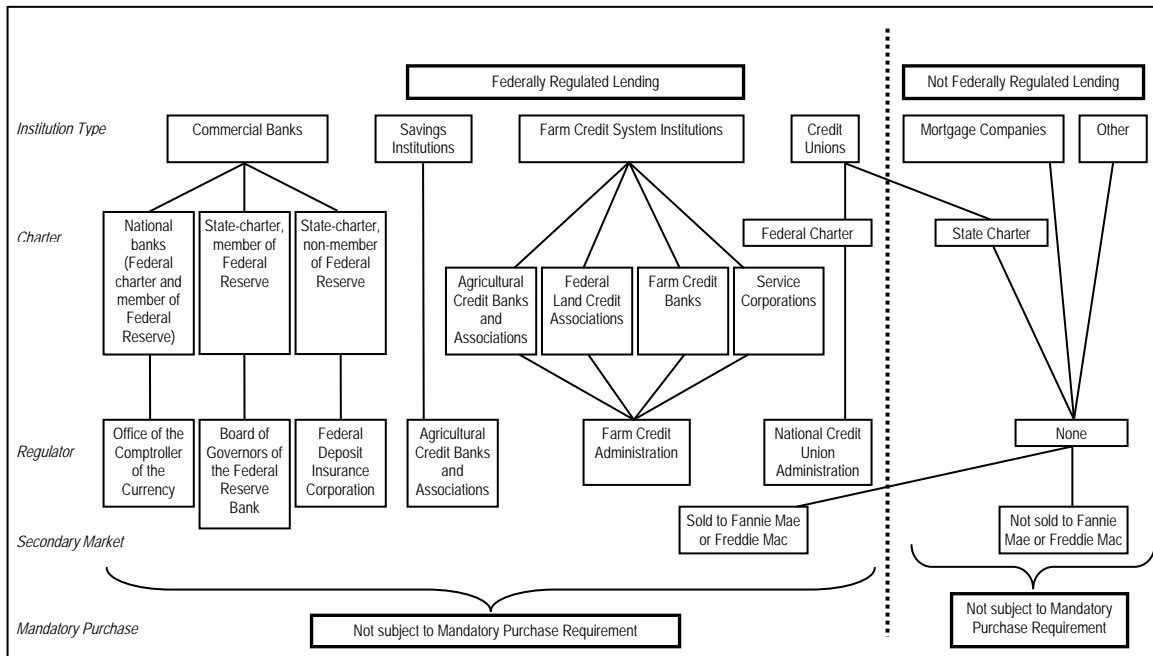
There are several kinds of commercial banks, depending on their charter (state or federal) and membership in the Federal Reserve System. The OCC regulates all national banks. The FRB supervises state-chartered banks that are members of the Federal Reserve System as well as all bank and financial holding companies. The FDIC regulates state-chartered banks that are not members of the Federal Reserve System. The OTS is the primary regulator of all federal and many state-chartered savings banks and savings and loan associations, which are primarily involved in the extension of credit through mortgages. The FCA supervises the Farm Credit System. For purposes of mandatory purchase, the NCUA supervises federally chartered credit unions and state-chartered, federally insured credit unions. In addition, each of these agencies has concluded that the mandatory purchase requirement is applicable to subsidiaries of regulated lending institutions (U.S. Department of the Treasury et al. 1996)

Nonregulated institutions, which are typically private mortgage companies, are not regulated by the federal regulatory agencies for their lending practices.<sup>29</sup> Mortgages from these nonregulated lenders are not subject to the requirement (unless these mortgages are subsequently sold to Fannie Mae or Freddie Mac or issued by subsidiaries of regulated lenders).

<sup>29</sup> Such institutions are, nevertheless, subject to certain federal regulations related to lending, such as those governing truth in lending and the Real Estate Settlement Procedures Act.



**FIGURE 5: Regulatory Structure of Lending Institutions\***



\*The Federal Trade Commission regulates independent mortgage lenders but not for purposes of flood insurance.

Most mortgages are subject to the requirement either because a regulated lender has issued them or because they have been sold on the secondary market to Fannie Mae or Freddie Mac. The Department of Commerce collects information on lending activity from the federal regulators, but the information does not yield data on nonregulated lending activity. Fannie Mae and Freddie Mac know the number of loans they purchase. What is not known is the number they do not purchase and the proportion of the loans not purchased that nonregulated lenders originated. It is thus difficult to determine the proportion of all mortgages that are subject to the mandatory purchase requirement.

The Federal Reserve System tabulates total outstanding mortgage debt in the United States by the holder of the debt. Regulated lenders, the federal government, Fannie Mae, and Freddie Mac hold most of the mortgage debt in the United States. For properties in SFHAs in participating communities, nearly all of this debt is subject to the mandatory purchase requirement. Entities subject to the requirement held at least \$1.1 trillion of mortgage debt in 1980 (or at least 77 percent) and a similarly high percentage of the \$9.4 trillion in mortgage debt in 2003.<sup>30</sup>

<sup>30</sup> Data on federally regulated and state-chartered federally insured credit unions could not be disaggregated from a larger sum of mortgage debt prior to 1995. Therefore, the regulatory status of this debt cannot be determined. The inclusion of mortgage debt from credit unions not regulated by the NCUA would increase the share of nonregulated mortgage debt for 1980.

## 6. STATUTORY REQUIREMENTS FOR REGULATED LENDERS

Regulated lenders are private lending institutions that are regulated by one or more of the federal regulatory agencies. These lenders include commercial banks, savings institutions, credit unions, and farm credit institutions. In the process of issuing or holding loans, these lenders are required to take the following actions to comply with the mandatory purchase requirement:

- Determine whether a loan is secured by any improved real estate or manufactured home in a SFHA and then complete a Standard Flood Hazard Determination form to record this determination and, if applicable, specify the type of flood hazard zone within which the improved real estate or manufactured home is or will be located.
- Provide notice of the availability of flood insurance and any other information FEMA considers necessary to the borrower and any loan servicers involved with the loan when the property is in a SFHA.
- Ensure that flood insurance is maintained for the life of the loan on buildings or manufactured homes that are, or will be, located in a SFHA where insurance is available through the NFIP and force place such flood insurance on the property if necessary after providing the borrower opportunity to renew and retain it.
- Place premiums collected from the borrower for flood insurance into escrow if the lender also requires that payments for taxes, insurance premiums, fees or other charges must be placed in escrow.

Although these requirements may appear to be straightforward, such is not the case in terms of their implementation. The requirements bind the federal entities for lending regulation as well as all regulated lenders and the third parties that assist them in achieving compliance, but the interpretation of the requirements varies considerably. In turn, the requirement's complexity and misinformation about them can frustrate even well-intentioned efforts to comply with them. As the president of the National Lenders' Insurance Council (Moye 2004) observed, the mandatory purchase requirement "creates an adverse selection process fraught with perplexing, inconsistent and sometimes unworkable rules that create seemingly endless customer service and compliance issues." The following discussion offers some explanation for this conclusion.

### 6.1 Flood Determinations

Prior to the closing of a mortgage loan, regulated lenders are required to determine whether any improved real estate (or any portion of it) or a manufactured home securing the loan is or will be located in a SFHA.<sup>31</sup> In all instances, lenders, or the third-party vendors with whom they contract, are required to complete a Standard Flood Hazard Determination (SFHD) form to record the results of a determination.<sup>32</sup> Lenders are further obligated to retain a copy of the form

<sup>31</sup> If the permanent location of a manufactured home is not known at the time of closing, the lender must insure that a determination is completed as soon as the permanent location is ascertained.

<sup>32</sup> Federally regulated lenders have been required to use the form since January 2, 1996. Lenders that sell loans to Fannie Mae and Freddie Mac must also use the form. For mortgages issued prior to January 1996, the NCUA (2004) requires regulated credit unions to retain "(a) copies of official maps, including the date and complete panel number of the FEMA map used to determine whether the collateral is located in or out of a flood hazard zone; (b) written statements in each [loan] file indicating a loan determination was performed and the result; and (c) copies of any

for the life of the loan and to be able to produce a copy upon request by an examiner of their federal regulatory agency. The form records the determination and identifies the flood hazard zone within which the building or manufactured home is or will be located.

Although the completed form specifies whether a structure is or is not in a SFHA, the form does not indicate a building's elevation relative to the base flood elevation. In some instances, therefore, when a SFHD form indicates that the building is in a SFHA, the lender will require flood insurance even when a building is well above the BFE. Through the use of Letters of Map Amendment or Letters of Map Revision, the obligation to purchase flood insurance can be eliminated, but borrowers or developers must be informed about the procedures associated with these letters and obtain elevation certificates from licensed surveyors before applying for the amendments or revisions.

In addition, to facilitate compliance with the mandatory purchase requirement, the form must also include information on the status of the community in which the building or manufactured home is located. Although NFIP coverage is not available in communities suspended from the NFIP or in those that have declined to participate in it, lenders are obligated to complete a SFHD form for properties in those communities.<sup>33</sup>

Once a determination form has been completed, the determination can be used for seven additional years when a borrower increases, extends, or renews a loan secured by improved real estate with the original lender. A new determination is required if the FIRM has been revised or updated since the initial determination. It is unclear, however, how a lender could confirm that no map changes had taken place in the prior seven years without obtaining a new hazard determination. Similarly, a new flood determination is required when the property owner refinances a loan or obtains a home equity loan or second mortgage from a lender other than the one that obtained the initial determination, regardless of the interval since the original determination. In contrast, a lender's purchase of a loan does not create an obligation to obtain a flood hazard determination, even if one has never been conducted (U.S. Department of the Treasury et al. 1996; FFIEC 1997).<sup>34</sup> In contrast, if Fannie Mae or Freddie Mac purchase a loan, the affected lender has a continuing obligation to the GSE to have flood insurance in place if the home is in a SFHA.

To complete determinations, lenders can maintain paper FIRMs for their lending jurisdiction and use in-house staff to read them, access FIRMs at FEMA's website, or contract

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written contracts between the [credit union] and the appraiser performing flood assessments." The NCUA (2000b, 2004) incorrectly notes that a copy of the completed SFHD form must be kept in every loan file. Lenders are permitted to retain these forms electronically (U.S. Department of the Treasury et al. 1996).

<sup>33</sup> Federally regulated lenders have been allowed to provide mortgages to property owners in SFHAs in nonparticipating communities since 1977, but Fannie Mae and Freddie Mac are prohibited from purchasing these mortgages. As a result, these loans often have higher interest rates and shorter terms than conventional loans issued to borrowers in SFHAs in participating communities. Property owners in SFHAs in nonparticipating communities are not eligible for federal disaster assistance related to flooding if their community has been identified as a SFHA for one year or more or for federally insured or guaranteed loans at any time.

<sup>34</sup> The NCUA's regulations permit a federal credit union to purchase a loan only if the credit union could grant the loan or if the federal credit union refinances the loan within 60 days. In order to grant a loan, a federal credit union would have to complete a SFHD Form; a refinancing would also require a determination. The regulation applies only to federal credit unions, not to federally insured state-chartered credit unions.

with a flood zone determination company. Using paper FIRMs involves locating the address of the property on street maps before locating the structure on FIRMs, which often do not plot many streets. Street maps and FIRMs are unlikely to use the same scales, so moving between maps entails familiarity with FIRMs and flood zones. When a building is located on or near the boundary of a SFHA, the lender may need to ascertain the exact placement of the building to determine whether it is located in a SFHA.

Institutions with large geographic lending areas may face challenges when using paper FIRMs. They do not include information about Letters of Map Amendment or Map Revision, so it is unlikely that a lender doing manual flood determinations would know whether the property of interest had been subject to a map amendment or revision. As the Independent Community Bankers of America (2004) contends, “it is often difficult to assess whether a particular property is located in a flood hazard zone since flood maps are not easily accessible and are not always current.”

Lenders can obtain flood determinations from companies in the private sector. Using an external vendor for flood determinations involves sending the property address to a flood determination company, usually electronically. To process determinations quickly, most determination companies have developed detailed databases that combine information from FIRMs, changes in these maps that affect single properties, and data from other sources, such as local tax maps, into an automated process. When addresses are transmitted electronically and when the determination process is automated, a flood hazard determination can be completed and returned to a lender in minutes. Among flood determination companies that responded to a survey for the National Flood Determination Association (NFDA), 82 percent of their business was transacted electronically in fiscal year 2002 (as opposed to less than 55 percent in 1999). Their median “automatic hit rate” in 2002 was just over 84 percent.<sup>35</sup> Despite this rate, a previous survey conducted for the NFDA in 2000 found that 5 of 23 companies completed all of their determinations manually.

When AIR asked, some lenders did not know what processes their flood determination vendors use to make determinations. In fact, some lenders believe that their vendors visit each property to complete a determination, which is unlikely, given the small profit margins associated with individual determinations.

Several factors influence lenders’ decisions about how to make flood determinations. Paper flood maps require storage space and human capacity to interpret them. Institutions that lend over large regions may be disinclined to use paper FIRMs because they require a large number of FIRMs, and staff must be familiar with large geographic areas. Cost is another factor. Flood determination companies can charge according to volume, thus reducing the cost of each determination as the number of determinations increases. Lending institutions that extend few loans may then incur larger per-determination costs than do lending institutions that extend many loans.

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<sup>35</sup> Murray Franke Greenhouse List & Lippitt LLP conducted surveys for the association in 2002 and 2004. The responses are not representative of all flood determination companies. The results are available at <http://www.floodassoc.com>

As many as 100 or more companies provide flood determinations. Many provide determinations for limited geographic areas, such as for a single state. The largest firms provide determinations for most or all states and for the District of Columbia, Guam, Puerto Rico, and the Virgin Islands. The relative technological sophistication of flood determination companies varies considerably as does the number of determinations that each firm completes each year. A few flood determination companies complete several million determinations each year, encompassing all states, while smaller firms may provide a few thousand (or even fewer) determinations covering limited parts of a single state.

Prior to the development of the flood-determination industry (and prior to the 1994 Reform Act), lending institutions themselves typically made determinations about a property's location relative to a SFHA. As the FIA (1978b) once explained, in some instances, FIRMs "may not be clear enough to permit lending institutions to decide with certainty whether or not property is located" in SFHAs. As a consequence, the FIA

determined that a lender's decision made in the exercise of due diligence and good faith as to the location of a property, which is the subject of a loan...will be final and sufficient to comply with the [1973] Act. In such instances where a good faith finding has been made by a lender or its agent...such finding as to the location of a property shall be final with respect to such property, regardless of any subsequent contrary conclusion by any person, agency, or body, and regardless of any change of ownership of the property or status of the loan or transaction, provided [that] the map upon which the original finding was based is still in effect and remains unrevised as to the property in question.

Much has changed. Most regulated lenders now depend on flood determination companies, but as a result of the 1994 Reform Act lenders can do so "only to the extent [such a company] guarantees the accuracy of the information." What constitutes this guarantee is not consistent among companies. Although all information provided on the SFHD form must be guaranteed, the consequences of providing incorrect information are unclear but possibly detrimental. Some companies limit their liability to refunds for insurance premiums paid when a structure is not in a SFHA but incorrectly declared to be in one.

In other instances, companies may cover actual flood losses up to the limits of an NFIP policy when they have made an erroneous determination that a building is not in a SFHA but the building subsequently suffers damage from a flood (at or less than the magnitude of the 1 percent annual chance flood). Still other companies do not limit their liability to that associated with NFIP policies. These differences suggest the desirability of developing standards for what constitutes an adequate guarantee. To date, however, neither FEMA nor the federal regulatory agencies have proposed such standards or what constitutes an adequate guarantee of the information.

For several reasons, including ongoing remapping, the methods used to make the determinations, and the need to be aware of amendments to FIRMs, different flood determination

companies may not agree on whether a building is in a SFHA or whether a building in a SFHA is in an A or in a V zone with its higher premiums for flood insurance.<sup>36</sup>

To estimate the percentage of structures in flood-prone areas, AIR collected data on approximately 94 million flood determinations performed for lending institutions between 1997 and 2003 by seven flood determination companies' all of which provide determinations in all states. If the lenders complied with the requirements of the 1994 Reform Act, the determination companies guaranteed the accuracy of each of their determinations. The data, found in Appendix 1, suggest that slightly more than 5 percent of all residential properties in the United States are in SFHAs. Among the states, about one-quarter of such properties in Florida and Louisiana are in SFHAs. Fourteen states and the District of Columbia have 2 percent or fewer of their properties in SFHAs.<sup>37</sup>

Of equal interest, AIR found considerable variation among the seven determination companies in their assessments of the percentage of properties in each state that are in SFHAs. In Florida, as an illustration, one company estimated that 34.3 percent of residential properties are in SFHAs; another company estimated that percentage to be 24.7. Part of the explanation for the differences is that the companies may not provide determinations in all parts of a state. One company's lending clients may be concentrated in northern Florida whereas the clients of another determination company may be concentrated in southern Florida.

Having lending clients in different parts of the same state provides the most likely explanation for the differences, but still other data underscore the fact that flood determinations may be as much art as science. As part of an internal portfolio review in 2002, Fannie Mae randomly selected 9,500 loans in its portfolio and then asked four flood determination companies to indicate whether the buildings associated with these loans were inside or outside of SFHAs. All four firms agreed on the determinations for 3,001 addresses. For 2,784 of these addresses (or 29 percent), all four companies agreed that the properties were inside or outside of SFHAs. The four companies also agreed that the location of another 217 properties (2 percent) was indeterminable. One or more companies disagreed about the location or the ability to determine the location of 3,261 properties (34 percent). For the remaining 3,238 loans (34 percent), no three firms were able to agree that the properties were inside, outside, or indeterminable.

At the least, these data suggest that many property owners are told they are in SFHAs when they are not while others are told that they are outside of these areas when they actually are in them. The differences among the companies and the errors in some determinations suggest the need to assure the accuracy of flood determinations, especially when they are the basis for decisions about whether borrowers will be required to purchase flood insurance.

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<sup>36</sup> Some people interviewed for this report suggested that potential disagreements among flood determination companies provide opportunities for lenders to "shop" for determinations favorable to a borrower (i.e., a determination that a property is not in a SFHA or that it is in an A zone rather than a V zone). No evidence was found to substantiate such claims.

<sup>37</sup> The data in Appendix 2 provide estimates of the total number of housing units in each state.

### **Are Lenders' and Borrowers' Interests Protected Outside of SFHAs?**

The mandatory purchase requirement is restricted to properties in SFHAs, thus emphasizing the importance of accurate FIRMs. If these maps accurately portray areas that are prone to flooding, then damages associated with floods equal to or less than the 1 percent standard should be limited to buildings and their contents within SFHAs. If, in contrast, FIRMs are not as accurate as is desirable and property owners are therefore informed incorrectly that they face a low risk of flooding, then floods equal to or less than the 1 percent standard may cause considerable damage outside of SFHAs. In such instances, property owners outside of SFHAs may be at risk of floods of a magnitude less than the 1 percent standard, and failure to require flood insurance may be unwise.

Which of these situations best explains what occurs? An examination of flood insurance claims provides at least a partial answer. FEMA maintains a record of all claims since 1978. If SFHAs accurately identify areas of high risk, then a majority of claims should originate from within these areas. Several eastern states display exactly this pattern. About 64 percent of all NFIP policyholders in Virginia are located in SFHAs, but 76 percent of all claims from 1978 until mid-2004 were filed by policyholders in these areas. Similar patterns are found in Delaware, Rhode Island, and North and South Carolina. In these states flooding occurs exactly where it is expected – in SFHAs.

Across the United States and within many states, however, a different pattern emerges. For all states (plus the District of Columbia, Puerto Rico, and the Virgin Islands), almost 69 percent of all NFIP policies are in SFHAs, but 64 percent of claims are from these areas. A more dramatic pattern emerges in more than a quarter of the states. In 13 states, the District of Columbia, and the Virgin Islands, *more than half of all claims have been from policyholders outside of SFHAs*. At the extreme, 52 percent of policyholders in Utah are in SFHAs, but 82 percent of all claims in the state originated from outside these areas. In Arizona, less than 22 percent of policyholders are outside of SFHAs, but they have generated over 56 percent of the claims.

As one insurance executive (Goodwin 2004) has hypothesized, when flooding occurs outside of SFHAs, the level of damage and impact is typically more extreme than for similar events inside SFHAs. Data from many states support this conclusion. In 21 states and Puerto Rico, the average claim payment from 1978 to mid 2004 was larger outside of SFHAs than in high-risk A zones. In New Jersey, the average claim in X zones was almost 35 percent higher than in A zones (\$11,260 versus \$8,393). *In ten states and Puerto Rico, average claims were higher in low-risk X zones than in coastal, high-risk V zones despite premiums for coverage in V zones that are more than four times higher than in X zones for comparable amounts of coverage*. The average X zone claim payment in Texas was \$15,359 compared with \$6,257 in V zones. High claims outside of SFHAs may be due to a lack of preparation, low awareness, and the absence of any required flood-related construction standards.

These findings suggest that large numbers of uninsured losses occur outside of SFHAs and large numbers of uninsured properties are at risk. More important, these data also bring into question the wisdom of exempting property owners outside SFHAs from the mandatory purchase requirement when many of them face at least as much risk as owners within SFHAs. Informing property owners that they are outside of SFHAs may encourage a false sense of security, exempt them from a community's flood-related building standards, and discourage them from buying flood insurance when doing so would be desirable. Finally, the data underscore the importance of FEMA's map modernization program, which should improve the delineation and understanding of areas at high risk of flooding.

(Readers should be aware of at least two caveats regarding the data discussed in this text box. On the one hand, some flood-prone properties are not in officially designated SFHAs because they are in

areas that have not been mapped. There is not enough money to assess the flood risk in every part of the United States, so some watercourses susceptible to flooding may not be included in SFHAs. On the other hand, administrative grandfathering, which is discussed below, permits some policyholders in SFHAs to pay premiums associated with areas outside of SFHAs. FEMA is not able to distinguish readily which structures are administratively grandfathered. The consequence is that some insurance claims that appear to be from outside of SFHAs are actually from claimants within SFHAs.)

An issue related to flood determinations involves the “tracking” of loans over their life. The mandatory purchase requirement imposes obligations on lenders to ensure that flood insurance is in place “at any time during the term of a loan secured by improved real estate” when that real estate is in a SFHA in a participating community. Flood insurance is thus required even when the SFHA designation is identified after a loan closes (FEMA 1999).

To address the possibility that a community’s status may change or that map revisions will move buildings into or out of SFHAs (or from an A zone to a riskier V zone or vice versa), many flood determination companies offer “life-of-loan service.” For a small additional fee, often no more than \$5 per determination, the companies will monitor the status of a loan and inform the lender or its loan servicer whenever the relative location of a loan or its community status has changed. Lenders are permitted to charge borrowers a reasonable fee for the cost of the life-of-loan service (as well as for the original determination).

Some companies also offer “transferability,” which accommodates changes in loan servicers or the sale of a loan in the secondary market. An informal survey of flood determination companies suggests that about 90 percent of lenders use life-of-loan service, but the characteristics of the service vary among companies.

Despite the obligation to ensure that flood insurance is in place during the life of a loan in a SFHA, the 1994 Reform Act *does not* require life-of-loan tracking with transferability, *does not* require lenders to monitor changes in FIRMs or community status, and *does not* require lenders to make hazard determinations at any time other than when making, increasing, extending, or renewing a loan.<sup>38</sup> The absence of these obligations has not prevented some flood determination companies from claiming incorrectly that lenders must monitor map changes or have life-of-loan tracking. As an illustration, a brief search on the Internet found these erroneous assertions among the websites of several flood determination companies:

“Lenders are required to monitor existing loans for possible changes in flood zone status that may occur when the Federal Emergency Management Agency (FEMA) re-maps or re-designates special flood hazard areas.”

The 1994 Reform Act “requires that lenders must monitor loans to ensure that flood insurance is continued for the life of the loan and that changes in Flood Insurance Rate Maps be reflected in the requirement for insurance and the amount of premiums paid.”

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<sup>38</sup> As a practical matter, however, a lender is likely to perform these acts in order to fulfill its statutory responsibility for having flood insurance in place for whatever time the property is in a SFHA.



“Lenders are required to track flood zone determinations against post-origination map changes. If during the life of a loan, the flood insurance rate map changes, showing the structure in a Special Flood Hazard Area (SFHA) when it previously was not, lenders have to require that the borrower get flood insurance.”

The 1994 Reform Act declared “that all lenders are required to have a life of loan determination on all closed and portfolio loans.”

Life-of-loan service is not required, but it is increasingly popular among lenders. The NFDA’s surveys of its members indicate that the average number of life-of-loan certificates per respondent was about 5.1 million in fiscal year 1999. By 2002, this average had increased to nearly 10.7 million per respondent.

FEMA’s current map modernization program has important implications for the mandatory purchase requirement and for the desirability of life-of-loan tracking. During the modernization program, which will cost about \$1 billion, FEMA will increase the accuracy of FIRMs and increase their ease of use. In addition, however, FEMA expects that the completion of new FIRMs may add thousands of additional communities to the NFIP and place tens of thousands of properties into newly designated SFHAs. Similarly, the mapping initiative is likely to expand the boundaries of existing SFHAs, thus “relocating” thousands and even tens of thousands of properties into the expanded SFHAs. For these reasons, map modernization may exacerbate the levels of noncompliance with the mandatory purchase requirement because lenders are not presently required to monitor changes in FIRMs or a community’s status in the NFIP.

The federal regulatory agencies (U.S. Department of the Treasury et al. 1996) acknowledge that “Congress intended the flood insurance purchase requirements to be applicable at origination, or any time thereafter during the life of the loan when the institution determines that the security property is located in an area having special flood hazards.” Despite this requirement, the agencies do not consider remapping to be a trigger or tripwire event that mandates lenders to assess whether properties within their loan portfolios have been moved into or out of SFHAs as a result of the remapping. In the agencies’ words, the 1994 Reform Act “does not require lenders to monitor for map changes, and the agencies will not impose such a requirement by regulation” (U.S. Department of the Treasury et al. 1996).

These agencies (FFIEC 1997) and FEMA (1999) agree that if a lender “becomes aware” during the life of a loan that flood insurance is required because of remapping or a change in a community’s status, then flood insurance must be purchased, even after a loan has closed. What constitutes a lender’s awareness of a building’s changed status is unclear. For example, FEMA publishes a *Compendium of Flood Map Changes* in the *Federal Register* every six months.<sup>39</sup> The 1994 Reform Act requires FEMA to make available at no cost copies of each compendium to federal agency lenders, to the federal entities for lending regulation, and to the states and

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<sup>39</sup> The *Federal Register* is the official daily publication for rules, proposed rules, and notices of federal agencies and organizations as well as executive orders and other presidential documents. The semiannual compendium identifies all new FIRMs, changes in FIRMs, and all Letters of Map Amendment and Letters of Map Revision issued during the previous six months. These letters are discussed below.

communities that participate in the NFIP. FEMA (1999) recommends that lenders review their loans located within geographic areas affected by changes in the compendia.

Whether such reviews occur and whether the compendium also creates “awareness” among lenders is unclear. Few lending institutions maintain an internal capacity to determine which properties are inside or outside of SFHAs. Moreover, the federal regulatory agencies do not require lending institutions (or their loan servicers) to monitor map changes or to review the semiannual compendia, so there is no perceived need for lenders to do so or penalty for failing to do so.<sup>40</sup> In addition, many in the lending industry consider the *Compendium* to be of little value because it does not provide information at the property level. Despite this concern, both Fannie Mae and Freddie Mac require lenders that sell loans to or service loans for the GSEs to make themselves aware of changes in FIRMs and to take appropriate action as these changes occur. This requirement creates a powerful incentive for such lenders and servicers to use flood determination companies that provide life-of-loan determinations.

For lenders with life-of-loan flood determinations, their flood determination companies also provide notice of the consequences of map revisions. According to ten companies that responded to surveys conducted for the NFDA, 17.1 million of their life-of-loan certificates were affected by map revisions between 1999 and 2002. Of this number, the status of about 1.3 million properties changed as a result of a map revision over the same period. The actual number of changes is likely to have been much higher because only about one-third of the NFDA’s membership responded to the surveys. Moreover, many flood determination companies, albeit smaller ones, were not among those surveyed.

The flood legislation also does not require regulated lenders to review their loan portfolios either retroactively or prospectively to ensure compliance with the mandatory purchase requirement. FEMA (1999) has encouraged lenders to conduct such reviews to identify uninsured or underinsured risks. In contrast, the federal regulatory agencies (U.S. Department of the Treasury et al. 1996) have noted that none of the flood-related legislation that affects lenders prescribes portfolio reviews as a required means to determine whether security property is adequately covered by flood insurance, even in instances in which lenders are found to have inadequate systems in place to ensure compliance or when lenders “are significantly exposed to the risks for which flood insurance is designed to compensate.”

## 6.2 Provide Information on Flood Insurance Requirements

When regulated lenders determine that a loan on improved real estate or a manufactured home is or will be located in a SFHA, these lenders are required to provide borrowers and the servicers of the loan with written notice: a) that the building or manufactured home is located in a SFHA; b) of the mandatory purchase requirement; c) of the availability of flood insurance through the NFIP; and, d) any other information that the director of FEMA considers necessary. This information must be provided “a reasonable period in advance of the signing of the purchase agreement, lease, or other documents involved in the transaction.” The lending

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<sup>40</sup> At least some regulated lending institutions believe that remapping does not trigger the requirement even when an institution becomes aware of a map change. As one bank official noted: “Flood insurance for someone in a flood zone is required for new loans, but it wouldn’t affect an existing loan on the books.” See Dodge (2003).

institution is further required to retain a receipt of the notice by the purchaser and the loan servicer for as long as the lender owns the loan.

The federal regulatory agencies have interpreted the “reasonable period” requirement flexibly, but they do note that a “borrower should receive notice timely enough to ensure that (1) The borrower has the opportunity to become aware of the borrower’s responsibilities under the NFIP; and (2) where applicable, the borrower can purchase flood insurance before completion of the loan transaction” (U.S. Department of the Treasury et al. 1996). The agencies added, however, that they “generally continue to regard ten days as a ‘reasonable’ time interval” for notification of borrowers.<sup>41</sup> Notice to loan servicers is typically required as “promptly as practicable” after a lender provides notice to the borrower but “no later than the time the bank provides other similar notices to the servicer concerning hazard insurance and taxes” (U.S. Department of the Treasury et al. 1996).

Borrowers are expected to use the information to purchase flood insurance, as required, prior to closing their loans. Each of the federal entities for lending regulation provide sample forms of notice of special flood hazards and availability of federal disaster relief assistance (see, for example, U.S. Department of the Treasury et al. 1996).

For borrowers to purchase flood insurance, they must contact an insurance agent or WYO company that can provide coverage. Many insurance agents are not familiar with flood insurance and have little or no experience providing information about it to prospective purchasers. According FEMA, more than 3,000 communities that participate in the NFIP had no policyholders in late 2004, and an additional 7,000 communities had ten or fewer policyholders. Such communities may not have many insurance agents who are knowledgeable about flood insurance or have much experience with it.

Although flood insurance is available in all flood zones, including those outside of the areas of highest risk, some property owners have been told that they cannot purchase flood insurance because their homes are in SFHAs.<sup>42</sup> Others are told that they are not eligible for coverage because their homes are not in SFHAs. As one experienced representative of the lending industry noted to AIR, “If insurance agents knew as little about auto and homeowners insurance as they do about flood, they would not keep their jobs long.”

Complaints about agents’ lack of familiarity with flood insurance reached a peak after Hurricane Isabel hit the eastern seaboard in September 2003. In a report that reviewed the response to Isabel’s victims in Baltimore, Maryland, Larsen, Benoit, and Ewing (2004) cite repeated instances in which policyholders complained of “wide frustration with the lack of familiarity insurance professionals had with the flood program. . . . Agents and their insurers may view the possibility of severe and widespread flooding as so remote as to not justify the time

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<sup>41</sup> When a lender provides a loan for a manufactured homes and does not know where the manufactured home will be located until just prior to the time of loan closing, the lender can meet the reasonable requirement notice if it provides the notice to the borrower “as soon as practicable after determination that the [manufactured] home is or will be located in a SFHA and before completion of the loan transaction” (U.S. Department of the Treasury et al. 1996).

<sup>42</sup> A survey of consumers conducted for FEMA in 1999 found that 26 percent agreed that “You can’t buy flood insurance if you are located in a high-risk area” (KRC Research & Consulting 1999)

needed to become familiar with the policy and its coverage.” As a result, the authors recommended that FEMA develop rigorous training requirements for agents and their insurance affiliates.

In response to such concerns, the Flood Insurance Reform Act of 2004 requires FEMA to “establish minimum education and training requirements for all insurance agents who sell flood insurance policies” by the end of 2004. As the U.S. Senate’s (2004) report on the legislation commented, while the training requirements should not be burdensome, they should ensure that insurance agents have a “thorough understanding” of the NFIP. This may be a problematic assignment for FEMA because state insurance regulators, not the agency, establish training and licensing requirements for insurance agents within each state. Furthermore, the training requirement may discourage some insurance agents from selling flood insurance.

When insurance agents are available to sell flood insurance, they must know whether the building that secures the loan is or is not in a SFHA and, if it is, in which flood zone. The SFHD form includes this information and also indicates the availability of federal flood insurance, but lenders are *not* required to provide copies to their borrowers or their insurance agents. When FEMA developed the standard form in 1995, the draft instructions proposed that lenders “provide a copy of [the] completed form to an insurance agent” (FEMA 1995a).

The final version of the form, published a few months later, changed this wording in an important way. Although FEMA had declared that the “form provides most of the information that an insurance agent needs to write a flood insurance policy,” the agency revised the instructions to indicate that lenders “may” provide a copy of the form to insurance agents (FEMA 1995b).<sup>43</sup> In addition, despite noting that “having a copy of the form would be useful to the customer” (FEMA 1995b), the current instructions do not mention or even suggest that lenders provide borrowers with copies of the completed SFHD form. Similarly, the federal regulatory agencies have declared that “lenders are neither required nor prohibited from providing the borrower with a copy of the form” (FFIEC 1997).

FEMA’s IG (2000) believes there is merit in requiring lending institutions to provide the form to insurers or insurance agents and has recommended that the agency work with federal regulatory agencies to develop such a requirement. Others agree. FEMA once solicited suggestions from its partners and customers about how the NFIP can be improved. One suggestion (FEMA 2000) was that lenders provide borrowers and insurance agents with copies of flood zone determinations to facilitate the writing of policies. FEMA responded to the

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<sup>43</sup> In the same *Federal Register* notice in which FEMA (1995b) declared that lenders “may” provide the form to insurance agents, the agency also stated that the form “should” record a lender identification number “that will be transferred onto the flood insurance policy application by the insurance agent,” thus implying that the agent would routinely receive a copy of the form. In fact, however, the policy application does not require or provide any space to record a lender identification number. FEMA (2003) now considers inclusion of a lender identification number on applications for flood insurance to be “impractical.” All of this results in a situation in which lenders are required to record a lender identification number on the form (even though many lenders do not know what their number is) and, once the number is recorded, it serves no apparent purpose. As one FEMA official informed AIR, “there is no rationale for including the lender identification number on the Standard Flood Hazard Determination form.” Despite the absence of a rationale, the FDIC (2001a) informed the banks that it regulates that the identification number is “required information” and helps the NFIP “track insurance policies in force.”

suggestion by declaring that it would encourage federal regulatory agencies to encourage lenders to provide the determinations to borrowers. In fact, however, FEMA has chosen not to do so.

When borrowers or their insurance agents do not have access to lenders' determination forms, conflicting determinations and additional expense for borrowers are possible. To obtain a properly rated flood insurance policy, borrowers must know the zones in which their properties are located. Absent a copy of the determination form from a lender, borrowers (or, more likely, their insurance agents) must obtain a separate determination. With scores of flood determination companies, an insurance agent is likely to obtain a determination from a company other than the one the lender used. The two determinations may conflict, thus creating a situation in which a lender insists that flood insurance is required whereas the insurance agent may disagree completely (or with respect to the zone in which the building is located).<sup>44</sup> Unless the borrower successfully challenges the lender's determination, that determination is definitive for purposes of deciding whether flood insurance is required.

### **6.3 Require Flood Insurance at Loan Origination**

Lenders must require flood insurance on improved real estate or manufactured homes that are, or will be, located in a SFHA in communities that participate in the NFIP. Regulated lenders are prohibited from making, increasing, extending, or renewing any designated loan unless the real estate or manufactured home securing the loan is covered by flood insurance for the term of the loan. Neither the law nor any regulations specify how borrowers must demonstrate that they have obtained the required coverage. As a consequence, lenders accept various forms of proof of coverage, ranging from a copy of the policy's declaration page showing the amount of coverage, a paid receipt for a policy, and, apparently, a range of other proofs.

As noted earlier, such coverage must be in an amount at least equal to the lesser of:

- The outstanding principal balance of the loan; or
- The maximum limit of coverage made available through the NFIP with respect to the particular type of property.

Lenders interpret the coverage requirements in different ways. Some lenders require that borrowers retain flood insurance to the value of the property or to the maximum coverage, whichever is greater.<sup>45</sup> Some lenders require insurance to the full balance of a loan, even when part of the loan covers land. At least one large lender requires its borrowers to maintain flood

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<sup>44</sup> One large lending institution estimated that conflicts in determinations between those obtained by lenders and borrowers or insurance agents occur with about one of every ten loans. Borrowers and lenders can jointly request that FEMA review the accuracy of a lender's determination. Until FEMA responds to the appeal, borrowers are not required to purchase flood insurance (U.S. Department of the Treasury et al. 1996). If a borrower's appeal is successful, FEMA provides a Letter of Determination Review (LODR). Requests for LODR are rare, and most are returned to the applicants due to late submission or because the proper documentation was not submitted.

<sup>45</sup> Consistent with this industry practice, the FDIC has informed the lenders it regulates that "the amount of insurance should not be less than the value of the improved structure" (FDIC 2001a). The FDIC recognizes that this amount of coverage is generally not required, but the agency has offered this advice in an effort to encourage lenders to protect themselves and their customers thoroughly from flood losses.

insurance coverage in the same amount as their hazard or homeowners' insurance. Other lenders require the amount of flood insurance required for purchase in the secondary market. More common, still other lenders allow property owners to retain the coverage they initially acquired at the time of purchase despite increases in property values and replacement costs. Such levels of insurance comply with the mandatory purchase requirement and protect the lender's interest, but they do not provide suitable coverage for the property at risk. As a consequence of this legal practice, coverage that is inadequate relative to the value of a home is common, at least according to reviews that Fannie Mae and Freddie Mac conduct of loans in their portfolios.

In the event of a flood, the NFIP provides reimbursement for full replacement costs (up to the total amount of insurance available) for only two types of risk – condominiums covered by a Residential Condominium Building Association Policy and single-family principal residences. For the latter, if the amount of the coverage is less than 80 percent of the replacement cost, the NFIP will pay no more than the greater of the actual cash value of the cost to repair or the proportion of the cost based on the amount of the coverage divided by the amount that represents 80 percent of the replacement cost.<sup>46</sup> As a consequence, although a property owner may have at least as much insurance as is legally required, such as full coverage for the amount borrowed, there is a coinsurance penalty if the property is insured for less than 80 percent of the replacement cost.<sup>47</sup>

Some regulated lenders believe that they are at a competitive disadvantage relative to nonregulated lenders. The former require a flood determination, which increases their loan-closing fees, and they must require flood insurance when appropriate, which is unpopular among some borrowers. If this is the case, it seems that nonregulated lenders would attempt to preserve their alleged advantage and not complete flood determinations. In fact, however, Fannie Mae and Freddie Mac purchase large numbers of loans, including loans from nonregulated lenders. Such lenders must comply with the mandatory purchase requirement so they will require a flood determination if they expect to sell the loan to Fannie Mae or Freddie Mac.

Some officials believe that borrowers who obtain loans that are not sold to Fannie Mae or Freddie Mac or do not meet their standards are borrowers who are probably least able to afford flood losses without insurance. Loans that do not meet the GSEs' standards are usually considered to be subprime. The borrowers are often people with poor or no credit histories and with low incomes. This situation provides reason to find ways to spread coverage to loans made by nonregulated lenders.

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<sup>46</sup> As FEMA (2005) explains in its *Flood Insurance Manual*: "If 80 percent of the full replacement cost of the dwelling is less than the maximum amount of insurance available under the NFIP, then the proportion [of the loss settlement] is determined by dividing the actual amount of insurance on the dwelling by the amount of insurance that represents 80 percent of its full replacement cost. But if 80 percent of the full replacement cost of the dwelling is greater than the maximum amount of insurance available under the NFIP, then the proportion is determined by dividing the actual amount of insurance on the dwelling by the maximum amount of insurance available under the NFIP."

<sup>47</sup> This procedure may conflict with congressional intent. The Flood Insurance Reform Act of 2004 directs the GAO to conduct a study of the "adequacy of the scope of coverage provided under flood insurance policies in meeting the intended goal of Congress that flood victims be restored to their pre-flood conditions." In addition, the U.S. Senate's (2004) report on the legislation declares that FEMA should conduct a comprehensive review of its rules "to determine if changes should be made to ensure that families who are flooded receive adequate payments under their flood insurance policies to allow them to repair or rebuild their homes."

## 6.4 Escrow Funds for Flood Insurance

Regulated lenders must escrow funds for flood insurance (if required and purchased through the NFIP) for loans on residential improved real estate if these lenders also require escrow funds to cover other expenses such as property taxes or hazard insurance.<sup>48</sup> When a building is of mixed use and is part residential and part commercial, the building's primary purpose determines whether the escrow requirement applies (FEMA 1999). A slightly different rule applies to condominium buildings. They are not considered residential, and thus subject to the escrow requirement, unless at least 75 percent of the floor area is residential (FEMA 2005).

FEMA and the federal regulatory agencies disagree about whether escrow accounts are required for loans on multifamily dwellings of five or more units. FEMA (1999) believes that such units are not subject to the escrow requirement. The federal regulatory agencies insist that such units are subject to the requirement (e.g., U.S. Department of the Treasury et al. 1996, FFIEC 1997; OCC 1999; OTS 2001). In turn, FEMA (1999) has encouraged lenders to impose the escrow requirement on nonresidential loans, but the federal regulatory agencies do not believe they have the legal authority to do so (U.S. Department of the Treasury et al. 1996).

## 6.5 Life-of-Loan Coverage

Regulated lenders are required to ensure that borrowers retain flood insurance for the life of the loan. There are at least two ways that lenders ensure that borrowers do so: lenders can track borrowers' retention of flood insurance or contract the responsibility to third-party loan servicers, which typically rely on (or are also) flood determination companies. Such vendors provide several services such as tracking hazard and flood insurance premiums to ensure that they are up-to-date, processing loan payments, providing customer service, completing the forced-placement processes for hazard and flood insurance, escrowing funds for property taxes and insurance, and paying property taxes and insurance premiums from the escrowed funds. Lenders determine how many of these services to contract for and how many different vendors to use. Some lenders perform all the required functions themselves, others use a single vendor for all services, and still others use multiple vendors.

Regardless of what procedures are involved with the tracking of flood insurance, retention of policies among those obligated to have flood insurance is a continuing concern. As the GAO (2003a) concluded, "data to determine whether insurance is retained over the life of loans are unavailable, and this issue remains unresolved. The GAO (2002) similarly noted FEMA's concern that "significant noncompliance problems" exist with the retention and renewal of policies. FEMA (2004) estimates that as many as 500,000 policyholders cancel or do not renew their policies each year. Many of these cancellations or nonrenewals are appropriate, but some unknown portion of them also include property owners who remain subject to the

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<sup>48</sup> The regulatory agencies (U.S. Department of the Treasury et al. 1996) have determined that a "construction loan, loan secured by 25 acres or more of real estate, or commercial loan is subject to the escrow requirements if the loan is secured by improved real estate primarily used for residential purposes" and an escrow account is also required in connection with the loan for fees, taxes, insurance premiums, or other charges.

mandatory purchase requirement and who are obligated to retain flood insurance for the life of their loans.

## 6.6 Forced Placement of Flood Insurance

At any time during the life of a designated loan, if there is no evidence of flood insurance *or* in instances in which coverage is less than the minimum amount required for a building or a manufactured home, the 1994 Reform Act requires lenders or their loan servicers to purchase the insurance on behalf of the property owner after notification to the borrower that insurance is required.<sup>49</sup> The amount that must be force placed is equal to the difference between the amount of coverage in place and the lesser of the outstanding principal balance or the maximum coverage available through the NFIP (U.S. Department of the Treasury et al. 1996).<sup>50</sup> When calculating the amounts of insurance required, the value of the land can be deducted from the overall value of the secured property (FEMA 1999). Forced placement is not intended for use when a lender makes, increases, extends, or renews a loan because such loans are not permitted unless flood insurance is already in place.<sup>51</sup>

To address situations in which there is *no* coverage when it is required, lenders and servicers have several options. First, regulated lenders (as well as federal agency lenders) are obligated to refuse to extend a loan until the building or manufactured home that secures the loan is covered by flood insurance. Second, if a loan complies with the purchase requirement at origination but later is not in compliance, lenders can purchase a Standard Flood Insurance Policy (SFIP) for the property if the property owner has not done so (FEMA 1999). To do so, however, lenders or loan servicers must have information about the property so that it can be rated properly.

There are disparate perspectives about the feasibility of acquiring the information needed to force place a Standard Flood Insurance Policy. On the one hand, property owners who never had a policy or who have cancelled or not renewed their policies are unlikely to provide the information necessary to write a SFIP, so purchasing such policies for the property owner may be impractical from a lender's perspective and is unlikely to occur often. Requiring lenders to initiate the information-gathering process needed to rate a recalcitrant owner's property would, in many instances, be unduly burdensome for the lender, especially in instances in which the

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<sup>49</sup> Within FEMA, such purchase is typically referred to as force placed, although "lender placed" is the preferred and more palatable term among those who purchase or impose the insurance on their borrowers. The 1994 Reform Act preempts state laws that limit or prohibit forced placement or that require a borrower's agreement in order to force place flood insurance.

<sup>50</sup> The *Comptroller's Handbook* (OCC 1999) incorrectly notes that the "amount that must be force placed is equal to the difference between the present amount of coverage and the lesser of the outstanding principal balance, *the value of the improved property*, or the maximum coverage limit" (emphasis added).

<sup>51</sup> Section 102(e)(1) of the 1994 Reform Act declares that forced placement of flood insurance is appropriate "at the time of origination," but the federal regulatory agencies (U.S. Department of the Treasury et al. 1996) have jointly interpreted the law to mean that forced placement "should not be necessary" at the time of origination and that "flood insurance coverage must be in effect at the time of closing a designated loan." In contrast to this interpretation, the FDIC (2001a) has informed institutions subject to its regulation that they must force place insurance "in situations where a borrower either does not obtain required flood insurance coverage before closing a loan, or allows flood insurance coverage to lapse after the loan is made."



property owner and lender (or servicer) are in different states. On the other hand, most lenders will have an appraisal of the property that contains much of the information required to obtain a rating – with the exception of a building’s elevation, a crucial piece of information in determining the proper rate.

Third, lenders and servicers can force place coverage through the Mortgage Portfolio Protection Program (MPPP). FEMA created the MPPP in 1991 to facilitate lenders’ and servicers’ efforts to ensure that affected property owners have coverage when no or only limited underwriting information is available.

Due to a lack of information and, therefore, an unknown level of risk, policies purchased through the MPPP are almost always more expensive than are Standard Flood Insurance Policies.<sup>52</sup> As FEMA (2000) explains, the rates for MPPP policies are high to discourage forced placement. For example, as of May 1, 2005, using a SFIP, owners of post-FIRM, single-family residences with more than one floor and no basement or enclosure in an A zone paid base rates as low as \$.24 per \$100 for the first \$50,000 of building coverage and an additional \$.08 per \$100 for coverage in excess of \$50,000. In contrast, using the MPPP, the lowest base rate for a property in an A zone would have been \$2.40 per \$100 for the first \$50,000 of building coverage and an additional \$1.20 per \$100 for coverage in excess of \$50,000. In a V zone, rates for the MPPP increase to \$3.70 per \$100 of building coverage. The MPPP is not intended for use at loan origination, but this restriction is not universally respected.

As of December 31, 2004, there were 3,926 MPPP policies in force. The average annual premium was about \$1,264, and the average building coverage was about \$65,400. In contrast, for all federal flood insurance policies, the average annual premium at the same time was about \$440, for which the average building coverage was approximately \$134,000.

Prior to force placing flood insurance, lenders or servicers must notify borrowers of: a) the requirements of the Flood Disaster Protection Act of 1973; b) the flood zone location of their property; c) the statutory requirement for flood insurance; d) the fact that the lender has no evidence of their having flood insurance; e) the amount of coverage required; and, f) the opportunity to obtain a SFIP. If borrowers fail to purchase flood insurance within 45 days of this notification, lenders or servicers can purchase a SFIP for the mortgaged property or use the MPPP and, in either case, impose the costs of premiums and fees incurred on the borrower.

Most of the WYO companies that offer SFIPs do not also offer policies through the MPPP. In the words of one WYO representative, the administrative and record-keeping burdens associated with the MPPP are unduly onerous. In addition to the notifications, some insurers

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<sup>52</sup> FEMA (1999) cites the “absence of any underwriting data” as a rationale for MPPP rates that are “considerably higher than those rates for voluntary policies.” In fact, however, it is not clear that there is a dearth of information. Forced-placed insurance through the MPPP is available only for those property owners who previously had flood insurance but who cancelled or failed to renew it. As a consequence, since the property owner previously had flood insurance, FEMA is already in possession of all or nearly all the information it might need to rate at least some properties properly and to continue coverage, albeit it force placed. In some instances, such as when a structure does not comply with a community’s floodplain ordinance, rates for force-placed insurance through the MPPP may be less expensive than those associated with a Standard Flood Insurance Policy.

perceive NFIP policies to be difficult to cancel (e.g., such as when a property owner switches to a SFIP from a forced-placed policy issued through the MPPP).

Force-placed coverage through the NFIP is effective on the date the application is completed and the premium is paid. MPPP policies cannot be renewed, but they can be rewritten each year following the notification procedures just described.

In instances in which a borrower has coverage through the NFIP, but it is less than the minimum amount the law requires, lenders and servicers who wish to comply with the mandatory purchase requirement must use private insurance to increase their borrowers' coverage. Only one NFIP policy can be issued per residential structure or manufactured home, so the MPPP cannot be used in conjunction with a SFIP.<sup>53</sup>

Some insurers, such as Lloyd's of London, offer private flood insurance that can be purchased and lender placed at any time. With private insurance there is typically no gap in coverage between the expiration of an NFIP policy and the imposition of the force-placed coverage. Such a gap exists when a lender wants to place flood insurance through the MPPP. Although NFIP policies expire on the last day of each one-year policy term, coverage continues during a 30-day "grace" period after a policy's expiration. FEMA assumes that policies will be renewed and thus grants policyholders 30 days after expiration to submit the premiums associated with renewal, but the 1994 Reform Act prohibits the forced placement of federal flood insurance until 45 days after a policy's expiration. This anomaly creates a 15-day period in which no coverage is available through the NFIP. In the words of one representative of a national lending institution, the 15-day gap in coverage is a "dominant" reason that his bank eschews use of the MPPP in favor of lender-placed, private insurance, which can be effective immediately after the NFIP coverage is cancelled or not renewed. FEMA (2004) agrees and would prefer a change in the flood insurance legislation to eliminate what it calls "the unacceptable exposure gaps that the program currently presents."

Private insurance can be used in lieu of coverage through the NFIP at loan origination, to provide additional coverage when the value of a property exceeds the amount of coverage available through the NFIP, or when a lender or servicer deems that coverage through the NFIP is not commensurate with the value of the property or the law's requirements for coverage. Private insurance can also be used in areas where NFIP coverage is prohibited, such as in communities that are suspended from participation in the NFIP due to their failure to adopt or enforce floodplain management regulations and in units of the Coastal Barrier Resource System. The Coastal Barrier Resources Act of 1982, as amended, restricts most federal expenditures and financial assistance, including federal flood insurance, and any form of loan, grant, guarantee, insurance, payment, rebate, subsidy, or any other form of direct or indirect federal assistance in parcels within the Coastal Barrier Resource System, including Otherwise Protected Areas (OPA).<sup>54</sup> Flood insurance is permitted in OPA, regardless of the date of construction, if the

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<sup>53</sup> FEMA (2000) prohibits the purchase of more than one NFIP policy on a single structure due to concerns about fraud or abuse with respect to claims and the possibility that multiple policies could lead to insurance in excess of that permitted by law.

<sup>54</sup> An "otherwise protected area" is an undeveloped coastal barrier used primarily as a wildlife refuge, sanctuary, or recreational or natural resource conservation area.

building or structure is used in a manner consistent with the purposes for which the area is protected.

Some national lenders appear to use private insurance exclusively when their borrowers are required to have flood insurance but fail to retain adequate coverage. According to one insurance company, it can provide coverage for a lender's portfolio for such borrowers with only minimal information, namely the flood zone in which the property is located; whether it is residential or commercial; the property's address; the borrower's name, and his or her loan number. This company indicated that one of the lenders with whom it works routinely requests private, lender-placed insurance for 300 to 400 properties per week. FEMA (2004) estimates that private insurers may force place as many as 100,000 to 200,000 policies each year. These policies insure compliance with the mandatory purchase requirement, but they also account for as much as 20 to 40 percent of the NFIP's annual loss of policies.

Force-placed insurance is intended primarily to protect buildings, which represent the borrowers' collateral, but some lenders place additional coverage for the contents of these buildings. Lenders may do so if the contents serve as collateral for a portion of the loan or because such placement is explicitly permitted by the loan documents. Lenders that elect this approach may be trying to discourage law suits from victims of flooding who might claim that force-placed coverage on buildings protects lenders' interests but not the borrowers' interest in the contents. Such a justification is less likely today than in the past because the standard loan documents now in use are explicit about the lender's right to place insurance that does not cover a borrower's interests. Policies issued as part of the MPPP provide coverage to both the lender and to the borrower.

## 7. CHALLENGES TO COMPLIANCE

In addition to the processes and procedures described in the previous section, lenders must also deal with issues that are not as clear as they might be or that otherwise produce confusion, at least among some borrowers, lenders, and insurance agents. In turn, these issues may complicate lenders' efforts to comply with the mandatory purchase requirement and federal agencies' monitoring of compliance.

### 7.1 Flood Insurance During Construction

The flood insurance legislation requires that "improved real estate" be insured when it is in a SFHA in a participating community and when it is secured by a loan from a regulated lender, when the loan is sold to Fannie Mae or Freddie Mac, or when it has been acquired with federal funds. The flood insurance legislation defines improved real estate as "real estate upon which a building is located." The NFIP defines a building as a structure with "two or more outside rigid walls and a fully secured roof, that is affixed to a permanent site" and that is principally above ground. FEMA's *Flood Insurance Manual* (FEMA 2005) is similarly explicit in noting that "Insurance may be written only on a structure with two or more outside rigid walls and a fully secured roof that is affixed to a permanent site" while FEMA's (2002a) *Program Description* notes that eligibility for flood insurance requires two "solid walls and a roof."

These statements suggest that flood insurance is not required at least until construction is well underway and perhaps even close to completion because a fully secured roof and solid walls are required. In fact, however, FEMA encourages and permits flood coverage during construction.

The issue with respect to such coverage is the date that insurance is required and the amount of required coverage. FEMA (1993, 1999) stipulates that flood insurance must be purchased at loan origination in an amount to meet the mandatory purchase requirement based on the "eventual value of the property to be constructed." The effective date of such coverage is the time construction begins, which can be interpreted to mean the date that building materials are delivered to the site. In other words, coverage is not delayed until a building has two walls and a roof. FEMA's *Mandatory Purchase of Flood Insurance Guidelines* (FEMA 1999), which is probably the most common source of information for lenders on the topic, indicate that coverage can also be arranged for materials to be used for construction and delivered to the site prior to construction.

FEMA's *Flood Insurance Manual* (FEMA 2005), which is the primary source of information on flood insurance for agents, specifies that insurance is available for buildings in the course of construction but does not indicate when such coverage should or must commence. The *Manual* does imply, however, that coverage can begin after construction has started.<sup>55</sup> For condominiums under construction, coverage is not possible through a Residential Condominium

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<sup>55</sup> The *Manual* states that the "start of construction...for insurance purposes means the date the building permit was issued, provided the actual start of construction...was within 180 days of the permit date." FEMA's *Flood Insurance Application* asks agents to indicate whether a building is in the course of construction. For a building to be in the course of construction, the loan would have already been provided.

Building Association Policy (RCBAP) until a condominium association has been created and at least two units have been sold.

In addition, the *Manual* stipulates the materials or supplies intended for use in construction, alteration, or repair cannot be insured “unless they are contained within an enclosed building on the premises or adjacent to the premises.” Given FEMA’s definition of a building, these materials can be insured only if they are in a structure affixed to a permanent site. This may not be FEMA’s intent because storage areas for building materials often are not situated permanently at a building site.

The federal regulatory agencies agree that insurance must be purchased at loan origination if the building will be in a SFHA in a participating community, but the amount of coverage required appears to vary from FEMA’s perspective. As an illustration, the OCC (1999) and OTS (1999) note that insurance must be purchased to keep pace with construction (as opposed to purchasing full coverage at the time of loan origination).

Regardless of the perspective, some lenders and insurers are uncertain how to apply the requirements for mandatory purchase during or immediately before construction. FEMA (1999) has indicated that elevation figures derived from construction drawings should be the basis for determining premiums during construction, but many agents, according to one FDIC official, will not write the insurance until after a slab is poured and a “true” elevation can be obtained based on actual construction. As this official observed, “We have found this problem in certain areas of Florida, where the practice exists among virtually all the insurance agents,” despite FEMA’s guidance to the contrary. In other instances, developers are required to obtain insurance when a loan is made but there is no building to insure for 90 days or more. This may happen when the loan is for acquisition, development, and construction. This situation means that there are policyholders with no risk paying premiums on buildings that do not yet exist.

At the 2004 National Flood Conference, one representative of an insurance company that writes thousands of flood policies each year related her experience that many policies are not written on new construction until the first floor of the building is completed. One lender reported that her bank requires flood insurance for new construction only when the building is “framed in.” A representative of one of FEMA’s regional offices stated that insurance must be in place, not at loan origination, but at the “first draw” of funds. Still another FEMA official said that the best approach would be to allow the federal regulatory agencies to decide among themselves what insurance requirements they would impose on construction. In short, clarification of and common agreement on the requirements for insurance during construction are highly desirable.

## **7.2 Letters of Map Change**

Other than changing entire FIRMs, FEMA has two processes for removing properties from SFHAs. Once removed, they are no longer subject to the mandatory purchase requirement if loans associated with these properties are from federally regulated lenders. From another perspective, however, the only reason to employ these processes is to avoid the purchase requirement.

To accommodate instances in which the lowest ground touching a single structure is naturally at or above the base flood elevation, FEMA can issue a Letter of Map Amendment (LOMA) when a property owner provides evidence, and FEMA verifies, that a structure was incorrectly placed in a SFHA. LOMA can thus be seen as technical corrections.

Developers can apply for Letters of Map Revision – Based on Fill (LOMR-F) when they use human-made or earthen fill to raise the lowest ground touching a structure so that this ground is at or above the base flood elevation.<sup>56</sup> Although a community must confirm that the area subject to the LOMR-F will be “reasonably safe from flooding,” the regulations governing LOMR-F do not address or consider potential impacts in downstream communities. LOMR-F, which can be used for entire developments, are potentially controversial because they alter natural terrain. Some experts believe that LOMR-F transfer risk from one area to another because they reduce storage capacity and can create obstructions that channel flood waters or prevent their dissipation. In the opinion of one such expert (Thomas 2000), LOMR-F impose significant cost burdens on other communities and property owners in SFHAs “who, unaware, accrue the transferred flood risk without receiving protection from or compensation for the additional risk.” Due to such concerns, Thomas characterizes LOMR-F as “bad public policy...like a cancer eating at the foundation of the NFIP.”

In addition to concern about the potential downstream impacts of LOMR-F, others have expressed apprehension about potential detrimental impacts on the natural and beneficial values of floodplains. As an example, the Department of Agriculture (1988) states that filling floodplains is inconsistent with preservation of these values. Executive Order 11988, *Floodplain Management*, directs federal agencies whenever they construct in floodplains and wherever practicable, to “elevate structures above the base flood level rather than filling in land” (Office of the President 1977).

Similar concerns are widely shared. As one senior NFIP official (Pasterick 1998) has commented, because the “primary purpose for requesting a Letter of Map Change is to excuse the owner from purchasing flood insurance, the entire LOMC process represents a rather shortsighted attitude toward the value of insurance as well as an under appreciation of the flood peril.” The number of requests for letters of map change places this comment in perspective. In 1993, there were approximately 2,800 such requests (Pasterick 1998). By 1997, this number had increased to about 11,000 and then almost quadrupled to 43,000 in fiscal year 2002.

### **7.3 Multiple Loans on a Single Property**

When flood insurance is required because a mortgagor’s structure is located in a SFHA in a participating community, a lender must ensure that the amount of insurance in place meets the law’s minimum requirements. If a borrower has only a single loan, the single lender can monitor compliance with these requirements directly or through a loan servicer.

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<sup>56</sup> A LOMR is an official revision to a FIRM and can change flood insurance zones, floodplain and/or floodway boundaries, planimetric features, and/or the BFE.

In contrast, compliance can be hampered when there are two or more loans (e.g., a home equity loan or a second mortgage) from different lenders on a single property.<sup>57</sup> Each lender is responsible for insuring that coverage is in place, but the lender with the junior lien does not necessarily know the amount of coverage in place on the senior lien. Likewise, the holder of the first mortgage may not be aware of the second mortgage or be willing to share information with the second lender. Furthermore, the senior lien holder may incorrectly consider the coverage amounts to meet the law's requirements.

Only one NFIP policy is permitted per property, so the subordinate lien holder is unable to require the property owner to obtain an additional NFIP policy, and the lien holder is similarly prohibited from using the MPPP to force place coverage should that be necessary because the initial lender did not require an adequate level of coverage (FEMA 2000). Under some circumstances, these constraints can lead to a situation in which a subordinate lien holder is required to force place coverage for the total balance of all loans on a property, using private insurance, even when the amount of the second loan represents only a small portion of the aggregate balance of all loans. The alternative is to refuse to grant the loan if the borrower does not obtain additional coverage.

#### **7.4 Multiple Structures Securing a Single Loan**

In some situations, notably with agricultural buildings, several structures may provide the collateral for a single loan from a regulated lender. Borrowers can purchase a separate policy for each building, and FEMA permits borrowers to insure nonresidential buildings with a single policy that lists the individual buildings (FCA 2003). Nonetheless, determining the value of a farm structure for purposes of flood insurance may be difficult, and borrowers and lenders may be unsure how much coverage is required when the structures are spread over large geographic areas. In such instances, structures may be in several communities, not all of which participate in the NFIP. Insurance through the NFIP is not available in nonparticipating communities. In these cases, the FCA (2003) has taken the position that the amount of insurance required depends on the principal amount of the loan, the value of the buildings located in participating communities, and the amount of insurance available through the NFIP.

#### **7.5 Flood Insurance for Condominiums**

The NFIP offers coverage for condominiums through its Residential Condominium Building Association Policy. This master policy provides coverage for the common areas of residential condominiums as well as individual units within the condominium and is issued in the name of the condominium association.<sup>58</sup> Owners of units within a condominium can obtain separate coverage (by purchasing a "Dwelling Policy") for their units, but the coverage is in excess of the association's policy and can only supplement coverage provided through a RCBAP.

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<sup>57</sup> According to the Department of Commerce (2004c), nearly nine million owner-occupied housing units had more than one mortgage in 2003.

<sup>58</sup> An RCBAP offers coverage of up to \$250,000 per unit.

A person who obtains a mortgage from a regulated lender to purchase a condominium unit in a SFHA in a participating community is required to obtain flood insurance for that unit, but the amount of insurance required may be confusing to the lender and the borrower when an RCBAP is in place. When making loans, lenders work with borrowers, not condominium associations. It may be the case, therefore, that the lender and the borrower's insurance agent are unsure of the coverage required or already available through a RCBAP. Furthermore, although FEMA (1999) notes that an owner of an individual unit can use the RCBAP to demonstrate proof of coverage, that coverage may not be sufficient to meet the mandatory purchase requirement. In such instances, FEMA recommends that a lender request the borrower to ask the condominium association to increase its coverage, but the association is not obligated to do so (or even obligated to purchase or retain any flood insurance), thus frustrating the lender and the borrower.

FEMA strongly encourages condominium associations, as part of their property insurance responsibilities, to purchase flood insurance, to protect its buildings in SFHAs, and to do so in amounts that will provide insurance to value. Although the NFIP's mandatory flood insurance purchase requirement does not directly apply to such associations unless they have mortgage loans from lending institutions under the jurisdiction of the flood legislation, the requirement does apply to all individual unit owners with such mortgages. As such, FEMA believes that by purchasing sufficient flood insurance coverage condominium associations both help their unit owners fulfill their flood insurance requirements and satisfy their own property insurance responsibilities. FEMA believes it has no regulatory responsibility for the mandatory purchase requirement, so it looks to the federal agencies with such authority to promote the purchase requirement in condominium associations by encouraging regulated lending institutions to seek such compliance through those associations exercising their overall property insurance responsibilities on behalf of their unit owners.

Despite these well-intentioned efforts, the *Mandatory Purchase of Flood Insurance Guidelines* (FEMA 1999) for insuring condominiums are difficult for lenders (and insurers) to understand and apply in the opinion of representatives of their industries. For example, a lengthy conversation ensued at a presentation on coverage for condominiums at a recent meeting of the American Bankers Association about appropriate coverage for condominiums. The panelists, presumably chosen for their knowledge and expertise, were in conflict over adequate coverage amounts. Moreover, lenders attending the meeting suggested still other variations on the requirement, and FEMA (2000) has received repeated requests for clarification and simplification of the requirements for condominiums.

## **7.6 Buildings in Violation of State or Local Laws**

Section 1316 of the National Flood Insurance Act of 1968 prohibits the sale of *federal* flood insurance for any property that FEMA's director "finds has been declared" by a duly constituted state or local zoning authority or other authorized public agency to be "in violation of State or local laws, regulations, or ordinances which are intended to discourage or otherwise restrict land development or occupancy in flood-prone areas."

Although the number of properties that have been declared in violation is small, the use of the provision can complicate efforts to comply with the mandatory purchase requirement in



several ways. First, there is some misunderstanding about whether regulated lenders and federal agency lenders can make loans to owners of these so-called 1316 properties. FEMA (1999) twice notes that lenders can make *conventional* loans for these properties, thus implying that federal agency lenders, such as the VA, cannot guarantee or insure loans for these properties. In fact, despite FEMA's position to the contrary, there is no restriction on federal agency lenders' involvement with loans for 1316 properties, although private insurance would be required (see, for example, U.S. Department of Veterans Affairs 1996). Nonetheless, because these properties are in violation of state or local ordinances and are notably susceptible to flood damage because of their noncompliance, some might suggest that these properties should not be eligible for loans from regulated lenders or financial assistance from federal agency lenders.

Second, neither lenders nor flood determination companies have access to data on 1316 properties. Property owners are not required to inform prospective buyers that a property is ineligible for federal flood insurance and few, if any, communities require official property records to note this lack of eligibility. As a result, a flood hazard determination company can complete a SFHD form indicating that a property is in a SFHA in a participating community and thus requires flood insurance. Under these circumstances, the instructions for the SFHD form direct the company to indicate on the form that *federal* flood insurance is available because the community participates in the NFIP.<sup>59</sup> Completion of the form should prompt the lender to inform the borrower that flood insurance is required on the property.

That notification will be appropriate and legally proper. Nonetheless, if the borrower receives a copy of the SFHD form from the lender, the borrower will be informed incorrectly that federal flood insurance is available. The same situation will occur if the borrower's insurance agent obtains a separate flood determination. Although federal flood insurance is not available, the mandatory purchase requirement still applies.<sup>60</sup> In addition, the federal regulatory agencies (e.g., OCC 1999; OTS 2001) do not indicate that 1316 properties are ineligible for federal flood insurance.

Third, insurance agents do not have direct access to FEMA's database on 1316 properties, so agents may write and issue an NFIP policy to a borrower, who, in turn will use that policy to demonstrate compliance with the mandatory purchase requirement to a lender, which will then make the loan. WYO companies do have access to information on 1316 properties.<sup>61</sup> When agents submit completed applications to their insurance companies, FEMA requires them to compare the applications with the agency's list of these properties.

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<sup>59</sup> The SFHD form makes no mention that certain properties may be ineligible for federal flood insurance because of section 1316. In fact, the directions for the form specify incorrectly that "federal flood insurance is available to all residents of a community that participates in the NFIP."

<sup>60</sup> FEMA's *Mandatory Purchase of Flood Insurance Guidelines* (1999) incorrectly notes that a loan on a 1316 property "is not eligible for flood insurance protection because it has been declared to be in violation of local floodplain management building codes." The *Guidelines* should indicate that *federal* flood insurance is not available.

<sup>61</sup> FEMA's *Flood Insurance Manual* (FEMA 2005) alerts insurance agents that "flood insurance is not available for properties that are placed on the 1316 Property List," but does not indicate how an agent would identify such properties or make clear that it is *only* federal flood insurance that is not available for such properties. In addition, the *Manual* incorrectly implies that only states are authorized to declare a structure to be in violation of a law, regulation, or ordinance.

Compliance with this screening requirement is mixed. Some companies are conscientious; others are less so. Due to the latter companies, FEMA also screens all new policies against its list of 1316 properties and occasionally identifies some that have federal flood insurance. The matching process may be problematic. It requires that the property address that the insurance agent provides be the same as or nearly identical to the address in FEMA's database of 1316 properties (Office of Inspector General 2002). Inconsistent address information is a recurring problem with the NFIP's records and one not amenable to an easy solution because FEMA must depend on insurance agents and companies to provide correct and complete addresses.

When FEMA identifies a 1316 property with federal flood insurance, the agency must notify the insurance company that the policy is invalid and will be cancelled. In turn, the company must notify the agent, who must notify the borrower, who would be expected, but not required, to inform the lender, who would then notify its loan servicer if one is used. FEMA (1999) has alerted lenders to the possible problem with 1316 properties but does not tell them how to avoid or resolve the problem except to discourage issuance of the loan.

A 1316 property can have its eligibility for federal flood insurance restored when the violations have been corrected and the 1316 declaration rescinded. There is currently no process or procedure in place to ensure that lenders are informed of the rescission.

## **7.7 Selling or Transferring Loans**

Most large lenders use loan-servicing companies to collect payments from borrowers and perform other administrative functions. These companies are responsible under their contracts with lenders for insuring that real estate taxes are paid and that insurance is in place. Payment for these obligations is typically made by the borrower as part of the monthly installment and accumulated in escrow accounts by the servicer, which then remits these funds to the taxing authority and insurers on an annual or semiannual basis.

It is common in the lending industry to sell loans, not only to the GSEs but also to other lending institutions. In addition, loan portfolios can be transferred to different lending institutions when one acquires or merges with another. When transfers or sales of loans occur, it is common for the loan servicer to change as well; changes of servicers can also be made even when the owner of the loan does not change. It is not unusual for a single loan to be sold several times, with each sale introducing a new servicing vendor. To address these changes, the 1994 Reform Act requires regulated lenders (and subsequent regulated lenders who become owners and their servicers) to inform the director of FEMA or the director's designee, within 60 days, whenever a loan is made, increased, extended, renewed, sold, or transferred. Similar notification is also required whenever there is any change in the servicer of a loan. FEMA has designated the insurance provider as the agency's designee to receive these notices.

As FEMA (1999) explains, this notification process makes the insurer aware of the identity of the party (i.e., the owner of a loan or its servicer) who is supposed to receive mailings about the impending expiration of a flood policy, the need for renewal, and, possibly, the need to

force place coverage. Furthermore, the requirement is intended to combat what FEMA (1999) calls the “high nonrenewal rate that occurs after the first year of the loan.”

When this notification process works well, the insurance providers, primarily the WYO companies, know which vendors are servicing their policyholders. Interviews with insurance companies and lenders suggest, however, that the process does not work as well as intended. As one insurance company explained to AIR, “When a mortgage is sold, ‘it is often lost in the wind’ because the company does not know whom to contact when borrowers do not retain flood insurance.” In other instances, the new owner of a loan does not inform the insurance provider of the purchase of the loan or may not be informed that a borrower is insured. The loan’s new owner may then force place coverage without knowing whether insurance is already in place. Furthermore, although FEMA is not supposed to receive the notices of change in servicers, it often does.<sup>62</sup>

In contrast to the seemingly widespread problems with the notification process that may result in a lack of required coverage when the loan or servicing is sold or transferred, the procedural requirements may also create unnecessary redundancy. The law requires that the director’s designee be informed of the identity of the loan servicer when certain events occur even when there is no change in servicer or the owner of the loan. This can occur when a borrower increases, extends, renews, or refinances a loan with the original lender. In such a situation, the lender must again inform the WYO of the servicer’s identity even when the servicer has not changed.

## 7.8 Grandfathering

As noted earlier, FEMA’s map modernization initiative will update, revise, or publish new FIRMs for thousands of communities. These changes may change the risk zones in which buildings are located. As a result of a map change, for example, a home formerly in a low-risk X zone may now be in an A zone. Similarly, a building previously in an A zone may now be in a V zone. When a lender obtains a flood determination, it is based on the FIRM in effect at the time the determination is obtained, not necessarily at the time of construction. In the examples just cited, a lender would require flood insurance based on the location of the properties *after* the maps had changed (assuming that the buildings are located in participating communities).

In both instances the property owners’ premiums would be expected to increase due to an increased exposure to risk. This reflects a fundamental premise of the insurance industry, namely that policyholders should pay premium rates that are commensurate with the risks they face.

In fact, however, regardless of a change in risk exposure, FEMA administratively created grandfather rules that permit property owners who are remapped to benefit from the rating for the former flood zone (or to use the rating in the new zone if it is more favorable) in two

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<sup>62</sup> The NCUA’s (2004) Automated Integrated Regulatory Examination Software, which the administration’s examiners use to complete examinations of credit unions, asks whether credit unions notify FEMA – but not the director’s designee – of the identity of the servicer of each loan requiring flood insurance. The instruction for the NCUA’s “Flood Questionnaire” also notes incorrectly that credit unions are required to notify FEMA of any change in the servicer of a loan.

circumstances. First, despite map changes that identify higher risks, existing policyholders can renew their policies based on the former zone as long as they retain continuous coverage and the building has not been altered in a way that places the building's lowest floor below the BFE on the applicable FIRM.<sup>63</sup>

Second, property owners who built in compliance with the FIRM or BFE in effect at the time of construction can use the rates applicable at the date of construction and obtain coverage for the first time before the map change is effective as long as the building has not been substantially improved or altered in a way that places the building's lowest floor below the BFE on the applicable FIRM.<sup>64</sup> Property owners must provide documentation to the insurance company that substantiates the building's compliance with the FIRM at the time of construction.<sup>65</sup>

In both situations, the administrative grandfathering continues as long as the property owner renews the policy, which can be assigned to subsequent owners of the property.

Legislative grandfathering applies to certain buildings in units of the Coastal Barrier Resources System and Otherwise Protected Areas. The Coastal Barrier Resources Act of 1982 and the Coastal Barrier Improvement Act of 1990 prohibit insurance coverage through the NFIP on buildings constructed or substantially improved after an area's designation as a unit in the CBRS. In contrast, buildings constructed or permitted and under construction before such designation and those not substantially improved after designation are eligible for coverage. Continuous or uninterrupted coverage is not required to obtain or initiate coverage.<sup>66</sup> Portions of approximately 400 participating communities in 21 states, Puerto Rico, and the Virgin Islands are in the CBRS, OPA, or both.

As just noted, once an area is included in a CBRS unit, federal flood insurance is prohibited on all new construction and on buildings that are substantially improved. In spite of this prohibition, privately owned properties in these areas have been and continue to be insured through the NFIP. The GAO (1992) identified 952 residences in five CBRS units. Of these units, the GAO sampled 250, of which 42 had federal flood insurance. Salvesen (2003) reported that more than 100 NFIP policies had been issued erroneously in one CBRS unit in North Carolina. More recent analyses by AIR, in 2005, found several federally insured properties in one of these

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<sup>63</sup> The lowest floor is the floor of the lowest enclosed area, including a basement, except that an enclosed area used solely for parking, access, or storage in an area other than a basement is not considered to be the lowest floor.

<sup>64</sup> Substantial improvement "represents any reconstruction, rehabilitation, addition, or other improvement of a building, the cost of which equals or exceeds 50 percent of the market value of the building before the start of construction of the improvement" (FEMA 2005). The cost of improvements to correct violations of state or local building codes is excluded. Communities can have a lower threshold percentage, and some are as low as 10 percent, and calculate the cumulative costs of improvements over a multiyear period.

<sup>65</sup> This documentation must indicate the date of the FIRM; the zone on that FIRM in which the building is located; the BFE, if any, for that zone; a copy of the map panels showing the location of the building, and the rating element to be grandfathered. A letter from a community official verifying this information can also be used.

<sup>66</sup> FEMA's *Mandatory Purchase of Flood Insurance Guidelines* (1999) may contribute to misunderstanding about coverage within units of the CBRS. These guidelines indicate that a building that is walled or roofed and insured prior to inclusion in a unit of the CBRS can retain flood insurance after designation. In contrast, as noted earlier, buildings under construction (or to be constructed) are eligible for flood insurance prior to being roofed or walled. Insurance in place before designation can be continued after an area becomes part of the CBRS.

units (i.e., in Bethany Beach, Delaware). The number of residences in this CBRS unit increased to 201 in 2000 from 74 in 1992 and from only two in 1982 (GAO 1992; Salvesen 2003).

Each year, according to FEMA's database on policies in force, insurance agents improperly write hundreds of policies for properties in CBRS units. FEMA successfully identifies many of the properties as being ineligible for federal flood insurance, but the WYO companies (or their agents) that provided the policies are not always prompt in canceling them. For other properties in the CBRS, FEMA may not be aware that their owners are insured through the NFIP.<sup>67</sup>

Grandfathering can complicate lenders' and borrowers' efforts to assure that proper coverage is in place (or is in place when it should not be, such as for buildings in the CBRS constructed after inclusion in the system).<sup>68</sup> From the perspective of insurance companies and their agents, grandfathering increases their workloads without a commensurate increase in their commissions. To assemble the data needed to justify administratively grandfathering a property, an insurance agent must know the exact date of construction and have access to previous FIRMs (and, in some instances, their predecessors, Flood Hazard Boundary Maps). FEMA asserts that communities maintain map repositories that provide access to outdated FIRMs, but this a problematic claim. Participating communities are not required to retain outdated FIRMs or Flood Hazard Boundary Maps, and many do not. A representative from FEMA's Map Service Center indicated that it can assist an insurer in determining the existence of superseded FIRMs but is typically unable to provide such FIRMs to insurers or their agents.

The NFIP's system for identifying grandfathered properties further compounds the situation. The NFIP's application for flood insurance does not provide an insurance agent the opportunity to indicate that grandfathering is the basis for the rates applied or for an agent to indicate that a building is eligible for flood insurance despite its location in the CBRS. In addition, without knowledge that administrative grandfathering is the basis for the premiums charged, claims adjusters may incorrectly believe that buildings have been improperly rated, thus causing problems for grandfathered policyholders after they have filed a claim due to damages from a flood.

FEMA recognizes the difficulty in understanding and managing administrative grandfathering but is uncertain how best to address this situation. On the one hand, some agency officials believe that policyholders who built in compliance with the NFIP's requirements should not be charged higher premiums because of changes to FIRMs. On the other hand, in addition to

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<sup>67</sup> Section 7 of the Coastal Barrier Improvement Act of 1990 (P.L. 101-591) requires the head of each federal agency affected by the act to certify annually to the Congress and the secretary of the interior that the agency is in compliance with the act's provisions. Although this certification requirement applies to FEMA and the sale of federal flood insurance in the CBRS and in OPAs (GAO 1992), the Department of Interior was unable to locate any certifications from FEMA. As the GAO noted in 1992, "FEMA needs to take the steps required to comply with the act" and to certify that federal flood insurance is not underwritten in CBRS units.

<sup>68</sup> As Stephen Kalaf (1998) has noted, the concept of coastal barriers "has been difficult for many to understand, and, for 15 years, insurance agents, lenders, and homeowners have struggled with the procedures for determining whether or not a particular building is eligible for flood insurance." Mistakes are common, and the processes for resolving disputes as to whether homes are in or out of the CBRS are time consuming. Some disputes require more than a year to resolve (Office of Inspector General 2001).

complicating efforts to ensure compliance with the mandatory purchase requirement, other officials concede that *administrative* grandfathering results in different premium rates for policyholders facing the same risk. The issue of grandfathered properties is so complex that FEMA is unable to determine its extent and, according to the FEMA's IG (1995), the agency's "recordkeeping system does not provide easy access to the information needed to verify that grandfathering was used in calculating the premium." As one senior NFIP official noted, administrative grandfathering "will continue to be a nightmare." FEMA's IG (1995) recommended that the agency assess the impact of eliminating administrative grandfathering "and, if feasible, begin phasing it out." FEMA responded to this recommendation by noting its consideration of alternatives to its grandfathering rules, but no major changes in the rules have resulted.

## 7.9 Manufactured Homes

Manufactured homes are an increasingly important segment of the housing market in rural, nonmetropolitan areas, especially in the southern United States. These homes represented about 35 percent of all homes built in these areas between 1995 and 2004. Manufactured homes occupy land in SFHAs at a rate similar to or even greater than that of traditional site-built homes. In some areas, restrictive zoning laws have meant that manufactured homes are located on the least desirable lands and, as one organization (IllinoisProBono 2004) has noted, this "often makes mobile home owners desperate to find and keep whatever lot they can get." For many of these owners, the consequence is that they live in flood-prone areas.

According to the U.S. Department of Commerce (2004c), about one in four manufactured homes was within 300 feet of a body of water in 2003. Despite this proximity to water, manufactured homes, which are potentially subject to the mandatory purchase requirement, appear to be insured against floods at lower rates than other kinds of home, at least according to FEMA. This occurs for several reasons. Manufactured homes are eligible for federal flood insurance only when they are on permanent foundations and meet specific requirements for anchoring. Many manufactured homes may not meet these requirements.

In addition, many owners of manufactured homes are never in a position to trigger the requirement. Manufactured homes are often financed through companies that are not federally regulated for purposes of flood insurance. This may occur when manufactured home dealers arrange the financing for their customers, in much the same way as an automobile purchase. A survey conducted by the Foremost Insurance Group (2002) found that 41 percent of manufactured home residents had purchased homes from dealers. Additionally, several companies that produce manufactured homes have their own finance divisions. According to one outdated estimate (Housing Assistance Council 1996), finance companies provided 73 percent of all financing for manufactured homes in 1993. These companies can offer the advantage of quick approval, which may appeal to customers with weak credit histories. In rural areas where few banks or credit unions are located, finance companies may also be the most readily available source of financing.

Furthermore, many loans for manufactured home are ineligible for sale on the secondary mortgage market. Buyers of manufactured homes have traditionally used personal property

loans, also known as chattel loans, as opposed to conventional mortgages.<sup>69</sup> This situation stems from the early history of manufactured homes as truly mobile units. To be eligible for conventional loans, manufactured homes must be treated as real estate as opposed to personal property. In many situations, manufactured homes can be considered to be real estate if they are located on the owner's private property. According to one recent survey (Foremost Insurance Group 2002), approximately half of manufactured homes are located on the owner's private property, but many of these owners use personal property loans rather than mortgages (Genz 2001). In many states, however, manufactured homes cannot be classified as real estate, regardless of the ownership of the land (Apgar et al. 2002).<sup>70</sup> Of the 138,000 new manufactured homes placed in the United States in 2003 more than 60 percent were titled as personal property compared with 33 percent titled as real estate (U.S. Department of Commerce 2003). It is likely that some portion of the latter have had their title changed to real estate.

Even in instances in which manufactured homes are eligible for classification as real estate, regulated lenders may be reluctant to provide mortgages. Owners of manufactured homes are significantly more likely to default on their loans than are owners of conventional homes (Genz 2001). Moreover, when finance companies provide loans for the purchase of manufactured homes, loan-to-value ratios well over 100 percent are common (Genz 2001). Such ratios promote rapid depreciation and can discourage traditional lenders from offering long-term mortgages.

Those who wish to purchase manufactured homes are eligible for federal loan guarantees, but such opportunities are rarely pursued. In 2000, for example, the Rural Housing Service originated fewer than 900 loans for manufactured homes. HUD's Title I manufactured home loan program, which can be used for personal property loans, had only 377 loans in 1999 (Genz 2001). Similarly, although the VA guaranteed over 1.5 million home loans from fiscal year 1997 through fiscal year 2001, only 13 of these loans were for manufactured homes. This number may underestimate the actual number of loans issued for manufactured homes because lenders may not classify the loans as such.

All of these conditions contribute to a situation in which many owners of manufactured homes, while often vulnerable to flooding, are often not subject to the mandatory purchase requirement. While some owners may find this desirable, owners of manufactured homes are typically less affluent and have lower incomes than do owners of conventional homes, meaning that the former may be less able to recover quickly, if at all, from the consequences of flooding.

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<sup>69</sup> Chattel loans do trigger the mandatory purchase requirement (FEMA 1999), but many such loans for the purchase of manufactured homes are from nonregulated lenders.

<sup>70</sup> According to Fannie Mae, manufactured homes can be treated as real property in all states, although some states prevent changing chattel loans to real estate loans.

## 8. PENALTIES FOR NONCOMPLIANCE

The Flood Disaster Protection Act of 1973 did not provide federal regulatory agencies with authority to impose penalties on lenders that did not comply with the act's requirements. With the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, however, the agencies were given authority to impose civil money penalties (CMP) on lenders that do not comply with any federal law, rule, or regulation, including the flood legislation. The 1989 law did not mention the 1973 flood legislation, and no CMPs were imposed on any lenders as a result of violations of that law.

With the passage of the 1994 National Flood Insurance Reform Act, however, the federal regulatory agencies are now required to impose CMPs administratively when they identify a "pattern or practice" of committing violations of the act's requirements. A CMP is required when a regulated lender fails to:

- notify borrowers (and the servicers of their loans) in writing that the structures or manufactured homes to be purchased are in SFHAs and of the requirement that they purchase flood insurance;
- require flood insurance when it is required;
- escrow payments for flood insurance when the lender also requires the escrowing of other expenses (e.g., for fees, taxes, or for hazard insurance); and,
- purchase flood insurance on behalf of borrowers if at any time during the life of their loans insurance less than the federal minimum is in place.

In addition to these four violations, the federal regulatory agencies also have authority, derived from the Federal Deposit Insurance Act, to impose CMPs when other violations are detected.<sup>71</sup> One such example involves the failure to complete a SFHD form (FDIC 2001b). Despite identifying the violations that are subject to a CMP, the 1994 Reform Act does not define what constitutes a pattern or practice, and the federal regulatory agencies have declined to provide a definition (U.S. Department of the Treasury et al. 1996).<sup>72</sup>

The 1994 legislation imposed a limit on CMPs of \$350 for each violation, with a maximum total of \$100,000 against any single institution in a calendar year.<sup>73</sup> As a result of the Federal Civil Penalties Inflation Adjustment Act of 1990, as amended by the Debt Collection Improvement Act of 1996, however, agencies with authority to impose CMPs are required to adjust them for inflation at least every four years, with the first adjustment required no later than October 23, 1996.

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<sup>71</sup> The FCA has similar authority under the Farm Credit Act of 1971, as amended.

<sup>72</sup> In FEMA's (2000) *Call for Issues Status Report*, the agency noted a request for clarification of what the phrase means and how a pattern or practice is determined. FEMA indicated that the issue would be subject to further study, but the study, if it did occur, did not lead to a substantive response to the suggestion.

<sup>73</sup> The caps on CMPs do not limit the repercussions a lending institution can face for noncompliance with the mandatory purchase requirement. The 1994 act declares that CMPs "shall be in addition to any civil remedy or criminal penalty otherwise available."



Agencies' implementation and interpretation of this requirement have not been consistent (GAO 2003b). The FDIC, FRB, OCC, and OTS retained the \$350 per violation limit per violation when they adjusted their flood-related CMPs in 1996 (1997 for the OCC) but increased the maximum total per calendar year to \$105,000. In 2000, the four agencies again retained the limit of \$350 per violation but increased the calendar year limit to \$115,000. The NCUA made its initial adjustment for flood-related violations for inflation in 2000, and OFHEO followed in 2001.<sup>74</sup> Both entities raised the per-violation limit to \$385 and the annual limit to \$110,000. The FDIC, FRB, NCUA, OCC, and OTS again adjusted the amount per violation and the annual maximum CMP in late 2004. The Farm Credit Administration is adjusting its flood-related CMPs to \$385 per violation with an annual limit of \$110,000. This intended adjustment should be completed in 2005. Table 12 summarizes the CMPs that each agency can impose when it detects a pattern or practice of committing violations of the Flood Disaster Protection Act.

**TABLE 12: Maximum Allowable Civil Money Penalties by Agency, as of March 1, 2005**

Agency	Maximum Penalty		Date of Last Adjustment
	Per Violation	Per Calendar Year	
FDIC	\$385	\$125,000	October 2004
FRB	\$385	\$125,000	September 2004
FCA	\$350	\$100,000	None <sup>1</sup>
NCUA	\$385	\$120,000	October 2004
OCC	\$385	\$125,000	November 2004
OFHEO	\$385	\$110,000	December 2001
OTS	\$385	\$125,000	November 2004

<sup>1</sup> The FCA anticipates that its initial inflation-related adjustment of civil money penalties for violations related to flood insurance will occur in 2005.

Differences in the maximum amounts of CMPs are seemingly matched by differences in their application. As just noted, neither the law nor the federal regulatory agencies define a pattern or practice of committing violations. Each of the agencies' experiences with CMPs are discussed below, but it is worthwhile to note considerable variation in the frequency with which the agencies impose CMPs as well as with their total value.

Through December 2004, the federal regulatory agencies had imposed CMPs on 95 lending institutions, but the FDIC accounted for 60 percent of these CMPs. The large number of FDIC-initiated CMPs may reflect the number of lending institutions it regulates.

All but three of the 95 CMPs were issued after 2000. All of the agencies except the FCA and the NCUA have issued a CMP for a pattern or practice of violating the flood legislation. CMPs have been issued in 26 states and Puerto Rico, but the largest number has been in Missouri (12), Indiana (11), and Arkansas (7). Lenders in these states, plus Florida, Nebraska, and Oklahoma, account for half of all CMPs. No flood-related penalties have been imposed in any state west of Colorado or South Dakota or in any of the New England states (except for

<sup>74</sup> FEMA (1999) incorrectly notes that the penalty for each violation is \$350, but that represented the maximum penalty per violation under the terms of the 1994 Reform Act. As discussed below, OFHEO has oversight responsibility for Fannie Mae and Freddie Mac and can impose CMPs on these GSEs for certain violations.

Massachusetts). The average total penalty in 2001 was about \$5,250, but this average increased to more than \$9,300 in 2003, due primarily to the single largest penalty – \$56,800 – ever imposed. For 2004, the average was about \$8,800. The average for all 95 flood-related CMPs was about \$6,800. Almost two-thirds of these CMPs were for \$5,000 or less, and about one of five was for \$10,000 or more. The smallest CMPs were for \$800.

Although a few enforcement orders specify the nature and number of violations committed, most orders do not. An examination of the orders that do specify the violations indicate that their number and seriousness is often not a good indicator of the total CMP. As an illustration, the OTS imposed a penalty of \$3,850 on a bank in Kentucky in early 2004 for failure to purchase insurance on two loans, failure to provide notice on six loans, and failure to prepare and maintain SFHD forms on three loans. The FDIC, in contrast, issued a CMP of \$2,150 to a bank in North Carolina in 2002 for failure to purchase insurance on two loans, failure to complete flood determinations on 51 loans, and failure to use the SFHD form for 139 loans.

## 9. MONITORING LENDERS' COMPLIANCE

Federal financial regulators monitor compliance with the mandatory purchase requirement. The Farm Credit Administration (FCA), Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (FRB), National Credit Union Administration (NCUA), Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) oversee the policies and processes that regulated lenders use to comply with the requirement.

For each of these agencies, monitoring compliance with the mandatory purchase requirement is one of many oversight responsibilities associated with ensuring that lenders conduct business in a safe and sound manner and honor consumers' rights. In addition to monitoring compliance with the flood insurance requirements, the agencies also monitor compliance with the Truth in Savings Act, the Truth in Lending Act, the Fair Housing Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act, the Home Mortgage Disclosure Act, the Community Reinvestment Act, the Expedited Funds Availability Act, and the Electronic Funds Transfer Act among others. This long but incomplete list suggests that the flood insurance laws and rules cannot be the sole or even the primary concern of the agencies that monitor lending institutions. Indeed, given multiple, competing demands, these agencies must allocate fixed resources to a wide range of responsibilities. As a consequence, the context under which the federal regulatory agencies operate must be considered when addressing the adequacy of monitoring regulated institutions for compliance with their flood-related obligations.

As an illustration, in addition to strengthening the mandatory purchase requirement, the 1994 Flood Insurance Reform Act required the FCA to promulgate flood insurance regulations for the first time and for the other five agencies to revise their existing regulations on flood insurance. Equally important, the 1994 act required the FDIC, FRB, OCC, and OTS to make uniform all regulations covering common statutory or supervisory policies. All six of the agencies subsequently addressed their flood insurance regulations with this obligation in mind.

In collaboration with the FFIEC the six agencies thus issued a joint final rule in the *Federal Register* (U.S. Department of the Treasury et al. 1996) that discussed their common understanding of the 1994 act and how regulated lenders should implement the revised requirement. In nearly identical wording, the final rule also provided the specific regulations applicable to regulated lenders. In turn, the regulatory agencies also developed checklists for their examiners (e.g., FRB 1997) specifying the issues related to flood insurance that should be reviewed during examinations of these lenders. The agencies' checklists are similar and typically require examiners to review the following:

1. Verify that adequate controls exist to ensure that lenders comply with flood-insurance requirements.
2. Determine whether lenders perform required flood determinations for loans secured by improved real estate or manufactured homes affixed to permanent foundations.

3. Determine whether lenders require flood insurance in the correct amount for designated loans.
4. Determine whether lenders provide the required notices to the borrower, servicer, and to the director of FEMA whenever flood insurance is required as a condition of the loan.
5. Determine whether lenders require flood-insurance premiums to be escrowed when flood insurance is required on a residential building and funds to cover other charges associated with the loan are required to be escrowed.
6. Determine whether lenders comply with the forced-placement provisions.
7. Initiate corrective action when policies or internal controls are deficient or when violations of law or regulation are identified.

Due to the similar examination procedures and issues reviewed by examiners for each of the six agencies, the following discussion describes what is different or distinctive in application or interpretation.

## **9.1 Farm Credit Administration**

The Farm Credit Administration (FCA) monitors the safety and soundness, including compliance with the mandatory purchase requirement, of the 110 banks, associations, and service corporations of the Farm Credit System (FCS). FCS institutions lend to farmers, ranchers, aquatic producers and harvesters, agricultural processing entities, farm-related businesses, rural homeowners, agricultural cooperatives, and rural utilities. These borrowers face unique needs with regard to the requirement, to which the FCS institutions became subject in 1996. The FCA also regulates the Federal Agricultural Mortgage Corporation (Farmer Mac), but Farmer Mac is not subject to the mandatory purchase requirement.

### **9.1.1 Examination Procedures**

FCA examiners use a statistical sample of an institution's portfolio, including loans that were originated before the examination period, to determine specific compliance measures. The examiner ensures that flood determinations are correctly prepared on the SFHD form and that the institution relies on a previous determination only if the previous determination was completed within seven years and the property is not in a community that has been remapped. The examiner must also review the contract between the institution and the flood determination company, if used. The FCA estimates that more than half of the institutions it regulates rely on third parties to conduct flood determinations.

Using the sample of loans, the examiner also assesses whether sufficient insurance was obtained prior to loan closing and is maintained for the life of the loan. Unlike other regulatory agencies, the FCA includes a requirement that the examiner note how the institution complies with SBA, VA, and FHA prohibitions against lending for properties in a SFHA in nonparticipating communities, if the institution makes loans guaranteed or insured by these agencies.

The examiner determines whether the institution complies with the regulations governing the mandatory purchase requirement as they apply to the institution, borrower, servicer (if applicable), and insurance company (if applicable).

The escrow requirement is largely inapplicable to FCS loans because such loans are usually for commercial loans, which are not subject to the escrow requirement.

The FCA notes that there are several ways in which the mandatory purchase requirement does not consider the particular needs of FCS institutions. Farm structures are often not adversely impacted by a flood. Farmers might simply “have their barns cleaned out” during a flood, without experiencing damage or loss. Also, agricultural properties tend to have old, existing structures of nominal value, but high replacement cost. Such structures would not be replaced if they were lost or damaged by flooding, yet the borrower is required to retain flood insurance coverage for them. It can be difficult as well to determine the insurable value of farm buildings of this nature.

### **9.1.2 Infractions**

At the end of the examination, the examiner gives written and oral presentations of the findings to the institution’s board of directors. If the examiner finds a pattern or practice of noncompliance with the mandatory purchase requirement, the FCA must assess a CMP on the institution. Through 2004, however, the FCA had not imposed any CMPs for a pattern or practice of violations of the requirement.

The FCA tracks the number of violations of flood insurance regulations each year (FCA 2002a, 2002b, 2004). The number of such violations decreased to 51 in fiscal year 2003 from about 140 in fiscal year 1999. The most common violation is the failure to complete a SFHD form. The second most common violation is the failure to require flood insurance. This logically follows from the most common violation. If flood determinations are not completed, neither lenders nor borrowers may know whether insurance is required. Overall, about 90 percent of the violations the FCA identifies are in one or both of these two categories. Similarly, in a typical year about 90 percent of the violations result in corrective actions by the institutions; the remainder do not require such action due to the nature of the violation.

## **9.2 Federal Deposit Insurance Corporation**

The Federal Deposit Insurance Corporation (FDIC) directly examines and supervises approximately 5,300 banks and savings banks, or more than half of all the institutions in the U.S. banking system. The FDIC is the primary regulator of state-chartered institutions that do not join the Federal Reserve System.

### **9.2.1 Examination Procedures**

The FDIC conducted approximately 1,800 compliance and/or Community Reinvestment Act (CRA) examinations during 2003. In general, the compliance and CRA examination

intervals for an FDIC-regulated financial institution are based on the institution's asset size and the compliance and CRA ratings assigned at its most recent examination.

The FDIC's compliance examinations blend both risk-focused and process-oriented approaches. By focusing on risk, information gathered about a financial institution is used to direct the corporation's resources to those operational areas with higher degrees of risk. Concentrating on the institution's internal control infrastructure and methods, or the "process" used to ensure compliance with federal consumer protection laws and regulations, acknowledges that the ultimate responsibility for compliance rests with the institution and encourages examination efficiency.

Initially, the FDIC sends a Compliance Information and Document Request (CIDR) to banks selected for an examination. Using the material provided in response to the CIDR, the scope of an examination is preliminarily established prior to entering the financial institution. The scope is refined as a result of discussions with the bank's management, its compliance officer, and its internal auditor. For example, the scope of the compliance review may be limited due to a finding that reliable procedures and controls are in place. In contrast, the review may be expanded because of a finding that necessary internal procedures or controls are lacking or that violations are present.

Through this risk-focused, process-oriented approach, the examiner identifies and quantifies compliance risk; assesses the institution's compliance infrastructure and methods for identifying, monitoring, and controlling compliance risk;<sup>75</sup> and determines the transaction testing needed to assess the integrity of a bank's compliance management system. The number of transactions selected and the type of sampling used is relative to the perceived risk and the need to assess the level of compliance in an activity or function.

Under examination procedures issued in 2003 (FDIC 2003), the agency's compliance examiners conduct transaction testing in a focused manner. If a review of a lender's compliance with the mandatory purchase requirement is appropriate, the examiner will typically obtain a list of loans secured by properties in SFHAs, including loans issued prior to the FDIC's most recent assessment of compliance. In some instances, as well, the FDIC will also obtain a list of properties from an outside vendor to avoid relying on an institution's potentially flawed determinations of which properties are inside or outside of SFHAs. The examine will typically review a sample of loan for compliance, but examiners can require a lender to conduct a complete a review of its entire portfolio if problems are found within the sample of loans initially reviewed.

The examiner also looks at the contract between the institution and the flood determination companies, if any, that are used. The institution must have procedures in place to ensure that the companies' financial condition is reviewed at least annually. The contract must provide a guarantee of the vendor's work and "contain provisions to resolve disputes relating to

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<sup>75</sup> The institution's approach to the forced placement of insurance is considered during this initial review. When risks are identified in this area, the scope of the examination will be expanded to test how force-placed insurance transactions have been handled.

determinations, to allocate responsibility for compliance, and to address which party will be responsible for penalties incurred for noncompliance.”

A component of the mandatory purchase requirement that the FDIC does not monitor relates to remapping. The FDIC has no codified definition of what constitutes “awareness” and does not monitor whether institutions require flood insurance if they become aware (apart from at loan origination) that a property has been remapped into or out of a SFHA.

### **9.2.2 Infractions**

When the examiner finds a pattern or practice of noncompliance with the mandatory purchase requirement, the examiner will discuss the finding with the institution’s management and will contact the FDIC’s appropriate regional director. If the regional director concurs with the examiner, the FDIC’s head office is contacted. At this point, legal staff may be included in the review. The FDIC will then levy CMPs when a pattern or practice of noncompliance is confirmed. The FDIC does not record what proportion of infractions lead to penalty charges.

The FDIC (2001b) has written guidance about CMPs for flood insurance violations. This guidance notes that the term “pattern or practice” is not defined in the 1994 Reform Act and indicates that a finding of whether violations are part of a pattern or practice “is based on many considerations which are typically unique to the case at hand.” The FDIC thus determines the amount of a CMP on a case-by-case basis.

Should a pattern or practice of violations be found, the FDIC uses a sliding scale to determine the penalty per violation. The lowest amount, \$100 or less per violation, is intended for first occurrences (except for failure to notify borrowers that their properties are in SFHA and that they will be required to purchase flood insurance) and where the bank is “cooperative and quickly addresses the violations,” and when they result from “a reasonable misunderstanding rather than negligence or willful misconduct.” Fines of approximately \$200 per violation are appropriate for first occurrences of a failure to notify or to obtain insurance when the bank is cooperative, “diligently institutes corrective measures,” and when the violations result from a misunderstanding. The largest per-violation penalties, ranging from \$200 to \$350, are intended for “repeat violations, instances of widespread noncompliance, violations that significantly affect the bank’s borrowers, or negligent or willful misconduct.”

The FDIC’s Inspector General sampled FDIC-regulated banks and savings banks between January 1997 and March 1998 and found that 47 percent of these banks had flood insurance-related violations during that period (FDIC 1999). In 2002, the FDIC conducted 1,839 compliance examinations, of which 475 institutions (26 percent) had significant violations related to flood insurance. In 2003, the percentage of FDIC-regulated banks cited for such violations declined to 19 percent (i.e., 355 of 1,833 banks examined).

Between August 2000, when the FDIC issued its first flood-related CMP, and December 2004, the FDIC imposed 58 CMPs for a pattern or practice of violations of the Flood Disaster Protection Act. This number is significantly higher than the combined total of the other five regulatory agencies. The FDIC’s CMPs have ranged from \$800 to \$43,700; nearly 70 percent

have been for less than \$5,000. The FDIC was unable to provide an estimate of costs associated with issuing a CMP but agreed that the administrative costs associated with a CMP often greatly exceed the amount of the penalty, in many instances by ten or more times. For some of the smaller penalties, the cost-to-penalty ratio is probably substantially higher.<sup>76</sup>

Due to the current statutory requirements, the FDIC does not believe it has discretion to obtain corrective action through other means when a pattern or practice of violations of the mandatory purchase requirement is discovered. Nonetheless, enforcement actions, regardless of the amount of the CMP, carry stigma that lending institutions want to avoid, at least in the FDIC's opinion.

### **9.3 Federal Reserve Board**

The Board of Governors of the Federal Reserve System (FRB) monitors state-chartered commercial banks that are members of the Federal Reserve System. There are about 1,000 such banks, the majority of which have assets of less than \$500 million.

#### **9.3.1 Examination Procedures**

The FRB conducts risk-focused consumer compliance examinations that direct resources to the areas of a state member bank with the greatest compliance risk, while reducing regulatory burden by limiting the review of areas having low compliance risk. Risk-focused supervision relies on performing risk assessments and tailoring supervisory activities to fit a bank's risk profile. Vital to such a program is the expectation that each state-member bank will manage its own compliance risk effectively. Thus, risk-focused supervision emphasizes the appropriateness of an institution's processes for identifying, measuring, monitoring, and controlling its risk exposure. Examiners evaluate the effectiveness of an institution's program for managing its risks, particularly the oversight provided by the board of directors and senior management, the consumer compliance program structure, policies and procedures, compliance audits/reviews, internal controls, and training. The examiner's evaluation of the consumer compliance risk management program serves as the foundation for the consumer compliance examination.

In addition to compliance ratings from prior examinations, an institution's size determines the frequency with which the FRB examines it. Banks with a satisfactory compliance history and with assets of more than \$250 million are examined every two years. Since the passage of the Financial Modernization Bill in 1999, small banks with a satisfactory compliance history and assets of less than \$250 million, are examined every four or five years. Institutions with an unsatisfactory compliance history are usually examined every 12 months. The FRB uses a midterm monitoring system between examinations of small banks. The FRB's 1999 report to Congress reported slightly different periods between examinations: it reported a 36-month interval for small institutions with a satisfactory compliance history and a 24-month interval for large institutions with a satisfactory compliance history.

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<sup>76</sup> Similar situations appear to exist in the other regulatory agencies that have issued CMPs.



Examiners exercise their discretion in selecting appropriate sampling techniques, looking at the past one or two months of loan originations. Limiting the scope of the origination period means that the sample reflects the institution's current practices. The FRB could not estimate the approximate sample size used.

The FRB assesses whether flood determinations were completed before loans were originated. Most of the FRB's member institutions use flood determination companies. To examine the accuracy of flood determinations, examiners will review the vendor's process for "verification" instead of checking each flood determination. The FRB has also experimented with software to determine accuracy of flood determinations, but it found that the software did not have recent map information (FRB 1999). However, if the examiner notices that the institution is doing in-house flood determinations rather than using third-party vendors, the examiner is likely to require the bank to review and validate that process.

In addition, examiners pull a special sample of loans secured by property located in SFHAs. The FRB could not estimate the approximate sample size used. Examiners use this sample to determine the adequacy of flood insurance at loan origination and check to determine whether flood insurance is being required for the life of the loan, beyond loan origination, taking particular care to check that flood insurance is renewed as necessary.

### **9.3.2 Infractions**

In the event that violations are detected, the examiner discusses the findings with the institution's management to determine appropriate corrective actions. By the time the examiner leaves the site, the management is aware a problem exists. After the examination, the FRB reviews the bank's corrective action plan and ensures that the bank has taken the proposed actions. In later examinations, examiners confirm that these actions have been taken. Between 1997 and 1999, corrective actions generally included retaining flood insurance on non- or underinsured properties, strengthening management oversight of the mandatory purchase requirement, further review of the loan portfolio to ensure that flood policies are current, expanding existing procedures, and implementing staff training.

The FRB finds only a small percentage of the institutions it examines to have unsatisfactory compliance with the mandatory purchase requirement. During 1997-99, the FRB (1999) reported 223 institutions with violations of the mandatory purchase requirement. The most common violation was the failure to use the SFHD form – 142 institutions violated this requirement a total of 696 times. The second most common violation was failure to require flood insurance where available; this violation was reported in 71 institutions 116 times. The FRB issued the first CMP for a flood-related violation in June 1999.

Through 2004, the FRB had issued 20 CMPs for flood-related violations. Of these, seven were for \$10,000 or more, and nine were for less than \$5,000.

The FRB considers several factors in determining a reasonable assessment amount for a CMP, including the size of the bank, the cause of pattern or practice of noncompliance, the number and frequency of violations, past history of violations, prior precedents at the Board, and

any information it receives from the bank in mitigation of the CMP. The FRB cannot estimate the cost of issuing a CMP, but concurs that issuing a CMP is more costly than the revenue generated. It should be noted that CMPs, as with other public enforcement actions, are believed to act as a deterrent to future violations not only to the bank subject to CMPs but also to the industry.

## **9.4 National Credit Union Administration**

The National Credit Union Administration (NCUA) supervises and insures about 5,400 federally chartered credit unions. The NCUA also insures about 3,300 state-chartered credit unions that state regulatory agencies supervise.

### **9.4.1 Examination Procedures**

The NCUA examines credit unions, on average, every 18 months. Examinations are risk-focused, and the NCUA uses several variables to determine how often to examine individual institutions and what requirements to emphasize in the examination. Major personnel, policy, or portfolio changes can trigger more frequent examinations. Credit unions with high capital and steady management are generally examined less often, while less stable credit unions (often those with less capital), receive more frequent examinations. The amount of time spent on examinations varies with asset size and the institutional complexity. An examination of a small credit union may take a single examiner a few days whereas a larger credit union may take a team of examiners several weeks.

Examiners begin a review with an initial assessment of risk, which can survey a credit union's policies and procedures for originating loans. If the credit union has a tickler system for renewing all insurance, including flood insurance, then the examiner generally determines that there is little risk of noncompliance with the insurance requirement. In these cases, the examiner would follow risk-focused examination procedures and, if the examiner determines the risk to be low, would probably not look closely at a sample of loans for compliance with the requirement.

Then, examiners select a sample of loans from the institution's portfolio. The sample depends on the type of loan products the institution offers (residential or commercial), whether the institution has implemented any new programs during the examination period, and whether the institution has any new policies. Although not a selection criterion, if the examiner determines that significant flood risk exists in an institution's lending area, the examiner would perform a review of flood insurance in the loan files sampled. If the credit union previously wrote off several loans due to flood loss, the examiner would likely look at flood insurance issues.

When the examiner reviews a sample of loans, the sample generally includes only loans that originated since the previous examination. Examiners may review loan files or policies and procedures that were found deficient in the prior examination to ensure that appropriate changes were initiated. Therefore, in most cases, the NCUA examines whether an institution requires flood insurance beyond loan origination when the examiner had previously identified flood insurance concerns.

Examiners are required to perform examination procedures related to the mandatory purchase requirement based on the examiner's risk assessment. The examination objectives include checking that properties in SFHAs are covered by flood insurance.

The "coverage and internal control" procedure entails an examiner's review of the ways in which a credit union determines whether improved real estate or manufactured homes are or will be located in a SFHA; verifying that this process is accurate; and determining if the communities in which the properties in SFHAs are located participate in the NFIP (NCUA 2004). The NCUA does not have a standard procedure for checking the accuracy of flood determinations.

In the "property and determination requirements" procedure, the examiner verifies that a credit union prepares the flood determination forms correctly and that it "only relies on a previous determination if it is not more than seven years old, is recorded on the SFHD form, and is not in a community that has been remapped." This process clarifies the requirement that federally regulated lenders need not complete a duplicate flood determination form if the *property* has not been remapped. It is unclear how the lender would know whether a property had been remapped without looking at the maps and thereby completing another flood determination. The NCUA requirement is more logical because it would be possible to determine whether a community had been remapped without completing another flood determination on a given property.

The NCUA's *Examiner's Guide* (NCUA 2002a) does not discuss remapping. The NCUA reports that credit unions are unlikely to read the *Federal Register* and are thus unlikely to be aware of changes to FIRMs included in FEMA's semiannual *Compendium of Flood Map Changes*. The NCUA staff do not recommend that FEMA remedy this communication gap by notifying all credit unions before remapping exercises occur. The NCUA suggests that such communication might overwhelm credit unions, particularly small institutions. Instead, it might be useful for FEMA to notify specific credit unions when there are map changes in their lending area.

The NCUA uses locally based examiners and believes these examiners are familiar with the lending areas of local institutions. As such, the NCUA believes that these the examiners are likely to notice discrepancies in flood certification or notice something that merits attention within a credit union or among various credit unions in the community in which the examiner lives and works.

### **9.4.2 Infractions**

If noncompliance with the mandatory purchase requirement is found, the NCUA brings its concerns to the credit union's attention. If there are other large problems, problems related to the requirement may be dealt with informally until the larger problems are solved. If the credit union's management does not make adequate, timely changes to address the noncompliant pattern or practice, the NCUA will alert the credit union's board of directors to the problem. If the board of directors does not implement appropriate change, the NCUA can issue a document

of resolution, which is an official agreement as to what the credit union will do to achieve compliance.

If the document of resolution is unsuccessful, the NCUA can take administrative action, including cease and desist orders or CMPs.<sup>77</sup> Through 2004, the NCUA had not imposed any CMPs for noncompliance with the mandatory purchase requirement. As a consequence, the NCUA was unable to estimate how long the process of issuing a CMP might require.

## 9.5 Office of the Comptroller of the Currency

The Office of the Comptroller of the Currency (OCC) charters, regulates, and examines monitors approximately 2,000 national banks, which are financial institutions with federal charters. All federally chartered banks are members of the Federal Reserve System. Overall, the OCC supervises institutions that hold more than 56 percent of the total assets of the U.S. banking system (OCC 2003).

### 9.5.1 Examination Procedures

Similar to the FRB, OCC examiners conduct risk-based consumer compliance examinations of OCC-regulated institutions, which include some of the largest financial institutions in the United States. OCC supervision focuses on the bank's ability to manage risk properly. Using the "Core Assessment" standards, examiners draw conclusions about the adequacy of a bank's risk management systems. When risks are high, when activities, products, and services are more complex, or when significant issues or problems are identified, examiners will expand the scope of their supervisory activities to ensure that a bank's management has appropriately identified, measured, monitored and controlled risk. However, the extent of the additional supervisory activities will vary based on the impact of those activities, products, services or significant issues may have on the overall risk profile or condition of the bank. When examiners assess consumer compliance risk management systems related to the mandatory purchase requirement, they consider a bank's policies, processes, personnel, and control systems. A bank's risk management system would be deemed deficient if any one of these areas is unsatisfactory.

The OCC examines the institutions it supervises every 12 to 18 months. The size, compliance rating, and risk assessment of an institution are contributing factors in determining the frequency and thoroughness of those reviews. Most banks subject to the OCC's oversight have internal and external audits that assess their compliance with regulations, including the mandatory purchase requirement. The largest 25 banks regulated by the OCC have resident OCC examiners that are assigned to work full-time at these financial institutions. This enables the

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<sup>77</sup> Although the NCUA's compliance staff indicated the availability of CMPs, the *Flood Disaster Protection Checklist* (NCUA 2002b) distributed to all federally insured credit unions notes incorrectly that the 1994 Reform Act does not include provisions for any civil or criminal penalties. The related Letter to Credit Unions and checklist for the Flood Disaster Protection Act are in the process of being revised. In addition, the required Flood Disaster Protection Act questionnaire (revised in September 2004) states that the NCUA can assess CMPs of up to \$385 per violation and up to \$110,000 annually.

OCC to maintain an ongoing program of risk assessment, monitoring, and communications with bank management and directors.

Flood insurance reviews are part of every OCC consumer compliance examination. Examiners review prior examination results, consumer complaints against the institution, findings from internal and external audit reports, and minutes of compliance-related meetings of boards of directors. Examiners consider the types of products or services the institution offers, the volume and complexity of products or transactions occurring, the bank's location and market area, changes in processes (i.e., forms, contracts, software programs, etc.), changes in the institution's policies, processes, personnel, or controls, and other factors that could affect compliance with the regulatory requirements. These findings help the OCC's examiners to determine the bank's potential strengths and weaknesses in complying with consumer laws, including the mandatory purchase requirement, and the bank's aggregate risk and direction of risk (i.e., increasing or decreasing).

The OCC expects that the banks it regulates will have policies that address the mandatory purchase requirement that include responsibilities of key personnel, a training program, a process for responding to changes in laws and regulations, and the roles of audit and compliance reviews.

Based on the risk assessment, examiners use discretion in outlining their supervisory strategy. Examiners select a sample size based on the bank's overall risk profile to determine the bank's level of compliance with the mandatory purchase requirement. For example, less than satisfactory audit results, policies, processes, or controls may result in larger sample sizes. Examiners typically select a sample of at least ten loans that include at least five commercial and five residential. If, for example, an audit identified weaknesses in the bank's identification of commercial properties located in SFHA, the examination focus and loan samples selected would likely include loans on commercial properties located outside SFHAs. If flood insurance renewals were identified as high risk, the loan sample would likely include designated loans that were at least two years old. The sample includes loans that are over one year old. This enables examiners to determine whether borrowers obtain flood insurance at loan inception and whether borrowers renew their flood insurance throughout the life of their loans.

The institutions regulated by the OCC commonly use flood determination companies to determine whether a property is located inside or outside a SFHA. Examiners do not verify the accuracy of each determination, but rather review the vendor's policies and procedures. The OCC does not use the flood determination software that other regulators use because the software is not considered more reliable than other software used by OCC-regulated banks. Although a rare occurrence, if a bank uses maps to determine properties' location relative to SFHAs, the examiner will verify the accuracy of the determinations by checking the maps.

The OCC expects that a bank will monitor its loan portfolio to determine if secured properties have been moved into or out of a SFHA. The OCC also confirmed that if a bank does not have life-of-loan service and if no tripwire event occurs that triggers the mandatory purchase requirement, a bank should have sufficient internal controls in place to ensure that the property is

adequately insured against floods. Life-of-loan flood determination services may or may not inform the bank, but OCC-regulated banks are not required to monitor changes in FIRMs.

The OCC does not monitor the number of force-placed policies, but does include in its bank examinations whether the bank force places flood insurance as required. According to the OCC, the force-placed process does not always work as intended. In some instances force-placed coverage of flood insurance is not imposed immediately after the 45-day notification and waiting period. National banks report that they are open to risk in the 45 days between notifying a borrower that flood insurance has lapsed and force placing a new policy. Further, the OCC noted that differences between the requirements of the NFIP's MPPP and private force-placed insurance are confusing to some banks. Moreover, private force-placed insurance is usually less restrictive than is the NFIP's. Questions are frequently asked of the OCC about the proper procedures to follow when force-placed coverage is required.

### **9.5.2 Infractions**

If the examiner finds that a bank has failed to obtain or maintain adequate flood insurance coverage on designated loans, the OCC may direct a bank to conduct a regulated review of its loan portfolio to determine the extent of the problem. If examiners identify noncompliance with the mandatory purchase requirement, they cite violations and determine the root cause of the violations. The cause may be the result of an isolated problem or an errant loan officer. Conversely, the violation could represent a noncompliant policy. The examiner determines whether an instance of noncompliance represents a "pattern or practice."

A pattern or practice is defined subjectively but includes situations in which there is no policy for requiring flood insurance, there is significant repetition of violations, or if the institution's internal policies, procedures, or internal controls are deficient. If the examiners identify a root cause indicating a compliance risk to the bank (for example, similar violations cited during the last examination, deficient internal controls, a weak compliance management system, or poorly trained staff, among others things), the examiners will expand the sample to determine the extent of the problem.

At the conclusion of the examination, the examiner must identify actions needed to correct violations or weaknesses and discuss these with the institution's management. The examiner must also determine whether CMPs or other enforcement actions should be recommended in light of violations of the mandatory purchase requirement. Like the FDIC, the OCC may assess CMPs for violations in addition to those specifically identified in the 1994 Reform Act.

The OCC does not track how much it costs or how long it takes to execute a CMP. Most of the work occurs at the district level and it requires months to complete. Through December 2004, the OCC had assessed 11 CMPs, including one for \$56,800 in late 2003, the largest CMP ever issued for a violation of the mandatory purchase requirement by any federal regulatory agency.

The OCC has conducted a horizontal review of compliance with the mandatory purchase requirement, across various institutions, as it has deemed necessary. For example, after Hurricane Floyd in 1999, the OCC (2000) examined retention of flood insurance at several national banks whose loan portfolios included security properties in North Carolina. This review found that most banks had satisfactory compliance management systems and levels of compliance with the requirement. The OCC found that either the large number of uninsured properties as reported by FEMA did not involve loans extended by institutions regulated by the OCC or the properties associated with these loans were not located in SFHAs.

## **9.6 Office of Thrift Supervision**

As of March 31, 2004, the Office of Thrift Supervision (OTS) regulated 923 federally chartered thrift institutions, which include savings banks and savings and loan associations. In 2003, the thrift industry accumulated over \$806 billion in mortgage originations.

### **9.6.1 Examination Procedures**

OTS conducts compliance examinations using a risk-focused, top down approach. OTS applies the interagency FFIEC-approved flood insurance examination procedures when assessing compliance with the mandatory purchase requirement. The OTS is integrating its safety and soundness reviews as well as its compliance reviews into a single examination.

Under the combined safety and soundness and compliance examination schedule, savings associations are examined every 12-18 months. The OTS examines small institutions less frequently than it does large institutions. The length of the examinations also varies with an institution's size and rating. For example, it may take two people two weeks to conduct a compliance review of the smallest institutions and more time for larger institutions. Examiner assignments rotate so that the same examiners do not always examine the same institutions.

OTS examinations are planned or "scoped" by evaluating the institution's business operations and identifying the compliance risk ramifications of those operations. Next, the examiner evaluates the adequacy of the institution's compliance management program by conducting an assessment of an institution's policies and processes to determine whether the policies are in compliance with applicable regulations and statutes and whether the processes in place to ensure compliance. The examiner follows up on the results of past examinations. For example, if there had been an issue of noncompliance with the mandatory purchase requirement, the examiner would ensure that appropriate changes have been made. The examiner also identifies the institution's internal monitoring system and evaluates whether that system is appropriate for the operational complexity and compliance risk of the association. From the results of these initial procedures, the examiner determines what, if anything, to examine more closely. If the policies, procedures, or internal monitoring system suggest potential gaps in compliance for the risk inherent in the association's particular operations, the examiner will continue the examination with these gaps in mind.

The examiner might select a sample of loans to evaluate for compliance with the mandatory purchase requirement. An examiner applies the OTS sampling guidance to test for

performance in the specific area warranted by the analysis done during the scoping and initial examination procedures. Examiners have latitude to determine the sample size to best enable a reasonable conclusion about the adequacy of the compliance performance being tested. If the examiner selects a sample, it is usually drawn from the period since the last examination. When evaluating compliance with requirements to obtain initial flood insurance, a sample is taken of loans originated during the period. When the examination scoping focuses on risk of nonrenewal, the sample is drawn from loans in the institution's servicing portfolio. This allows examiners to tailor their review to the deficiency suspected as a result of the initial examination process. Where there is general concern about compliance performance, the sample can include loans representing different stages of the flood insurance process.

When the examiner selects a sample, it is used to evaluate all relevant compliance issues, not just those associated with the mandatory purchase requirement. When asked if OTS examiners make an effort to include properties in SFHAs in this sample, the staff responded with a weak "yes." The decision is dependent on the risk ramifications of the institution's business operations and the record of compliance management controls. Given the relatively small proportion of properties located in SFHAs, a judgmental sample under the OTS guidance is more likely to select properties that will test for compliance with the mandatory purchase requirement when an examiner identifies such a risk.

The OTS (2002) republished its long-standing self-assessment guidance for institutions. The latest version of this guidance clarifies overall compliance requirements, helps institutions prepare for examinations, and promotes comprehensive internal compliance. The OTS staff noted that this guidance recognizes that institutions must tailor their compliance programs to their size, operational complexity, product diversity, and staffing resources. Therefore, smaller institutions with traditional business plans are likely to have less sophisticated self-assessment programs than larger, more complex institutions.

OTS examiners do not check loans made in remapped communities to determine if secured properties have moved into or out of a SFHA because institutions are not required to monitor changes in FIRMs or make flood determinations except when making, increasing, extending, or renewing a loan. The OTS also confirmed that in the absence of an event that triggers the mandatory purchase requirement, a bank might not know that a property should be insured against floods. Life-of-loan flood determination services may or may not inform the bank, but OTS-regulated institutions are not required to monitor changes in FIRMs. The OTS also noted that use of the *Federal Register* to report changes in FIRMs is an ineffective means of notifying lending institutions of remapping.

### **9.6.2 Infractions**

When isolated instances of noncompliance are identified, they are documented in the examination work papers and brought to management's attention for corrective action. If an examiner finds a "pattern or practice" of noncompliance in an institution, the examiner documents the issue, brings it to the attention of the institution, and requests that the institution remedy the violation and change its policies or processes or to otherwise correct the cause of the deficiency. In most instances, this is sufficient to effect change in the institution. If change does



not occur, the OTS initiates other supervisory action that might entail a meeting with the institution's board and a written agreement with the institution to correct deficiencies. The OTS usually initiates the CMP process only after these steps fail to address an issue of noncompliance. The OTS prefers to address compliance without unnecessarily escalating an issue to a CMP.

The OTS issued its first CMP related to the mandatory purchase requirement in June 2001. Through December 2004, the OTS had issued five additional CMPs for violations of the flood-insurance legislation. The OTS does not track the cost of issuing the penalties, of which all but one has been for less than \$4,000.

## 10. GOVERNMENT-SPONSORED ENTERPRISES

### 10.1 Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac purchase and securitize mortgages from both regulated and nonregulated lenders. Doing so replenishes lenders' funds so that they can continue to extend credit for home loans. Fannie Mae purchased \$1.35 trillion of single- and multifamily mortgages in 2003; Freddie Mac purchased about \$750 billion in that year. Conventional, fixed-rate loans for single-family residences (with a conforming loan limit of \$359,650 in 2005) represent the overwhelming majority of these purchases (OFHEO 2004).<sup>78</sup> In addition to the purchase of conventional loans, the GSEs also purchase loans that the FHA insures or that the VA or the RHS guarantee. In total, the two GSEs own or guarantee, in the form of mortgage-backed securities, more than 40 percent of the total U.S. residential mortgage debt outstanding. Due to their large role in the residential mortgage market, Fannie Mae and Freddie Mac effectively establish industry standards for all residential loans that the originator does not intend to retain in its portfolio (U.S. Department of the Treasury et al. 1995).

FHA-insured, VA-guaranteed, and RHS-guaranteed loans are all subject to the mandatory purchase requirement upon origination, regardless of their subsequent purchase by Fannie Mae or Freddie Mac. Neither GSE is technically required to ensure that conventional mortgages purchased in a SFHA in a participating community must have flood insurance. In contrast, the law requires the GSEs to “implement procedures reasonably designed to ensure that, for any loan” that is secured by improved real estate in a SFHA in a participating community and that is purchased by Fannie Mae or Freddie Mac to have flood insurance for the life of the loan. In other words, the GSEs are required to implement procedures, but the end result is the purchase of flood insurance for improved real estate and manufactured homes in SFHAs in participating communities.

Two publications outline Fannie Mae's relations with its lenders. The *Selling Guide* (Fannie Mae 2002a) describes the policies regarding the sale of mortgages for one- to four-family dwellings to Fannie Mae. The *Servicing Guide* (Fannie Mae 2002b) contains the requirements for servicing all Fannie Mae-owned or -securitized mortgages on one- to four-family dwellings. “Sellers” are lenders before a sale to Fannie Mae has occurred. Sellers may become “servicers” when a sale is completed, or they may transfer servicing contemporaneously with the sale of the loans. When Fannie Mae purchases a loan, the responsibility for servicing that loan remains with the original lender or with a servicer contracted by the lender. Fannie Mae and Freddie Mac do not service the loans in their portfolios nor those that they securitize. Freddie Mac's policies on its flood insurance requirements are addressed in its *Single-Family Seller/Servicer Guide* and its *Multifamily Seller/Servicer Guide* (Freddie Mac 2004b, 2004c).

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<sup>78</sup> The GSEs' conforming loan limits typically increase each year. The limits for single-family residences were \$93,750, \$187,450, and \$252,700 in 1980, 1990, and 2000, respectively. The limits are higher for two- to four-unit dwellings and 50 percent higher in Alaska, Hawaii, Guam, and the U.S. Virgin Islands. The FHA's insurable limits, which are lower than for the GSEs, are adjusted annually but are statutorily linked to the GSEs' conforming loan limits.

OFHEO is responsible for assessing whether the two GSEs have procedures in place to ensure that loans they buy have flood insurance when it is required. OFHEO is authorized to impose CMPs on Fannie Mae or Freddie Mac if it finds “a pattern or practice of purchasing loans in violation of procedures” established pursuant to the National Flood Insurance Reform Act, notably those associated with the mandatory purchase requirement.<sup>79</sup> OFHEO examined Fannie Mae’s and Freddie Mac’s compliance with these requirements three times in the 1990s and subsequently issued reports to Congress in 1996, 1998, and 2000. In each instance, OFHEO concluded that the GSEs had adopted and were appropriately implementing suitable flood insurance procedures.

### 10.1.1 Flood Insurance Requirements

In accordance with the 1994 Reform Act, both Fannie Mae and Freddie Mac require that a SFHD form be completed or available for all properties before they will purchase the mortgages associated with these properties. These forms must be available for inspection by the GSE that purchased the mortgage. Furthermore, property owners in A and V zones in participating communities must have flood insurance before either GSE will purchase their mortgages.

In contrast to the minimum flood-insurance requirements included in the 1994 Reform Act, both Fannie Mae and Freddie Mac impose different and often more stringent requirements. For example, the minimum amount of flood insurance required by Freddie Mac is:

- the higher of the unpaid balance of the mortgage or 80 percent of the replacement cost of the insurable improvements on the mortgaged property, but
- not to exceed the lower of 100 percent of the replacement cost of the insurable improvements or the maximum amount of insurance available from the NFIP.

Fannie Mae requires the lower of:

- 80 percent of the replacement cost of the structure, or
- the maximum amount of insurance available from the NFIP.

The differences between the statutory requirements and those of the GSEs have at least two important consequences. First, loans sold to either Fannie Mae or Freddie Mac may require property owners to purchase (or have force placed) additional flood insurance beyond the minimum required under the 1994 act. As an illustration, an owner of a single-family residence in a SFHA with a replacement cost of \$150,000 and an unpaid mortgage balance of \$80,000 would be in compliance with the law’s minimum requirements with \$80,000 of flood insurance.

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<sup>79</sup> In September 2001, OFHEO (2001a) proposed regulations to codify its authority to oversee and enforce the statutory requirements affecting Fannie Mae and Freddie Mac under the provisions of the National Flood Insurance Reform Act of 1994. Both GSEs contended that the proposed regulations exceeded OFHEO’s authority because they would permit the imposition of CMPs in instances other than violations associated with the purchase of loans (OFHEO 2001b). OFHEO disagreed, noting that the law “cannot be reasonably read to allow unlawful conduct to go without sanction or remedy.” The GSEs further asserted that OFHEO’s regulatory arsenal was limited solely to CMPs. OFHEO again disagreed, declaring its intent “to use its full array of preventative and remedial tools to ensure the [GSEs’] safety and soundness.”

If the loan were sold to either GSE, the minimum required coverage would be \$120,000. A second property owner with an unpaid mortgage balance of \$200,000 and a structure with a replacement cost of \$350,000 would be in compliance with the law's requirements with \$200,000 in coverage, but this amount would increase to \$250,000 if the loan were sold to either GSE.

The GSEs require what are typically higher coverage limits because NFIP policies do not fully protect borrowers against a partial loss if their policies cover less than 80 percent of the replacement cost of the improvements (OFHEO 2001b; FEMA 2005). To illustrate, if a home is insured for \$30,000 but has a replacement cost of \$100,000, the NFIP would cover only 30 percent of flood damages, even if the damages totaled less than \$30,000.

Second, despite the GSEs' coverage requirements, they may be exposed to some risk because the NFIP coverage limit (\$250,000 for single-family residences) is less than the conventional loan limit (i.e., \$359,650 in 2005) of mortgages for single-family loans that the GSEs are authorized to purchase. It should be noted that a property's market value includes the value of the land, structures, and other improvements, but flood insurance is not required (and not available) to cover the value of the land. With the increase in the loan limit to \$359,650 in 2005, the gap between this limit and the maximum amount of NFIP coverage (i.e., \$250,000) has also increased.

For Fannie Mae, condominium units that are in high rises or otherwise vertical units do not require individual flood insurance policies, but they must be covered by flood insurance. The lender must verify that the communal governing body maintains coverage. The amount of coverage must be equal to the lesser of 100 percent of the insurable value of each insured building or the maximum coverage available. If an owners' association refuses to obtain such a Residential Condominium Building Association Policy through the NFIP, a separate policy must be obtained for each dwelling unit that secures a mortgage owned by a GSE. Cooperative units do not require individual flood insurance policies because their occupants do not own the units in which they live.

Freddie Mac will purchase mortgages on condominium units only if "the association insures to the full replacement value of all improvements." If a condominium association's governing documents require individual unit owners to retain individual flood policies, Freddie Mac requires that the condominium association also retain flood insurance on all insurable common elements for 100 percent of their replacement cost. If the condominium association insures all common areas and individual units under a single policy, all improvements must be covered to 100 percent of the replacement cost of the condominium's insurable value.

Staff members at Freddie Mac are concerned about the NFIP's policies on condominiums. Freddie Mac's flood insurance requirements for one- to four-unit properties apply to individual residential units in condominiums where the governing documents obligate unit owners to insure building components within their respective units while their condominium association insures all remaining insurable common elements for 100 percent of their replacement cost. If all insurable common elements, including building components within individual units, are insured under a policy issued to a condominium association, such policy's

building limit must be maintained at 100 percent of the replacement cost of the condominium's insurable value. Freddie Mac questions the value of an exclusion found in the loss assessment coverage provided under NFIP policies purchased optionally by individual unit owners. Such policies cover insured unit owners' prorated share of an assessment levied by their condominium association following a flood loss but only when the association is not insured for flood losses. In contrast, if the association has a policy but it is for less than 80 percent of the replacement cost, the policy would not cover the loss assessment levied on the insured unit owners.

Freddie Mac and Fannie Mae have substantially similar policies regarding flood insurance for mortgages in nonparticipating communities. Mortgages on properties located in a SFHA in such communities are not eligible for purchase by Fannie Mae. Fannie Mae delegates responsibility for monitoring changes in community status to the lenders and requires that they routinely monitor changes in this status. If a community is suspended subsequent to Fannie Mae's purchase of a mortgage, the loan servicer must work with its borrowers to obtain private flood insurance on affected properties so that they continue to be covered by flood insurance.

Freddie Mac will purchase mortgages on properties in nonparticipating communities, but only if the properties are not in SFHAs. As a consequence, Freddie Mac will not purchase a mortgage on a property in a SFHA in such communities even when the property owner carries private insurance. Freddie Mac will acquire loans in unmapped communities, but only if there is not strong evidence that a flood hazard exists (for example, a property could not have recently been flooded). If a community is suspended from participation after a lender has issued the loan, the loan servicer must work with its borrowers to obtain private flood insurance on affected properties so that they continue to be covered by flood insurance.

### **10.1.2 Loan Servicing**

Although Fannie Mae's or Freddie Mac's purchase of a mortgage can trigger the mandatory purchase of flood insurance, responsibility for compliance with their respective flood-insurance requirements remains with lenders or loan servicers, even after loans have been sold or securitized. Both GSEs require that flood insurance be maintained for as long as a mortgage (on a property in a SFHA) is outstanding or as long as the property is in a SFHA, whichever is less. In contrast to the procedures the federal regulatory agencies use, the GSEs require lenders and loan servicers to track any remapping that places a property into a SFHA after a mortgage is purchased. Servicers must maintain up-to-date data and take appropriate actions to require flood insurance if it becomes necessary.

Fannie Mae requires flood insurance coverage for a mortgage if the remapping of a flood zone results in the property being in a SFHA (even though no flood insurance would have been required when the mortgage was originated). Fannie Mae further requires its lenders and their loan servicers to ensure that the properties that secure mortgages are protected by flood insurance when required, with no lapses of coverage for any reason. Thus, Fannie Mae holds its servicers responsible for the timely payment of the flood insurance premiums. If a borrower fails to pay a premium, the servicer must advance its own funds to pay the past-due premium (or to obtain substitute coverage, if necessary).

Freddie Mac gives lenders 120 days to ensure that flood insurance has been purchased on the properties when buildings are remapped into SFHAs. Lenders must force place insurance if a borrower refuses to secure suitable coverage.

For both Fannie Mae and Freddie Mac, if flood insurance coverage for a mortgage meets the requirements initially, but later the coverage requirement increases but the policy amount remains unchanged, then the lender or servicer must work with the borrower to obtain the additional coverage. If a borrower refuses to obtain the additional coverage, that coverage must be force placed. In these instances, the lender has the discretion to force place flood insurance to a level that qualifies the loan for sale to the GSE. Finally, Fannie Mae and Freddie Mac require loan servicers to monitor the maximum level of flood insurance available under the NFIP. If the coverage limit is raised, servicers are required to increase coverage of properties for which coverage had been limited by the prior maximum level.

### **10.1.3 Monitoring and Compliance**

Fannie Mae has never experienced a loss due to uninsured flood damage. It has three institutional structures in place to ensure that the loans it purchases are in compliance with its flood insurance requirements. First, it conducts operational and underwriting reviews to assess the overall underwriting quality of the loans delivered by its lenders. These reviews may identify loans that are required to have flood insurance but do not. Second, Fannie Mae reviews a sample of foreclosed loans and loans that have suffered early payment default. Again, this review process may detect a lack of compliance among lenders. Third, it completes an annual portfolio review to evaluate compliance with the insurance requirement among servicers. This review requires the servicer to select a sample of loans from its portfolio and send this sample to four flood determination companies. The properties that are determined to be in a SFHA by all four companies are referred to the respective servicers to validate that there is appropriate flood insurance coverage.

These monitoring efforts may duplicate what federal regulators do because they also monitor regulated lenders' compliance with the mandatory purchase requirement. It is important to remember, however, that the GSEs also purchase loans from nonregulated lenders that the federal regulatory agencies do not monitor. For these reasons, the GSEs depend on their own procedures to monitor compliance of the lenders with whom they work.

Fannie Mae finds high compliance with the mandatory purchase requirement among its seller/servicers. It infrequently encounters a loan that does not have flood insurance when it is supposed to, and it does not often detect a pattern of noncompliance or any systemic issues related to noncompliance with the requirement. In contrast, Fannie Mae does find many loans that are underinsured according to its standards. Representatives of Fannie Mae believe that this occurs because some lenders are reluctant to force place insurance on underinsured loans due to concern that doing so would jeopardize their relations with their customers.

Fannie Mae's staff identified several potential improvements to the NFIP. They suggested that the insurance limit is too low: it should change over time, as does the conventional loan limit. The MPPP should reflect the prevalence of underinsurance, and lenders

should be able to force place a second NFIP policy on a property that is underinsured. Finally, map modernization needs to be completed in order for flood determinations to be accurate and effective tools.

Freddie Mac has two primary processes in place to monitor lenders' compliance with the mandatory purchase requirement: quality control and on-site auditing. Through the first process, Freddie Mac reviews a sample of defaulted and performing loans each month for compliance with the requirement.

Reviewers examine documentation in the loan files, some of which flood determination companies provide or validate. If the properties are in SFHAs, Freddie Mac determines whether flood insurance to the required coverage amount has been purchased and retained on the property.

During on-site audits, Freddie Mac examines a lender's portfolio. This examination can occur at any point in the relationship with the lender. Freddie Mac uses four flood zone determination companies to check a single lender's portfolio. The first vendor selects properties from the portfolio that may be in a SFHA and provides the list of properties to three other vendors. If any one vendor determines that a property is outside of the SFHA, the property is removed from the examination pool. Freddie Mac then checks the group of properties that all four vendors agree are located in SFHAs for flood insurance. This process minimizes disagreements with lenders when the lender's private appraiser places a property outside of the SFHA. The on-site audit also includes a review of a lender's processes for ensuring placement of flood insurance when necessary.

When Freddie Mac's auditors discover that required insurance is lacking on loans it purchased, it directs the affected lenders to repurchase the loans. In most cases, however, the problem is the lenders' failure to provide proof of insurance, and they typically address the problem. Freddie Mac has never suffered a financial loss because of a flood.

Staff members at Freddie Mac are concerned that some questions they ask FEMA about flood insurance requirements are not answered. Freddie Mac also identified several potential improvements that could be made to the NFIP. Freddie Mac would like the Congress to strengthen the NFIP requirements for mandatory purchase of flood insurance to resemble more closely the stringent requirements that Freddie Mac and Fannie Mae apply. Furthermore, Freddie Mac would like to see FEMA change policy language to include an inflation escalator clause in flood insurance (there is such a clause in other types of insurance). Freddie Mac requires policies to be adjusted upward as warranted by increases in the insured dwellings' replacement costs, to avoid the penalty imposed by the NFIP for a dwelling, which, at the time of a loss, is insured for less than 80 percent of its replacement cost.

## **10.2 Farmer Mac**

The Federal Agricultural Mortgage Corporation (Farmer Mac) is another GSE and purchases mortgage loans on the secondary market from agricultural lenders so that these lenders

can continue to extend credit. Loans purchased by Farmer Mac are *not* explicitly subject to the mandatory purchase requirement.

Farmer Mac is nonetheless involved with the requirement in two ways. First, Farmer Mac purchases part-time farming loans and rural residence home loans, which can include a residence on a farm or in a rural area (Farmer Mac 2003). These loans are purchased “on Fannie Mae and Freddie Mac paper” as a means to provide the information they need to comply with their underwriting requirements.

Second, Farmer Mac also purchases full-time farming loans from regulated lenders. As with other loans from regulated lenders, borrowers are subject to the mandatory purchase requirement when all or part of the structure that secures their loan is within a SFHA. Farmer Mac’s purchase of the loan would not affect this requirement. In contrast, Farmer Mac does not require flood insurance on loans purchased from nonregulated lenders regardless of a property’s location.



## 11. FEDERAL AGENCY LENDERS AND GRANTEES

### 11.1 Department of Housing and Urban Development

The Department of Housing and Urban Development (HUD) triggers the mandatory purchase requirement when it provides financial assistance for the acquisition, construction, reconstruction, repair, or improvement of properties in SFHAs. HUD provides financial assistance through loan and grant programs. Loan programs that trigger the requirement include but are not limited to mortgage insurance origination for single and multifamily homes and loan guarantees for Native American housing. Grant programs that trigger the requirement include community development block grants to entitlement communities and block grants for housing for Native Americans.<sup>80</sup>

#### 11.1.1 Flood Insurance Requirements

The department's environmental regulations as well as its regulations governing individual grant and loan programs cite the mandatory purchase requirement. As a result of these regulations, HUD and the institutional recipients of its grants or loans are prohibited from providing any financial assistance for structures located in SFHAs within communities that do not participate in the NFIP. Furthermore, except in emergencies, HUD cannot provide grants or loans for activities in floodplains unless the agency can demonstrate that no practicable alternatives exist outside the floodplain (U.S. Department of Housing and Urban Development 2002a). If flood-free sites are available within a community or housing market area, they are considered practicable.

For loans, loan insurance, or loan guarantees, HUD requires flood insurance coverage to the amount of the outstanding principal balance of the loan, even when the loan covers the value of the land. This policy is consistent with the law's requirements but inconsistent with FEMA's interpretation of the law. The coverage must be maintained for the term of the loan.

Flood insurance is not required on loans with an original principal balance of \$5,000 or less that have a repayment term of one year or less, but grants of any amount trigger the mandatory purchase requirement. Flood insurance is required for grants in an amount at least equal to the project cost (minus the estimated value of the land) or to the maximum limit of coverage available with respect to the particular type of building, whichever is less.<sup>81</sup> The lack of a threshold for grants is problematic and can lead to cases in which the cost of flood insurance for the project is more than the value of the grant. Coverage must be maintained for the life of the structure regardless of any transfers of ownership (U.S. Department of Housing and Urban Development 2002b).

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<sup>80</sup> The U.S. Department of Housing and Urban Development (2003) provides a complete list of programs subject to the mandatory purchase requirement.

<sup>81</sup> HUD defines development or project cost as "the total cost for acquiring, constructing, reconstructing, repairing, or improving the building." This cost must include federal and matching funds, plus the costs associated with any machinery, equipment, fixtures, or furnishing.

By law, flood insurance is not required on formula grants (i.e., community development block grants, emergency shelter grants, and HOME investment partnership grants) made to the states. Flood insurance is also not required for any state-owned property that is covered under an adequate state policy of self-insurance. Local governments and other organizations are not authorized to be self-insurers for flood insurance. If a state agency has authority under state regulations, it may require a property owner to purchase and maintain flood insurance to protect the federal investment benefiting HUD-assisted properties in SFHAs.

In HUD’s opinion, financial assistance for “routine maintenance” on buildings in SFHAs does not trigger the mandatory purchase requirement, notwithstanding the obligation to impose the requirement in the event of repair, reconstruction, or improvement of properties. Routine maintenance is defined as an activity that does not add to a structure’s value, prolong its life, or add new uses to the structure (U.S. Department of Housing and Urban Development 2002b). Examples of routine maintenance include painting of interior or exterior walls, fixing gutters or floors, and replacing broken window panes or door locks.

The mandatory purchase requirement does not differentiate between “routine maintenance” and other forms of “reconstruction,” “repair,” or “improvement.” Nonetheless, HUD guidance advises that “routine maintenance” activities should be carefully distinguished from “repair” or “improvement” of any building in a SFHA to which the mandatory purchase requirement applies.<sup>82</sup>

### 11.1.2 Grants

Recipients of HUD’s formula grants include states, cities, urban counties, Native American tribes, Alaska Native Villages, and the Department of Hawaiian Home Lands. Recipients of competitive grants include housing authorities and nonprofit organizations.

Grant recipients must submit an environmental certification of compliance and a request for the release of funds to obtain approval from HUD (or from the state agency administering the HUD program) prior to committing or expending HUD or non-HUD funds to the project. A “responsible entity” (i.e., a local, tribal, or state government that assumes administrative responsibility for meeting HUD’s environmental responsibilities) must complete all environmental and flood insurance determinations. A responsible entity that oversees a project is required to make a flood determination as part of the environmental review it conducts. If the structure is determined to be in a SFHA, then the responsible entity is also responsible for determining the amount of flood insurance that a property owner must purchase and maintain as a condition for approval of HUD assistance and for monitoring retention of the insurance.

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<sup>82</sup> In the department’s opinion, the effect of the deductible amounts available through NFIP policies is to exclude coverage for HUD-assisted routine maintenance since the coverage would apply only to the HUD financial assistance, which generally would be in an amount less than the exclusion provided by the SFIP deductible. In addition, HUD-assisted routine maintenance is categorically excluded from compliance with the department’s environmental regulations (as well as its floodplain regulations) on the assumption that such maintenance lacks potential environmental impacts.

If the grant recipient is other than a responsible entity, a copy of the proof of purchase of flood insurance must be submitted to this entity, which must retain a copy in its environmental review record. When HUD visits the grant recipient to monitor compliance with its environmental requirements, the agency also monitors for compliance with flood insurance requirements.

The responsible entity documents its findings, including certification of compliance with the flood insurance requirements, in an Environmental Review Record (ERR), which it then makes available for public comment. After doing so, the responsible entity must submit its request for release of funds to HUD. Because the responsible entity has certified its compliance with federal laws (including requirements for the purchase of flood insurance) in the publicly available ERR, HUD does not require submission of the ERR, the flood determination, or proof of insurance as a condition of release of funds.

Responsible entities must track the retention of insurance through all transfers of ownership of the structures. Responsible entities are supposed to receive notice of insurance renewal from insurance companies. HUD field officers monitor the responsible entities through on-site audits. During these on-site audits, HUD staff review a sample of ERRs created by the responsible entities. According to HUD staff, field officers determine whether the responsible entity “has established and is effectively maintaining a proof-of-purchase system to monitor whether property owners with HUD-assisted buildings in SFHAs are annually reviewing their flood insurance policies” as part of “in-depth monitoring.” HUD’s policies stipulate that its regional offices should monitor grantees by examining a sample of projects every five years, although constraints on time and resources occasionally prevent this frequency.

For HUD’s grant programs in which the department conducts environmental reviews, the department enforces the mandatory purchase requirement as a condition of approval of HUD assistance for buildings in SFHAs. Flood insurance is required for all proposed assistance for property acquisition, disposition, construction, rehabilitation, repair, and improvement.

Many recipients of HUD’s assistance are low-income people who may have difficulty affording flood insurance. Nonetheless, the requirement to purchase flood insurance cannot be waived due to hardship. In some cases, a portion of grant funds can be used to subsidize the purchase and maintenance of flood insurance for low-income owners of properties in SFHAs (U.S. Department of Housing and Urban Development 2002b).

### **11.1.3 Loans**

Private lenders issue the loans initiated through HUD’s loan programs. HUD currently works with about 1,800 lenders, of which 700 to 800 are federally regulated.

Lenders notify loan applicants if they qualify for HUD financing. If the borrower chooses to use HUD financing, the lender contacts HUD, which supplies an appraiser to review the property securing the loan. The appraiser conducts a flood determination as part of every appraisal. These flood determinations are done with paper FIRMs in the appraiser’s portfolio. Some lenders acquire additional flood determinations from flood determination companies.

Appraisers often flag properties suspected of being in SFHAs and the lender may then buy flood determinations for these properties from a flood determination company. HUD requires that a borrower show proof of flood insurance as a condition of loan approval if the appraiser determines that the structure is in a SFHA. HUD's decision as to whether flood insurance is required depends solely on the appraiser's determination.

HUD contracts with a third party to conduct field reviews of appraisals for properties on which HUD provides loan insurance or guarantees. These examinations serve to audit both the appraisers and the lenders. The examiners select a sample of appraisals and use maps and automated flood-mapping systems to verify the accuracy of the flood determinations done by HUD-approved appraisers. Examiners can sample appraisals randomly or they can select a sample based on a trigger (e.g., they might select a sample of appraisals for properties on which loans were defaulted). If an examiner finds errors in an appraiser's portfolio, HUD can remove that appraiser from its list of approved appraisers. As a part of the review process, the examiners also determine whether flood insurance was purchased for the properties they determine to be in SFHAs.

Lenders are responsible for monitoring the retention of flood insurance over the life of the loan. If a borrower defaults on a loan and HUD finds that the borrower did not retain flood insurance, HUD can choose not to pay its guarantee and require the lender to indemnify the loan. In practice, however, representatives from HUD indicated that they are typically unaware as to whether flood insurance is retained unless a default occurs as a result of a flood.

## **11.2 Department of Veterans Affairs**

The Department of Veterans Affairs (VA) provides direct loans to veterans and acts as a guarantor of home loans for veterans issued by private lenders. The mandatory purchase requirement applies to all VA-related loans, including instances in which the department: a) acts as the guarantor of private-issued loans; b) purchases guaranteed loans from the original lender (in instances in which a veteran is unable to repay a loan); c) sells acquired properties to the public using vendee financing; d) issues direct home loans for Native Americans living on trust lands; or, e) issues direct loans to veterans with service-connected disabilities.

Any veteran who completes service requirements established by the department is eligible to apply for a guaranteed loan for the purchase or improvement of a home or for the refinancing of an existing mortgage. In fiscal year 2003, the VA guaranteed 508,000 loans valued at \$65 billion. Through January 2004, the VA had guaranteed about 17.4 million home loans since the program's inception in 1944. The VA began fiscal year 2004 with 2.7 million active home loans reflecting amortized loans totaling \$213.2 billion. The VA also provides grants to veterans with service-connected disabilities to finance the purchase, construction, or renovation of specially adapted housing. In fiscal year 2003 the VA issued 550 such grants at an average of \$40,000 per grant compared with 575 grants of the same average value the previous year.

### 11.2.1 Flood Insurance Requirements

When guaranteeing loans or making grants, the VA is subject to the same flood-related requirements imposed on other federal agencies, such as HUD, that provide financial assistance for acquisition or construction in SFHAs. As a consequence, VA cannot guarantee loans for the purchase of homes in SFHAs in communities that do not participate in the NFIP.<sup>83</sup> Likewise, the VA must also ensure that it does not provide any financial assistance, including loans, grants, insurance, or guarantees, for acquisition or construction purposes for properties in SFHAs in participating communities unless the recipient retains flood insurance for the life of the loan. As well, the VA cannot make, increase, renew, or extend a loan on improved real estate or a manufactured home in a SFHA in a participating community unless the borrower retains flood insurance for the life of the loan.

Despite the identical flood-related requirements imposed on all federal agency lenders, the VA's interpretation and application of these requirements vary from those of other federal agencies. For example, the VA does not allow the appraisal of properties (and thus VA-backed loans) in areas that are subject to "regular" flooding for whatever reason, including those not in SFHAs (U.S. Department of Veterans Affairs 2001). It is not clear what regular flooding is or how an appraiser would know whether a property is subject to regular flooding (as opposed to irregular flooding).

The VA also prohibits appraisals of proposed or new construction in a SFHA when the elevation of the lowest floor is below the base flood elevation. This is a stringent requirement because buildings with floors below the base flood elevation are eligible for federal flood insurance. For purposes of determining premiums, a lowest floor can be up to 6 inches below the base flood elevation and be rated as if it is at this elevation. Similarly, the NFIP permits construction of garages below the base flood elevation when they are properly vented. Likewise, the NFIP permits enclosed spaces below the lowest inhabited floor, without penalty, when those spaces are used solely for building access, parking, or storage. The VA seemingly does not make these distinctions.

The VA requires that changes in flood maps be monitored and that its borrowers purchase flood insurance when their properties are remapped into SFHAs after their loans have been issued (U.S. Department of Veterans Affairs 1996). The VA is expected to "exert all reasonable effort and care to ensure that, when appropriate, Certificates of Reasonable Value contain the requirement to obtain flood insurance" (U.S. Department of Veterans Affairs 1990). Despite this requirement, it is the lender's responsibility to ensure compliance with the mandatory purchase requirement, and the VA will not guarantee a loan if the lender is unable to provide proof of flood insurance at loan origination. Likewise, the VA can suspend a lender from participating in the VA-guaranteed loan program if it has been determined that the lender does not meet its flood-related responsibilities. The VA rarely exercises this prerogative.

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<sup>83</sup> The VA indicated that "given the special relationship between the United States and Native American tribes, which are sovereign entities within the United States," that it might make a direct loan to a Native American in a nonparticipating community.

The VA requires that flood insurance be purchased for all personal property securing VA loans. The security might include, in addition to the home, an additional structure owned by the borrower or contents such as appliances or carpets. The VA may therefore require that the borrower purchase contents insurance in addition to building coverage.

The VA does not require flood determinations when loans are renewed, deferred, or refinanced. The VA estimates that 60 percent of all of its loan activity involves one of these actions.

### **11.2.2 Loan Guarantees**

A veteran applying for a VA-guaranteed loan first chooses a private lender to serve as the primary issuer of the home loan. This lender can be a bank, savings and loan institution, mortgage company, or other type of lender; it can be either regulated or nonregulated. The veteran informs the lender that he or she is eligible for a VA-guaranteed loan and the lender then contacts the VA and orders an appraisal of the property by a VA-approved appraiser. The appraiser must provide a flood determination as part of the standard appraisal process.

Although lenders will receive copies of the appraiser's flood determination, lenders will typically obtain their own flood determination because third parties are obligated to assume liability for the accuracy of the determinations and offer life-of-loan service. VA appraisers offer neither. The lender is responsible for ensuring that flood insurance is maintained on any structure in a SFHA that secures a VA-guaranteed loan. This is true even when the VA appraiser incorrectly indicates that a structure is not in a SFHA (U.S. Department of Veterans Affairs 2001).

When the VA guarantees a loan, the lender is responsible for monitoring that insurance, if required, is maintained for the life of the loan. The lender is likewise required to monitor remapping and require insurance purchase for existing loans remapped into a SFHA. The VA has a monitoring unit in Nashville that does site reviews of lenders. The unit targets lenders making the most loans or lenders that the VA has identified as meriting attention. Monitors review files and can recommend that a loan be termed "egregious" (i.e., that it should have never been approved). The VA gives the lender the opportunity to take corrective action on the loan, but maintains that if an egregious loan goes bad within five years the lender should not contact the VA to provide its guaranteed funds. If the VA had already given money to the lender, the VA can request that money be returned. Problems with mandatory purchase requirement are seldom discovered.

When a veteran is unable to maintain a VA-guaranteed loan, the VA can repurchase the loan back from the original lender. The VA then takes responsibility for ensuring that flood insurance, if required, is retained for the life of the loan. If the lender had an escrow account that includes funds for flood insurance, the VA continues that account. In most instances, loans on acquired structures are less than five years old, so a new flood determination is not required. The VA is considering changing its policy and may require a flood determination whenever the department acquires a loan. This consideration stems from a desire to ensure that all determinations on VA-acquired properties include life-of-loan service.

### 11.2.3 Direct Loans

When the borrower of a VA-guaranteed home loan defaults on the loan, the VA acquires the structure and sells it to the public. Between 50 and 90 percent of all such home sales are financed using vendee (seller) financing. Vendee financing involves a direct loan from the VA to the buyer, and such loans are subject to the mandatory purchase requirement. The VA issues approximately 15,000 to 25,000 vendee loans each year.

The VA also provides direct home loans to Native American veterans living on trust lands and direct loans to supplement grants to veterans that finance the purchase, construction, or improvement of homes adapted to accommodate service-connected disabilities. Both of these direct loan programs are relatively small in scope. The VA has issued about 260 direct loans to Native American veterans living on trust lands since the program's inception in 1992 (about 60 percent of those loans were extended to native Hawaiians). The VA issues about one direct loan per year for specially adapted housing. The maximum value for a VA-direct loan is the lesser of the cost of the home or \$80,000. Homes eligible for direct home loans to Native American veterans living on tribal lands must be located in a tribal organization or other Native American group that has signed a memorandum of understanding with the VA. The memorandum of understanding defines the conditions for participation in the direct loan program.

When a veteran applies for a direct loan from the VA, the VA requires an appraisal including a flood determination conducted using FEMA's SFHD form. The VA requires proof of flood insurance be submitted by the borrower as a condition of loan approval if the structure is in a SFHA. Appraisers are directed to consult FEMA's *Community Status Book* to determine whether a community is participating in the NFIP.

The VA often sells vendee loans on the secondary market. The VA does not sell direct loans made to Native Americans living on trust lands or direct loans to veterans with service-connected disabilities on the secondary market. These loans remain in the VA portfolio and are maintained by a private servicer, which is responsible for monitoring the retention of flood insurance. This servicer can force place insurance if the property owners do not maintain insurance on their own. The VA does not require reports on the number of policies forced-placed by the servicer or the source of force-place coverage and, therefore, does not know how frequently forced placement occurs. The VA currently holds a portfolio of about 25,000 loans, but is not able to determine what percentage of these loans are in SFHAs.

## 11.3 Government National Mortgage Association

Ginnie Mae, part of the Department of Housing and Urban Development, is a GSE that guarantees the payment of principal and interest on mortgage-backed securities associated with federally insured or guaranteed loans, such as those insured by the VA, the FHA, the RFS, and HUD's Office of Public and Indian Housing. Ginnie Mae has guaranteed more than \$2 trillion in mortgage-backed securities. In 2003, Ginnie Mae issued more than \$215 billion in mortgage-backed securities and securitized almost 93 percent of the FHA-insured and VA-guaranteed loans that were issued (Ginnie Mae 2003).

The loans Ginnie Mae guarantees are already subject to the mandatory purchase requirement. These loans come from regulated as well as nonregulated lenders, all of which Ginnie Mae must approve as sellers (Ginnie Mae 2002). Ginnie Mae does not regulate lenders for purposes of flood insurance.

After flood disaster declarations, Ginnie Mae often issues a notice of buyout and forbearance. It encourages lenders to provide forbearance to their borrowers whose property has been damaged by flooding (e.g., Ginnie Mae 2004). Ginnie Mae offers financial assistance to lenders who can provide flexibility to their borrowers after flood disasters.

## 11.4 Rural Development, Rural Housing Service

The Rural Housing Service (RHS), part of the Department of Agriculture, provides grants, loans, and loan guarantees to individuals in towns and counties with fewer than 10,000 people. These funds are provided to purchase, construct, repair, and rehabilitate housing. The RHS also provides grants, loans, and loan guarantees to communities with fewer than 20,000 people. These funds are provided so that a community can construct, enlarge, or improve community facilities for health care, public safety, and public services (RHS 2003). These funds constitute federal financial assistance for construction and acquisition, so they are subject to the mandatory purchase requirement. At the end of fiscal year 2002, the RHS had a portfolio of nearly 665,000 loans, with a value of about \$41 billion.

### 11.4.1 Flood Insurance Requirements

RHS grants, loans, and loan guarantees fall under several programs that each have different flood-insurance requirements and servicing practices.<sup>84</sup> The RHS provides *direct loans for single-family housing* and *loan guarantees* at below-market interest rates to low-income borrowers. The RHS administers the program, but a private contractor services the loans.

Flood insurance must cover the lesser of the value of the loan amount or the structure's replacement cost, except the estimated land cost, or the maximum limit of NFIP coverage. If the federal financial assistance on a property is in the form of a loan, the amount of insurance required is the amount of the loan outstanding for the life of the loan. A flood determination contractor completes flood determinations as well as life-of-loan determinations.

For direct loans for single-family housing and loan guarantees, the RHS requires flood insurance if the structure is located in a SFHA, regardless of the loan amount (RHS 2003). Flood insurance must cover the lesser of the value of the loan amount or the structure's replacement cost, except the estimated land cost, or the maximum limit of NFIP coverage. If the federal financial assistance on a property is in the form of a loan, the amount of insurance required is the amount of the loan outstanding for the life of the loan. The RHS will accept insurance provided

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<sup>84</sup> As of February 2005, the RHS was revising its directives governing the requirements for flood insurance. A spokesperson for the RHS indicated that some of the agency's requirements in effect in early 2005 would be amended. Nonetheless, the present summary reflects the Department of Agriculture's policies and procedures applicable as of February 2005.



only through the NFIP; private insurance is not acceptable (RHS 2003a, 2005), although this prohibition will likely be eliminated when the RHS revises its requirements for flood insurance.<sup>85</sup>

The RHS program for direct loans and loan guarantees has at least two other distinctive insurance-related provisions. First, the RHS prohibits loan guarantees in SFHAs unless there is no practical alternative (RHS 1995). In contrast, such guarantees are permitted when the “potential environmental impacts and feasible alternatives have been fully considered.”

Second, the U.S. Department of Agriculture (1974) and the RHS (1995) prohibit the use of its financial assistance to purchase or substantially improve an existing dwelling (or a multi-unit housing facility) unless the lowest inhabited space is *above* the base flood elevation. This restriction applies to pre-FIRM buildings, most of which were constructed before base flood elevations were known. In September 2003, the RHS granted a one-year waiver for guaranteed loans only that permitted the purchase of existing (but not new) single-family dwellings when their lowest inhabited space is *below* the BFE, but only in Oregon. As the RHS (2003b) explained, “Removal of the first floor elevation requirement will allow RHS to better serve rural residents who need to purchase homes or improve their existing homes.” As a consequence, however, the RHS inadvertently permits the purchase of existing, post-FIRM homes in Oregon built in violation of the NFIP’s building requirements for construction in SFHAs.<sup>86</sup> These requirements mandate that such post-FIRM construction be at or above the base flood elevation. The RHS continued this waiver for fiscal years 2005 and 2006 (U.S. Department of Agriculture, Rural Development 2004), but anticipates that this provision will be altered when the Department of Agriculture amends its flood-related instructions.

The RHS has contracted with a private vendor to obtain flood hazard determinations. The vendor also provides life-of-loan coverage.

The RHS servicing vendor requires flood insurance as necessary, establishes escrow accounts as appropriate (and escrow for flood insurance if an escrow account is created), monitors the retention of flood insurance, and force places flood insurance if the borrower fails to retain it. As noted above, the RHS does not permit the use of private flood insurance, which means that only the MPPP can be used to force place coverage. In turn, however, because the MPPP is not available for use when property owners are underinsured and already covered by a Standard Flood Insurance Policy, the RHS portfolio may include underinsured borrowers.

The loan guarantee program for single-family housing allows middle-income borrowers to apply for loans from commercial lenders at market rates. These lenders administer and service

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<sup>85</sup> For example, the RHS *Multifamily Housing Origination Handbook* (RHS 2005) notes that “Property in a SFHA is not eligible for Federal financial assistance unless flood insurance is purchased through the NFIP.”

<sup>86</sup> A representative of the RHS in Oregon noted her understanding that all post-FIRM construction in the state is at or above the base flood elevation due to compliance with local floodplain ordinances. The NFIP requires participating communities to obtain the elevation of the lowest floor of all new and substantially improved buildings and to retain a record of this information. Despite this requirement, a national study of elevation-related compliance conducted as part of the evaluation of the NFIP found post-FIRM structures without elevation certificates or with elevations impermissibly below the BFE.

the loans. The RHS periodically reviews the lenders with which it does business to ensure that they are complying with RHS policies, including the mandatory purchase requirement.

Direct loans and loan guarantees for *multifamily housing* are available for entities to create housing for low- and moderate-income renters in rural areas. For loans and loan guarantees, flood insurance is required if the property is located in a SFHA, regardless of the loan amount (RHS 2003a). The amount and duration of the insurance required is the same as for single-family housing noted above.

Commercial lenders administer and service *multifamily loan guarantees*. These lenders are responsible for the flood determinations and for establishing and maintaining escrow accounts as necessary. The RHS periodically reviews the lenders with which it does business to ensure that they comply with RHS policies, including the mandatory purchase requirement.

Finally, the RHS administers repair and rehabilitation loans and grants. Grants are available to individuals 62 years old and older so that they can make their homes safer or more accessible. The lifetime limit on grants is \$7,500. The RHS requires flood insurance if a grant improves a property located in a SFHA in a participating community and the amount of the grant is greater than \$5,000, unless grant funds will be used to obtain the insurance (RHS 2003a). It is not clear whether the exemption for grants of low value is legally permissible. The National Flood Insurance Reform Act of 1994 exempts *loans* (but not grants) of less than \$5,000 from the mandatory purchase requirement and, as noted earlier, HUD requires its grantees to maintain flood insurance regardless of the amount of the grant.

Loans are also available to individuals under 62 so that they can make their housing safer, more modern, or more accessible. The maximum loan is about \$20,000. The RHS requires flood insurance if the property to which the loan will be applied is located in a SFHA in a participating community, regardless of the loan amount (RHS 2003b).

## **11.5 Rural Development, Rural Utilities Service**

The Rural Utilities Service (RUS), formerly the Rural Electrification Administration, is also part of the Department of Agriculture. The RUS provides insured and guaranteed loans to finance the construction and improvement of electric facilities in rural areas. The RUS requires borrowers to obtain and retain flood insurance, either privately or through the NFIP, for the full value of buildings in flood hazard areas to the extent available and required by the flood insurance legislation. In addition to coverage for buildings, the RUS also requires coverage for any machinery, equipment, fixtures, and furnishings contained in these buildings (U.S. Department of Agriculture 1999).

## **11.6 Rural Development, Rural Business and Cooperative Service**

The Rural Business and Cooperative Service (RBS) is also part of the Department of Agriculture. The RBS provides insured and guaranteed loans to finance the construction and improvement of businesses in rural areas. The RBS requires borrowers to obtain and retain flood insurance, either privately or through the NFIP, for the full value of buildings in flood hazard

areas to the extent available and required by the flood insurance legislation. Coverage for contents is also required.

## **11.7 Small Business Administration**

The SBA promotes the formation and growth of small businesses through direct loans and guarantees other loans to small businesses that are made and disbursed by private lenders. In addition, when disasters occur, the SBA offers low-interest, long-term loans to individuals, businesses, and nonprofit organizations to repair damages caused by disasters. The SBA can provide the disaster loans directly to the recipients or in participation with a financial institution. When financial institutions provide the loan, they close and service the loan, which, in turn, can be sold to other lenders. SBA's disaster-related assistance is not dependent on presidential declarations that a major disaster has occurred; the SBA is also authorized to declare that a physical disaster has occurred.

### **11.7.1 Flood Insurance Requirements**

For business loans, a loan recipient must obtain flood insurance prior to first disbursement of the loan when any building or manufactured home, machinery, equipment acquired, installed, improved, constructed, or renovated with proceeds of SBA financial assistance is located in a SFHA in a participating community. Similarly, flood insurance is required when any portion of the collateral for an SBA loan includes improved real estate in a SFHA. Coverage for contents is typically required when they are located on the ground floor.

Applicants for disaster-related loans, even those not related to flooding, are likewise required to show proof of flood insurance prior to obtaining a loan if any portion of their property is in a SFHA in a participating community.<sup>87</sup> Evidence of purchase requires a copy of an issued policy or other proof of the coverage obtained. If flooding caused damage to real or personal property, flood insurance is also required for applicants outside of SFHAs if the cause of the flooding would have been covered by federal flood insurance and the borrower owns the property. In these situations, flood insurance is still required even when the flood-damaged property is not used as collateral for the loan. Coverage is required on buildings (such as residences and businesses), their contents (personal property), and appurtenant structures. Disaster-related loans are not available to victims in SFHAs in communities that do not participate in the NFIP except if they must mandatorily or involuntarily relocate to an area outside of the SFHA.

Borrowers within SFHAs must maintain flood insurance for the full insurable value of the property (not to exceed the maximum insurance available through the NFIP) minus the value of the land on which the property is located for the life of the loan.<sup>88</sup> Private flood insurance is

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<sup>87</sup> The SBA permits an exception to this rule when the entire portion of the property located within the SFHA is uninsurable and all insurable property is located outside the SFHA. In such instances, the property is considered to be outside the SFHA (SBA 2004).

<sup>88</sup> Recipients of secured, disaster-related loans outside of SFHAs are required to retain the lesser of: a) the total of the disaster loan and all prior liens on the flood-damaged real or personal property; b) the maximum flood insurance

acceptable, but only if the community participates in the NFIP. If borrowers fail to maintain required levels of coverage, it must be force placed using the procedures described earlier. Furthermore, applicants for loans are ineligible for SBA disaster assistance in any form for any subsequent disaster if they were legally required to maintain flood insurance for the life of the loan as a result of a previous SBA disaster loan and failed to do so (SBA 2004). In addition, applicants are also ineligible for SBA assistance if they are required to have flood insurance because they have a mortgage from a regulated lender but do not have the insurance (except when an applicant can demonstrate that the lender did not provide the borrower with information on the mandatory purchase requirement or when the lender incorrectly informed the applicant that the damaged property was in a SFHA).

The SBA can also require additional flood insurance if it requires collateral other than or in addition to the damaged property. For example, if the value of a damaged property is insufficient to collateralize a loan adequately, then the business owners' personal property might be required as collateral. Flood insurance would be required on this collateral if it were located in a SFHA. Flood insurance can be required on such collateral when economic damage to the flood-damaged business has occurred even in the absence of physical damage. If a flooded business is leased, the lessee is required to purchase contents insurance whether or not the flooded property is located in a SFHA.

The process of determining whether a property is in a SFHA and whether an affected community participates in the NFIP depends on who issues the loan. If a financial institution issues an SBA-guaranteed loan, that institution's policies dictate the procedures used. When the SBA issues a loan, the agency conducts its own flood determinations using paper FIRMs. The SBA does not use the services of flood determination companies in the belief that using determination companies is more expensive than are internal determinations.

According to the SBA's *Standard Operating Procedures for Loan Processing* (SBA 1999a), these FIRMs and a list of communities participating in the NFIP are available at the SBA's field offices. After receiving an application for a disaster loan, for example, the SBA checks the list of participating communities and sends a loss verifier to the property to evaluate the damages and to determine whether the property is in a SFHA. That determination is recorded on a SFHD form. Reliance on paper FIRMs assumes that the maps are current and that loss verifiers can accurately locate all properties on the FIRMs. In addition, the SBA's procedures assume that every field office has access to all LOMA and LOMR in the area for which the field office has responsibility, which is unlikely, and that the field offices routinely monitor FEMA's *Compendium of Flood Map Changes* as well as changes in communities' status. Furthermore, the loss verifier has no way of knowing whether a property is in violation of state or local laws, regulations, or ordinances that are intended to discourage or otherwise restrict land development or occupancy in flood-prone areas (i.e., a 1316 property).

Reliance on paper FIRMs and the non-use of flood determination companies also means that the SBA may not be aware of changes in FIRMs that place properties in SFHAs (or remove them from SFHAs) after loans are issued. In other words, the SBA is seemingly unable to

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available on the flood-damaged real or personal property; or, c) the maximum insurable value of the real or personal property.

provide life-of-loans determinations, and its guidelines for loan servicing (SBA 1999b) do not address changes in FIRMs or in a community's status in the NFIP. Perhaps as a result of these concerns, the SBA is considering the outsourcing of its flood determinations.

### **11.7.2 Loan Servicing**

Although the SBA requires flood insurance for the life of the disaster loans it extends, it does not check whether borrowers retain flood insurance beyond loan origination for several reasons. First, until recently the SBA outsourced the servicing of two-thirds of its loan portfolio. Since this outsourcing contract ended, the SBA has been servicing all of its loans internally. External servicing costs two to three times as much as internal servicing. Nonetheless, the SBA is again considering outsourcing all loan servicing.

Second, the SBA sells some of its loans. Although there is not the same secondary market for disaster loans as there is for home loans, the SBA sells many of its loans to banks and private companies. Once a loan is sold, the responsibility for ensuring that the property owner maintains flood insurance is transferred to the loan's buyer. The SBA does not retain any records on loans after they are sold. However, there is a written condition in all sales agreements that the purchaser of the loans and any subsequent purchasers are responsible for requiring that loan recipients maintain insurance to the levels that the SBA originally required. The SBA does not monitor compliance with this requirement..

Third, the SBA does not actively track the flood insurance for the loans that it retains in its portfolio and services internally. The SBA learns that a property owner has not retained adequate insurance if it happens to receive notification of cancellation of the flood policy from the insurance agent, if the borrower contacts the SBA with a request to change the terms of the loan (in which case the SBA would revisit the loan file), or if the borrower's property is again damaged by a flood and the borrower applies for another SBA disaster loan. In the latter case, if the SBA learns that an applicant has failed to maintain the insurance required for the first loan, the borrower is ineligible for another disaster loan. Despite this restriction, the SBA cannot check the status of flood insurance on the first loan if it has been sold.

Although the SBA does not track flood insurance, the SBA has used forced placement on occasion. Officers analyze situations requiring flood insurance on a case-by-case basis and use force placement only if it is "financially sensible." When the SBA does force place flood insurance, it uses private rather than federal flood insurance.

The SBA does not require flood determinations beyond the initial determination so it does not track whether properties have been mapped into or out of SFHAs. The SBA is uncertain how remapping has affected the property owners to whom it has already extended loans. It would become aware of remapping only if a property owner notified the agency, which might happen when a property is removed from a SFHA.

The SBA's data systems are property-specific and aspire to track property histories regardless of changes in ownership. For example, if a repetitive loss property undergoes multiple changes in ownership, the SBA should remain aware of the property's flood history.

On certain occasions, a disaster-loan recipient may use an SBA loan to relocate out of a SFHA. When this occurs, the SBA requires that a “Notice of Disqualification” be put on the deed to the flooded property. The notice informs potential buyers that the property is not eligible for disaster assistance. The SBA would not approve a loan application for a property with such a notice on the deed. However, the SBA does not look at property deeds until after it has approved disaster loans, at which point it would be too late to renege on the loan approval.

### **11.7.3 Monitoring and Compliance**

The SBA anticipates that high levels of compliance exist with its flood insurance requirements at loan origination but that compliance declines over the life of loans due to borrowers’ failures to renew insurance policies.

## 12. FEMA'S ROLES AND RESPONSIBILITIES

FEMA does not have a central role in implementing the mandatory purchase requirement, but the agency does have opportunities to facilitate the processes associated with the requirement. The legislation governing flood insurance provides FEMA with at least the following responsibilities, all of which can support the requirement. First, the agency conducts or contracts for Flood Insurance Studies, which serve as the basis for the development of FIRMs and the delineation of Special Flood Hazard Areas. Second, the agency accepts and acts on applications from communities to participate in the NFIP. Third, FEMA provides flood insurance. Finally, the Flood Disaster Protection Act, as amended, provides FEMA with the authority to issue regulations “as may be necessary to carry out the purpose” of the legislation.

Although this authority has not changed since 1973, FEMA’s interpretation of this authority may have changed. In 1978, as an illustration, the Federal Insurance Administration (then still part of the Department of Housing and Urban Development) published guidelines in the *Federal Register* on the mandatory purchase requirement for federal agencies and private lenders subject to the requirement. These guidelines (FIA 1978b) described the properties eligible for flood insurance, discussed when the purchase of flood insurance is required, and indicated the amount of insurance available.

Most important, the guidelines interpreted the 1973 law’s intent with respect to the mandatory purchase requirement and discussed how lenders should implement the law. The guidelines indicated that the mandatory purchase requirement applied not only at loan origination but also to the purchase of loan portfolios in the secondary market. This position contrasted with that of the FDIC, the FRB, and the OCC, which contended that the requirement did not apply to mortgages sold in the secondary market. Similarly, the FIA declared that the “burden of determining the location of the real property to be financed is on the lender and cannot be discharged merely by obtaining a self-certification from the borrower.” In both instances, the FIA specified what regulated lending institutions were obligated to do to ensure their compliance with the mandatory purchase requirement.

In contrast to this perspective, the federal insurance administrator (cited in Office of Inspector General 2000) subsequently declared that the agency has “only *limited* authority or responsibility for the enforcement of the mandatory flood insurance purchase requirement” (emphasis added). More recently, FEMA (2002a) asserted that “FEMA administers the NFIP, [but] it has *no* responsibility or authority under either the 1973 act or 1994 act with respect to lender compliance with the Mandatory Flood Insurance Purchase Requirement – this responsibility falls on the Federal agency lender regulators and secondary-market purchasers though FEMA prepares guidance materials with respect to the NFIP and the Mandatory Flood Insurance Purchase Requirement” (emphasis added).

In the words of one FEMA official, “The question of what authority, if any, that FEMA should have regarding the enforcement of the mandatory purchase of flood insurance requirements, has been discussed and debated since the passage of the 1973 act. The outcome of those discussions has always been the same: FEMA is not a regulatory agency in this area. The intent of the Congress in both the 1973 act and the 1994 act seems clear on this matter: although

FEMA has the authority to administer the NFIP, other federal agencies have the authority to administer the NFIP's mandatory purchase requirement." Congress has often raised questions about the enforcement of the mandatory purchase requirement, and the agency has provided its views. Never, in FEMA's opinion, however, has the Congress provided FEMA the authority to *enforce* the requirement. Likewise, FEMA has no explicit legal authority to assess lenders' compliance or to impose any sanctions on lenders (or GSEs) that have violated the requirement.

Although there is no explicit statutory authority giving FEMA a role in the administration of the mandatory purchase requirement, other entities believe that FEMA can and should be more assertive in the implementation of the requirement. As an illustration, the National Performance Review (Office of the Vice President 1993) recommended that FEMA "should develop cost-effective proposals for enforcement of requirements for mandatory flood insurance in order to reduce the need for disaster assistance."

More recently, FEMA's Office of Inspector General (2000) noted that the law "does not place restrictions on the methods FEMA can use to enforce compliance" with the mandatory purchase requirement. The IG encouraged FEMA to pursue innovative ways to address what it labeled as the "compliance dilemma." "We continue to contend," noted the IG, "that FIA can, and should do more to assist other entities address the compliance issue." In the IG's opinion, such assistance need not have a regulatory or enforcement component.

The IG provided several examples of how FEMA could promote compliance without assuming a regulatory or enforcement role. For example, the IG (Office of Inspector General 2000) recommended that the agency determine the extent to which lending institutions use flood determination companies that provide life of loan with transferability services. The IG also suggested that FEMA could contribute to improved implementation of the mandatory purchase requirement by identifying structures that are remapped into SFHAs after loans are closed. In both cases, FEMA contested the IG's claims that FEMA has the necessary authority or budget and asserted that any changes in current roles would "require a clarification from Congress."<sup>89</sup>

The IG (Office of Inspector General 2000) further recommended that FEMA should examine the "feasibility of legislative changes that would address nonregulated lenders as well as uninsured homeowners who do not have mortgages." More than four years later, FEMA had not acted to implement this recommendation.

The IG also offered several recommendations that would assist federal regulatory agencies in their efforts to promote compliance with the purchase requirement. First, the IG suggested that FEMA should "develop a methodology for periodically identifying cancelled policies and corresponding lending institutions." Although FEMA once tried to develop and implement such a methodology, that effort was not successful and FEMA is not currently working to develop such a system.

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<sup>89</sup> Lack of explicit statutory authority has not prevented FEMA from initiating or imposing other requirements. In a *Federal Register* notice on disaster assistance, for example, FEMA (2002b) noted that it had published a rule on temporary family housing "in spite of the lack of explicit authority....Because no one has questioned this rule in the many years that it has been in place, we believe that there is implicit authority to retain a rule that calls for possible State management of the temporary direct housing authority...."



Second, the IG also proposed that FEMA re-institute a process it had used routinely and successfully in the late 1980s and early 1990s. At that time, FEMA collected information about mortgages and location in a SFHA from applicants seeking flood-related disaster assistance (GAO 1990). Matching this information with data on which property owners did or did not have flood insurance, FEMA was able to determine the level of compliance with the mandatory purchase requirement in flooded areas as well as the extent and causes of noncompliance. Indeed, the IG declared that postdisaster compliance studies “could be a significant step in identifying non-compliance,” a topic of continuing concern, as the present report demonstrates.

It is not clear why or when FEMA stopped collecting information on mortgages in SFHAs from applicants for disaster assistance. Regardless of when the process was terminated, the IG (Office of Inspector General 2000) urged FEMA to “determine the feasibility of adding several questions to the disaster assistance surveys so that information that would ascertain the level of compliance with the mandatory flood insurance purchase requirements could be obtained” in postdisaster situations. FEMA (2003) subsequently indicated to the IG that there had been “no negotiation to add questions to the survey,” and none are currently included. As the NFIP’s staff has explained, however, a request was made to add relevant questions, but FEMA’s Response and Recovery Directorate, which has responsibility for disaster assistance, opposed the request.

## 13. RECOMMENDATIONS

Consistent and effective implementation of the mandatory purchase requirement of the Flood Disaster Protection Act of 1973, as amended, is affected by the large number of agencies and institutions that are responsible for implementation as well as by the complexity of the requirement itself. Without a single agency that exercises an oversight or monitoring role to promote consistency and compliance, the key actors have understandably adopted different approaches to as well as different interpretations of the same legislative language. Different interpretations are not always undesirable, but they can be confusing. Few people describe the federal flood insurance program as easily understood, as the present study of a small part of the program suggests.

The recommendations that follow are intended to promote consistency and effective implementation of the mandatory purchase requirement. If the goal of the Congress is to reduce federal disaster assistance and to place some or all of the risk of living and working in floodplains on those who choose to do so, then there is much that can be done to achieve these goals through enhanced implementation of the requirement.

Many recommendations are feasible while others are less so. For example, some people have suggested that all property owners in SFHAs with mortgages, whether from regulated or nonregulated lenders, should be required to purchase flood insurance. Others argue that all property owners in these areas, including those without mortgages, should have that obligation imposed on them. These may be desirable objectives, but there presently exists no structure or institutional arrangement to monitor compliance among those not now subject to the mandatory purchase requirement or to sanction their noncompliance. The compliance system now in operation has the virtue of relying on agencies and institutions, although created for other purposes, that can monitor compliance and impose sanctions for noncompliance, both of which are prerequisites for successful implementation.

Among the recommendations that are feasible, improvements can begin with changes in the legislation that requires the purchase of flood insurance for certain property owners as well as with the agencies responsible for monitoring compliance.

### 13.1 Congress

#### 13.1.1 Essential Actions

Mandatory Purchase Recommendation #1 (MP1): Increase the maximum federal flood insurance available to the same amount as the maximum amount of a conforming loan that Freddie Mac or Fannie Mae can purchase (i.e., \$359,650 in 2005).

MP2: Permit annual automatic adjustments in the maximum coverage available through the NFIP to coincide with changes in the maximum dollar amount of conforming loans that Freddie Mac or Fannie Mae can purchase.

MP3: Require federal flood insurance policies to contain an escalator clause (similar to standard hazard policies) to ensure that the amount of coverage is automatically adjusted when the replacement cost of the insured structure increases.

MP4: Eliminate the differences between federally regulated lenders, Fannie Mae, and Freddie Mac in the minimum insurance requirements that now exist for loans subject to the mandatory purchase requirement. All loans subject to the requirement should have the same minimum requirements for flood insurance.

MP5: Require that the minimum amount of coverage in place for a designated loan be at least equal to the replacement value of a building or manufactured home or to the maximum limit of coverage made available through the NFIP with respect to the particular type of property, whichever is less, even when the principal balance of a loan is less than the replacement value.

MP6: Revise the requirements pertaining to lenders' notice of special flood hazard and availability of federal disaster relief. Regulated lenders should be required to notify their borrowers in SFHAs in participating communities that:

Coverage provided through the NFIP for contents is separate from coverage for damage to their homes or businesses;

NFIP policies do not fully protect borrowers against partial loss or damage to their homes or businesses if these policies cover less than 80 percent of the replacement cost; and,

They may be eligible for exemption from the mandatory purchase requirement if their property is above the base flood elevation.<sup>90</sup>

MP7: Prohibit, after a lender's notification that flood insurance is required, a property owner's receipt of federal disaster assistance related to floods if insurance coverage for floods is less than 75 percent of the minimum amounts of coverage required.<sup>91</sup>

MP8: Specify that a regulated lender's purchase of a loan requires the completion of a SFHD form.

MP9: Require that SFHD forms produced in conjunction with a regulated lender's making, increasing, extending, renewing, or purchasing of a loan *inside* of SFHAs in a participating community be given to borrowers as soon as practicable before such loans are made, increased, renewed, extended, or purchased. This change will reduce borrowers' costs, minimize or

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<sup>90</sup> The National Lenders Insurance Council believes that these recommended tasks should be the responsibility of WYOs or insurance agents, not lending institutions.

<sup>91</sup> Section 582 of the National Flood Insurance Reform Act of 1994 currently prohibits federal disaster assistance, including loans, in a flood disaster area for a person "for repair, replacement, or restoration for damage to any personal, residential, or commercial property if that person at any time has received flood disaster assistance that was conditional on the person first having obtained flood insurance...and subsequently having failed to obtain and maintain flood insurance as required under Federal law on such property."

eliminate the need for insurance agents to obtain separate determinations, and emphasize borrowers' location in areas of high risk for flooding.

### **13.1.2 Other High Priority Actions**

MP10: Require that SFHD forms produced in conjunction with a regulated lender's making, increasing, extending, renewing, or purchasing of a loan *outside* of SFHAs in a participating community be given to borrowers with information indicating that the purchase of flood insurance may be advisable because flooding is not limited to high-risk SFHAs and can occur almost anywhere. This notification can indicate the availability of FEMA's low-cost Preferred Risk Policies for homeowners in areas of low to moderate risk.

MP11: Exempt loans from federally regulated lenders with an original outstanding principal balance of \$10,000 or less and a repayment term of one year or less from the mandatory purchase requirement. The present limit of \$5,000 has not changed since 1994.

MP12: Require flood insurance for all improved real estate and manufactured homes in SFHAs (with the exception of loans with an original outstanding principal balance of \$10,000 or less and a repayment term of one year or less and for state-owned properties covered by self-insurance satisfactory to FEMA's director). However desirable this recommendation may be, it cannot be implemented successfully in the absence of system to monitor compliance. Such a system does not now exist.

MP13: Prohibit regulated lenders from making, increasing, renewing, extending, or purchasing loans for improved real estate or manufactured homes in SFHAs in communities that do not participate in the NFIP. This change could replicate a similar provision (i.e., Section 202(b)) in the 1973 Flood Disaster Protection Act.

MP14: Require regulated lenders to monitor loans in their portfolios for changes in FIRMs that increase or decrease the size of a SFHA or changes in the status of a community's participation in the NFIP.

MP15: Specify that such changes require a regulated lender's completion or revision of a SHFD form.

MP16: Mandate that regulated lenders have procedures in place to require a borrower's purchase of flood insurance (or the forced placement of flood insurance, if necessary) within 90 days of a change to a FIRM that places improved real estate or a manufactured home in a SFHA at any time after a loan from a regulated lender is made, increased, renewed, extended, or purchased.

MP17: Mandate that regulated lenders have procedures in place to require a borrower's purchase of flood insurance (or the forced placement of flood insurance, if necessary) within 45 days if a community's initial entry into the NFIP or its removal from suspension from the NFIP places improved real estate or a manufactured home in a SFHA at any time after a loan from a regulated lender is made, increased, renewed, extended, or purchased.

MP18: Require, for regulated lenders that use third-party vendors for flood determinations, life-of-loan service with transferability for all designated loans.

MP19: Prohibit regulated lenders that use flood determination companies from selling, purchasing, or securitizing loans that do not have life-of-loan flood determinations with transferability service.

MP20: Require condominium associations in SFHAs in participating communities to purchase flood insurance at least equal to the lesser of 100 percent of the insurable value of each insured building or the maximum coverage available through the NFIP.<sup>92</sup>

MP21: Require OFHEO's annual report to summarize its efforts and activities to ensure and monitor Freddie Mac's and Fannie Mae's compliance with the mandatory purchase requirement.<sup>93</sup>

### 13.1.3 Medium Priority

MP22: Amend sections 102(a) and (b) of the Flood Disaster Protection Act of 1973, as amended, to clarify that the value of land associated with a loan cannot be insured.

MP23: Strike the words "at the time of origination or" from section 102(a)(e)(1) of the Flood Disaster Protection Act of 1973, as amended. These words imply that forced placement of flood insurance is appropriate at the time of loan origination, a position contrary to the preferences and interpretation of FEMA and the federal entities for lending regulation.

MP24: Strike the words "other than general or special revenue sharing or formula grants made to states" from section 3(a)(3) of the Flood Disaster Protection Act of 1973, as amended. States should not be encouraged or permitted to use federal funds to finance or promote development, acquisition, or construction in SFHAs unless such development, acquisition, or construction is appropriately insured against the risks of flooding.

MP25: Eliminate the requirement in section 1364(b) of the Flood Disaster Protection Act of 1973, as amended, that the director of FEMA (or his designee) be informed of the identity of the loan servicer when a borrower with a designated loan increases, renews, or extends a loan with the original lender and there has been no change in the lender's loan servicer.

MP26: Include, in section 102(f)(2) of the Flood Disaster Protection Act of 1973, as amended, a regulated lender's pattern or practice of failure to complete a SFHD form as a violation that is subject to a civil money penalty

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<sup>92</sup> A similar requirement for cooperatives would not be effective because the maximum federal flood coverage for a multifamily cooperative is \$250,000, regardless of the replacement cost of the insured building.

<sup>93</sup> OFHEO's *Strategic Plan for FY 1998-2003* (OFHEO 1998) indicated the agency's commitment to include a flood insurance compliance review in its annual report in every even-numbered year, but the agency did not do so in 2000, 2002, or 2004.

MP27: Allow borrowers to use the SFHD form to confirm a building's location if a designated loan is refinanced, increased, renewed, or extended with the original or a subsequent regulated lender and no map changes have occurred within seven years of the initial determination.

MP28: Extend the escrow requirement, in section 102(d) of the Flood Disaster Protection Act of 1973, as amended, to all loans associated with improved real estate and manufactured homes in SFHAs in communities that participate in the NFIP. The requirement is now limited to residential improved real estate.<sup>94</sup>

MP29: Reinststitute the requirement, included in section 529 of the 1994 Reform Act, that federal entities for lending regulation complete reports every two years that summarize their efforts to ensure compliance with the mandatory purchase requirement. These reports should indicate the number of institutions examined, the number and types of violations identified, the number and amount of civil money penalties imposed, the number and type of violations associated with each civil money penalty, problems that regulated lenders encounter in implementing the mandatory purchase requirement, and suggestions for improving its implementation. A similar reporting requirement should be imposed on federal agency lenders. Although these agencies do not have the authority to impose civil money penalties, the agency reports should summarize their efforts to ensure compliance among recipients of federal grants and federally insured or guaranteed loans.

MP30: Require, for all regulated lenders deemed to have committed a pattern or practice of committing violations of section 102(f) of the Flood Disaster Protection Act of 1973, as amended, the chief executive officer to file annually a statement of full compliance with the mandatory purchase requirement with the appropriate entity for lending regulation until released from that obligation by that entity.

MP31: Require the Farm Credit Administration to ensure the consistency of its flood-related policies and procedures with the principles and standards that the FFIEC has developed for the federal examination of regulated financial institutions.

MP32: Consider whether the mandatory purchase requirement is appropriately sensitive to designated loans for agricultural buildings (but not for rural or farm residences). Alternatively, Congress (and FEMA) should consider lower premium rates for agricultural buildings, reduction in fees for multiple agricultural buildings, higher deductibles on federal flood insurance for such buildings, and less costly alternatives for Letters of Map Amendment.

MP33: Establish a limit below which flood insurance is not required for federal grants.

## **13.2 FEMA**

FEMA should explore opportunities to exercise a leadership role in promoting compliance and in assisting the federal entities for lending regulation to meet their obligations related to flood insurance. This role need not engage FEMA in a situation in which it regulates

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<sup>94</sup> The Farm Credit Administration believes that the use of escrow accounts with commercial property should be a business decision between a lender and a borrower and not legislatively mandated.

lenders or enforces compliance with the requirement. As the following recommendations suggest, however, there is much that FEMA can do.

### 13.2.1 Essential Actions

MP34: Simplify the explanation of federal flood insurance, which is often perceived to be difficult to understand and interpret, thus discouraging some property owners in SFHAs from purchasing and retaining coverage. The process of simplification should address the seeming inconsistency in FEMA’s explanation of how the NFIP works, depending on the report or document examined. The agency’s explanations about when insurance is required during construction provide an example.

MP35: Update and revise the *Mandatory Purchase of Flood Insurance Guidelines* (FEMA 1999) in collaboration with key stakeholders, including the federal entities for lending regulation, federally regulated lenders, insurance companies and brokers, flood zone determination vendors, and government-sponsored enterprises. FEMA should ensure that the *Guidelines* address a specific audience, such as the lending community, rather than a generic audience. The *Guidelines* should be simplified, should provide examples to illustrate requirements, and should be user-friendly. The *Guidelines* presently assume considerable familiarity with flood mapping and floodplain management. If the *Guidelines* are intended to address the needs of regulated lenders, then entire sections can be deleted (e.g., the discussion of community-initiated map revisions) while other sections should be added. As an illustration, the format should be amended to facilitate lenders’ explanation to borrowers why flood insurance is required (or recommended) due to a borrower’s relative exposure to flood risk.

MP36: Ensure the *Guidelines*’ accuracy and their consistency with the rules and procedures of federal lenders and the federal entities for lending regulation as well as with the agency’s *Flood Insurance Manual*. Revisions should address such topics as insurance during construction; escrow requirements for multifamily dwellings; loans in nonparticipating communities; coverage for condominiums; and the proper amount of civil money penalties that the federal regulatory agencies can impose. The use of plain English for the *Flood Insurance Manual* is highly desirable.

MP37: Revise the Standard Flood Hazard Determination form by:

Adding an explanation to the form of the various flood zones and the relative risk of flooding in each zone;

Eliminating the requirement for a lender’s identification number;

Changing Block 5, “Amount of Flood Insurance Required,” to “Minimum Amount of Flood Insurance Required”;

Indicating the availability of federal flood insurance in all zones and that flooding is not limited or restricted to SFHAs;

Indicating the possible eligibility for administrative grandfathering; and

Indicating that federal flood insurance is available for most buildings and manufactured homes in participating communities (rather than being available for *all* buildings and manufactured homes in participating communities).

MP38: Examine, as recommended by the agency's Office of Inspector General (IG 2000), the feasibility of legislative changes that would address nonregulated lenders and homeowners without flood insurance in SFHAs. This review should assess the feasibility of requiring flood insurance in states where there is a high incidence of flooding and flood insurance claims outside of SFHAs.

MP39: Eliminate Letters of Map Revision based on Fill (LOMR-F). Their sole purpose is to avoid the mandatory purchase requirement, and they are inconsistent with the purposes of the National Flood Insurance Act, which is intended to "guide the development of proposed future construction, where practicable, away from locations which are threatened by flood hazards."

MP40: Comply with Section 7 of the Coastal Barrier Improvement Act of 1990 (P.L. 101-591) by certifying annually to the Department of the Interior that the NFIP is in compliance with the act's provisions, which limits the sale of federal flood insurance in CBRS units and in Otherwise Protected Areas after their designation.

MP41: Ask flood determination companies, perhaps through the National Flood Determination Association, to provide either: a) copies of all SFHD forms that indicate a building or a manufactured home is in a unit of the Coastal Barrier Resources System (CBRS) or Otherwise Protected Area (OPA); or, b) a list of all such properties, including the street address, community name, and the date of the determination. FEMA should seek updated information from the flood determination companies at least annually. In turn, FEMA should compare the list of such properties with its record of policyholders.

MP42: Provide federally regulated lenders, federal regulatory agencies, and government-sponsored enterprises with real-time access to: a) a database of buildings and manufactured homes in CBRS and OPA that are legislatively grandfathered for purposes of federal flood insurance; and, b) a database of buildings and manufactured homes in CBRS and OPA that are ineligible for federal flood insurance because they were constructed after designation of the CBRS or OPA.

### **13.2.2 Other High Priority Actions**

MP43: Revise the Mortgage Portfolio Protection Program (MPPP), which was created as a means to force place insurance coverage on structures for which flood insurance is required. The program is not competitive with private insurance and is administratively difficult to use. Although the MPPP is not intended to be competitive, the reason for requiring flood insurance is to have property owners share some of the financial risk associated with flooding through insurance. The MPPP also does not accommodate situations in which a property owner has two or more loans from different regulated lenders or provide a solution to the problem of



underinsurance, which may be a more serious problem than the absence of required coverage. In particular, FEMA should:

Permit regulated lenders to use the MPPP to force place a second NFIP policy (with the total coverage not to exceed the maximum coverage permitted by law). The NFIP currently has no means to assist the efforts of regulated lenders to comply with the mandatory purchase requirement when borrowers have coverage in amounts less than the minimum required by law.<sup>95</sup>

Identify and minimize the disincentives to lenders' use of the MPPP.

Eliminate the 15-day gap in coverage that now exists when lenders force place coverage through the MPPP. FEMA may be able to do so administratively by extending to 45 days from 30 days the "grace" period after expiration of a Standard Flood Insurance Policy.

Clarify that policies force placed through the MPPP are not eligible for the premium discounts associated with a community's participation in the Community Rating System. This clarification should be included in the *Mandatory Purchase of Flood Insurance Guidelines* as well as the agency's *Flood Insurance Manual*.

MP44: Clarify whether a regulated lender can force place a Standard Flood Insurance Policy on a designated loan.

MP45: Collect information about mortgages and location in SFHAs from applicants seeking flood-related disaster assistance and add related questions to postdisaster assistance surveys.

MP46: Eliminate administrative grandfathering, beginning with severe repetitive-loss properties.<sup>96</sup> Terminate eligibility for administrative grandfathering upon any change in ownership of a building or manufactured home. Eliminate all other administrative grandfathering within three to five years (if not already terminated by a change in ownership).

MP47: Revise the application for federal flood insurance to indicate that, where applicable, premiums are based on administrative grandfathering.

MP48: Develop and implement a record-keeping system that provides access to information needed to verify that administrative grandfathering was used to calculate a policyholder's premiums for flood insurance. The absence of information on administrative grandfathering compromises FEMA's ability to determine the NFIP's actuarial soundness, the consequences of remapping, and the extent to which insurance claims are for properties inside or outside of SFHAs.

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<sup>95</sup> FEMA (2000) was asked to consider a change in its policies that would allow more than one NFIP policy on a building, thus facilitating a lender's forced placement of additional coverage when there is inadequate coverage. FEMA indicated that it would refer the request to its Lender Compliance Work Group for review and recommendation. It appears that the group did not issue a recommendation.

<sup>96</sup> The Flood Insurance Reform Act of 2004 defines severe repetitive loss properties as one- to four-family residences that have had four or more claims exceeding \$5,000 and cumulatively exceed the value of the property.

MP49: Consider how the *Compendium of Flood Map Changes* can better meet the needs of its intended users. For example, who are these users? What are their needs? How well are these needs addressed? What obligations, if any, does publication of the *Compendium* impose on regulated lenders (e.g., does it create the “awareness” required for these lenders to review loans affected by these changes to ascertain the need for flood insurance or change in existing coverage)?

MP50: Develop a procedure that permits federal agency lenders and insurance agents that sell federal flood insurance to be informed of properties duly declared to be “in violation of State or local laws, regulations, or ordinances which are intended to discourage or otherwise restrict land development or occupancy in flood-prone areas” and thus ineligible for federal flood insurance.

MP51: Provide points to communities in the Community Rating System that facilitate public access to and awareness of properties duly declared to be “in violation of State or local laws, regulations, or ordinances which are intended to discourage or otherwise restrict land development or occupancy in flood-prone areas” and thus ineligible for federal flood insurance. Points might be awarded for providing relevant information on a community’s website or for requiring deeds to indicate that a building is not eligible for federal flood insurance.

MP52: Provide the federal regulatory agencies with real-time access to data that would allow them to determine which buildings or manufactured homes are insured through the NFIP and which have had policies cancelled or not renewed.<sup>97</sup> To facilitate use of such data, FEMA must ensure and improve the accuracy of the addresses associated with each policy. Faulty addresses are a common problem in FEMA’s policy database.

MP53: Conduct a study to examine the implications and consequences of section 1364(b) of the Flood Disaster Protection Act of 1973, as amended. This section requires regulated lending institutions and federal agency lenders to notify the director (or his designee) of changes in loan servicers. FEMA has designated Write Your Own (WYO) companies to receive these notifications. FEMA should: a) identify quantitative indicators that can be used to measure progress and success; b) determine whether the process works as intended; c) in consultation with the WYO companies, identify ways in which the process can be improved; and, d) assess whether and how the delegation to the WYO companies effectively promotes the NFIP’s objectives.

### **13.2.3 Medium Priority**

MP54: Develop a flood insurance policy specifically addressed to the needs of owners of manufactured homes. These owners are not as well served as they might be with the present Standard Flood Insurance Policy.

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<sup>97</sup> FEMA authorized the release of “policy expiration information to...lending institutions and State and Federal agencies and financial instrumentalities which regulate the lending institutions,” in July 1988 but rescinded approval for lenders’ access to this information the following month. See FEMA 1988a, 1988b.

## 13.3 FEMA and the Federal Entities for Lending Regulation

### 13.3.1 High Priority

MP55: Develop a system that permits a comprehensive and ongoing assessment of the level of lenders' and borrowers' compliance with the mandatory purchase requirement. This system, which FEMA should initiate, fund, and administer, should identify levels of compliance at loan origination as well as when renewal of coverage is required. This system may require sharing of data among federal agencies. FEMA and the FFIEC should identify any legislative changes that may be necessary to permit the sharing of the data required to implement the system proposed.

## 13.4 The FFIEC

MP56: Revise and update the *Interagency Questions and Answers Regarding Flood Insurance* (FFIEC 1997). When these questions and answers were issued, the FFIEC indicated that it intended to update them on a regular basis. No updates have been issued. Within the revised questions and answers:

Clarify that lenders cannot initiate the notification process associated with forced placement until an existing Standard Flood Insurance Policy has expired.

Clarify when flood insurance is required for buildings under construction in SFHAs.

Specify what constitutes the proof of coverage that borrowers must provide before a lender makes, increases, extends, renews, or purchases a loan. The FFIEC may wish to replicate Freddie Mac's (2004b) requirements.

MP57: Conduct a study that identifies differences and similarities in the federal regulatory agencies' determination of what constitutes a pattern or practice of committing violations of section 102(f) of the Flood Disaster Protection Act of 1973, as amended. In addition, the study should assess the impact of civil money penalties as a deterrent and determine whether the consequences justify the agencies' administrative costs of the CMP process. If the present maximum penalty per violation does not serve as an effective deterrent, the study should recommend the dollar amounts per violation that would do so.

MP58: Establish minimum requirements for the guarantees associated with third parties' completion of SFHD forms.

## 13.5 Federal Entities for Lending Regulation

### 13.5.1 Essential Actions

MP59: Require regulated lenders to provide their borrowers with a completed SFHD form as soon as practicable before making, increasing, renewing, or extending a loan or at any other time a lender receives or completes a SFHD form that will affect borrowers' premiums or their obligation to obtain flood insurance.

MP60: Develop and implement during reviews of lenders' loan portfolios a common procedure for assessing the accuracy of lenders' flood determinations. The federal regulatory agencies may wish to consider procedures similar to those used by Freddie Mac or Fannie Mae.

MP61: Establish minimum requirements for life of loan with transferability services for flood determination companies. These requirements should address changes in flood zones; changes in community status; LOMA and LOMR; and the changes that require notification to regulated lenders. The requirements could usefully include a provision that limits the need for notification of lenders to changes that might affect borrowers' premiums for flood insurance. Conversely, the requirements should preclude the need for flood determination companies to notify lenders of minor or inconsequential changes that will have no effect on premiums or coverage.

### **13.5.2 Other High Priority Actions**

MP62: Adopt a common policy on requirements for the purchase of flood insurance for owners of condominium units and specify clearly the amount of coverage required. One goal of the requirements should be to facilitate lenders' and insurance agents' ability to explain and implement the mandatory purchase requirement.

MP63: Require that examination of lenders' loan portfolios for purposes of flood insurance review a sample of loans issued prior to the previous examination to monitor for renewal of flood insurance on existing loans.

MP64: Adopt a common definition of a "pattern or practice" of committing violations of section 102(f) of the Flood Disaster Protection Act of 1973, as amended. The goal should be a common understanding so that regulated lenders are subject to the same expectations about performance regardless of which agency oversees their compliance with the mandatory purchase requirement. The FDIC's (2001b) guidelines on the topic can serve as a model for this common definition.<sup>98</sup>

MP65: Inform regulated lenders and the agencies' examination staffs that federal flood insurance is not available for properties duly declared to be "in violation of State or local laws, regulations, or ordinances which are intended to discourage or otherwise restrict land development or occupancy in flood-prone areas."

MP66: Develop policies or procedures to address satisfactorily potential coverage problems when there are two or more loans on a building or manufactured home. Secondary lien holders should not find themselves in a position where they must force place coverage for the value of all loans on a building when they hold only a portion of the value of these loans.

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<sup>98</sup> The Farm Credit Administration notes that the FDIC's guidelines are similar to the guidance the FCA provides to its examiners, but the FCA wishes to retain the right to issue separate guidance due to the FCA's focus on agricultural structures. The National Lenders Insurance Council opposes a common definition of "pattern or practice" because of the varying portfolios and lending risks for different lenders. In the Council's opinion, in determining what constitutes such a pattern or practice, regulators should have the same discretion they now have in determining violations of safety and soundness.

### **13.5.3 Medium Priority**

MP67: Adopt a clear and common explanation of: a) when flood insurance is required and its effective date before or during construction; and, b) the amount of insurance required during construction (e.g., coverage should be equivalent to the anticipated value of the structure prior to construction, increasing amounts of coverage as construction progresses, etc).

### **13.6 Federal Agency Lenders**

MP68: Prior to providing any federal financial assistance, use flood determination companies to provide flood determinations with life-of-loan service with transferability. The life-of-loan service should include attention to changes in FIRMs, changes in a community's participation in the NFIP, and Letters of Map Amendment.

MP69: Develop and implement a system to track loans and grants so that it is possible to monitor compliance with the mandatory purchase requirement for the life of the loan or grant.

### **13.7 Department of Agriculture**

MP70: Complete the revision of the department's internal instruction guidelines for flood insurance as soon as possible. These guidelines, issued in 1974, are outdated.

### **13.8 Department of Veterans Affairs**

MP71: Clarify the meaning of "regular" flooding.

### **13.9 Farmer Mac**

MP72: Require flood insurance on loans its purchases from nonregulated lenders when property securing the loan is in a SFHA in a participating community.

## 14. APPENDICES

**Appendix 1: Percentage of Flood Determinations Indicating Location in a SFHA for Selected Flood Determination Companies by State, 1997-2003**

State	Firm A	Firm B	Firm C	Firm D	Firm E	Firm F	Firm G	Average Percentage in SFHA
Alabama	4.90	4.01	4.68	4.34	12.06	1.89	3.34	4.34
Alaska	1.87	2.15	2.67	5.54	2.62	3.81	3.11	2.89
Arizona	3.70	2.73	3.59	5.24	2.09	2.66	2.88	3.05
Arkansas	4.12	3.34	5.41	5.82	2.49	3.51	2.77	3.55
California	4.47	3.38	6.29	6.68	2.48	3.49	3.18	3.77
Colorado	2.01	1.41	1.65	3.35	0.79	1.33	0.95	1.48
Connecticut	3.82	3.49	4.28	4.43	2.85	2.94	3.60	3.58
Delaware	6.92	8.50	7.87	10.13	6.35	8.51	6.04	8.05
District of Columbia	0.42	0.10	0.23	0.46	0.37	0.08	0.05	0.17
Florida	34.25	27.81	28.31	29.80	24.74	25.71	35.32	29.17
Georgia	3.34	2.74	3.69	4.19	2.47	3.19	1.63	2.93
Hawaii	8.40	8.50	7.81	32.81	11.24	8.29	6.43	8.41
Idaho	3.17	2.91	2.91	4.66	2.06	2.70	2.65	2.83
Illinois	2.34	2.10	2.22	3.23	1.27	2.46	1.72	2.18
Indiana	3.78	2.56	2.34	3.11	1.97	3.06	2.70	2.69
Iowa	2.00	2.04	2.93	2.95	1.29	2.30	1.96	2.17
Kansas	2.91	1.91	2.77	2.52	1.04	2.10	1.83	2.17
Kentucky	3.49	2.54	3.81	4.10	1.98	2.80	2.33	2.84
Louisiana	32.60	32.67	25.65	26.50	24.08	23.61	29.65	29.43
Maine	2.09	2.86	2.87	2.37	1.35	1.28	1.41	2.56
Maryland	3.26	2.85	2.59	4.58	2.60	2.79	1.91	2.84
Massachusetts	2.68	2.34	8.99	2.83	1.95	2.12	2.32	3.04
Michigan	2.24	1.73	2.21	2.03	1.22	1.54	1.29	1.88
Minnesota	1.00	0.88	1.42	2.19	0.43	1.01	0.60	1.03
Mississippi	8.01	6.97	6.62	8.10	5.95	6.47	5.02	6.79
Missouri	2.44	1.59	1.87	3.03	0.84	1.75	1.40	1.75
Montana	2.77	2.39	6.93	2.51	0.80	2.56	1.79	2.89
Nebraska	5.31	4.58	4.95	4.13	3.67	3.51	3.41	4.64
Nevada	3.53	2.58	4.51	3.59	1.34	3.09	2.69	3.01
New Hampshire	2.28	2.02	2.84	2.26	1.12	1.27	1.40	2.04
New Jersey	8.18	7.85	11.68	17.66	6.76	9.50	7.76	8.31
New Mexico	5.24	5.59	11.25	9.60	3.99	4.30	4.64	5.89
New York	3.56	3.13	4.46	3.49	3.51	3.49	3.29	3.41
North Carolina	4.53	4.55	4.15	4.60	2.50	3.69	2.14	4.24
North Dakota	6.69	4.31	4.61	4.60	3.54	3.89	4.25	4.71
Ohio	1.96	1.67	2.09	2.75	1.23	1.90	1.66	1.86
Oklahoma	4.01	2.25	2.06	3.02	1.26	2.43	2.31	2.38
Oregon	4.19	3.19	3.85	3.85	1.91	2.85	2.13	3.29
Pennsylvania	2.10	1.65	2.02	2.46	0.85	1.74	1.09	1.78
Rhode Island	4.20	3.30	5.09	4.68	3.00	3.36	3.19	3.65
South Carolina	15.27	11.34	11.91	11.26	8.20	12.98	7.69	11.86
South Dakota	2.83	2.82	9.74	2.70	0.69	2.39	2.51	4.04
Tennessee	2.41	1.78	2.06	4.73	1.09	1.96	1.27	1.89
Texas	5.45	4.55	5.67	9.59	3.90	4.23	3.80	4.65

**Appendix 1: Percentage of Flood Determinations Indicating Location in a SFHA for Selected Flood Determination Companies by State, 1997-2003, continued**

<b>State</b>	<b>Firm A</b>	<b>Firm B</b>	<b>Firm C</b>	<b>Firm D</b>	<b>Firm E</b>	<b>Firm F</b>	<b>Firm G</b>	<b>Average Percentage in SFHA</b>
Utah	2.56	1.19	3.84	2.09	0.56	1.18	0.87	1.80
Vermont	2.73	2.03	3.02	1.95	0.97	1.98	1.18	2.67
Virginia	3.18	3.36	2.88	7.56	1.89	2.90	2.49	3.19
Washington	2.43	1.98	3.18	4.00	1.11	1.83	1.40	2.03
West Virginia	7.28	5.52	4.09	6.17	4.12	3.94	7.10	5.37
Wisconsin	1.60	1.60	2.26	1.53	1.04	1.70	1.10	1.66
Wyoming	2.20	2.18	5.41	2.34	1.29	2.09	1.87	2.42
<b>TOTAL</b>	<b>6.00</b>	<b>5.34</b>	<b>5.71</b>	<b>4.44</b>	<b>3.71</b>	<b>5.35</b>	<b>5.32</b>	<b>5.48</b>

NOTE: Seven flood determination companies, all of which provide determinations in all states and the District of Columbia, provided the data in 2003. Not all companies provided data for all years. The flood determination companies were asked to exclude determinations not associated with residential mortgages.

**Appendix 2: Total Flood Determinations, Total Number of Housing Units, Flood Determinations as a Percentage of Total Housing Units, and Estimated Number of Housing Units in SFHAs.**

<b>State</b>	<b>Total Determinations</b>	<b>Total Housing Units, 2002</b>	<b>Determinations as a Percent of Housing Units</b>	<b>Estimated Housing Units in SFHAs</b>
Alabama	1,163,824	2,014,536	57.77	87,452
Alaska	314,353	265,377	118.46	7,659
Arizona	2,366,149	2,328,720	101.61	71,105
Arkansas	528,826	1,202,028	43.99	42,689
California	13,979,128	12,507,767	111.76	471,361
Colorado	2,334,475	1,929,092	121.01	28,505
Connecticut	1,125,374	1,402,643	80.23	50,268
Delaware	273,847	352,031	77.79	28,338
District of Columbia	169,149	272,636	62.04	475
Florida	6,699,608	7,624,378	87.87	2,224,192
Georgia	2,878,198	3,487,088	82.54	102,245
Hawaii	340,364	470,512	72.34	39,569
Idaho	600,013	552,117	108.67	15,614
Illinois	4,241,496	4,981,258	85.15	108,682
Indiana	1,881,924	2,615,750	71.95	70,420
Iowa	760,607	1,257,184	60.50	27,319
Kansas	916,378	1,159,276	79.05	25,191
Kentucky	958,598	1,796,900	53.35	51,101
Louisiana	1,137,602	1,880,122	60.51	553,331
Maine	434,813	664,613	65.42	16,986
Maryland	2,141,389	2,197,126	97.46	62,297
Massachusetts	2,164,371	2,649,029	81.70	80,443
Michigan	3,432,575	4,331,986	79.24	81,327
Minnesota	2,100,182	2,132,632	98.48	21,971
Mississippi	750,498	1,195,133	62.80	81,143
Missouri	1,831,173	2,503,187	73.15	43,919
Montana	274,621	417,106	65.84	12,073
Nebraska	481,937	738,870	65.23	34,256
Nevada	984,076	901,597	109.15	27,158
New Hampshire	472,504	561,178	84.20	11,434
New Jersey	2,786,725	3,372,572	82.63	280,389
New Mexico	625,343	805,293	77.65	47,413
New York	4,443,090	7,754,508	57.30	264,269
North Carolina	2,771,293	3,707,129	74.76	157,281
North Dakota	148,663	294,165	50.54	13,869
Ohio	3,411,707	4,875,496	69.98	90,700
Oklahoma	956,967	1,541,518	62.08	36,734
Oregon	1,294,342	1,495,582	86.54	49,260
Pennsylvania	3,223,105	5,328,251	60.49	94,709
Rhode Island	338,336	443,761	76.24	16,185
South Carolina	1,332,604	1,825,531	73.00	216,440
South Dakota	217,841	332,360	65.54	13,441
Tennessee	1,615,135	2,519,825	64.10	47,506



**Appendix 2: Total Flood Determinations, Total Number of Housing Units, Flood Determinations as a Percentage of Total Housing Units, and Estimated Number of Housing Units in SFHAs, Continued**

<b>State</b>	<b>Total Determinations</b>	<b>Total Housing Units, 2002</b>	<b>Determinations as a Percent of Housing Units</b>	<b>Estimated Housing Units in SFHAs</b>
Texas	4,938,048	8,502,060	58.08	395,382
Utah	979,080	808,593	121.08	14,515
Vermont	514,458	299,570	171.73	7,992
Virginia	2,380,759	3,006,877	79.18	95,996
Washington	2,217,303	2,530,215	87.63	51,459
West Virginia	383,946	852,165	45.06	45,750
Wisconsin	1,666,662	2,386,848	69.83	39,522
Wyoming	152,079	227,941	66.72	5,522
<b>TOTAL</b>	<b>94,049,393</b>	<b>119,302,132</b>	<b>78.83</b>	<b>6,532,027</b>

NOTE: The total number of determinations represents the number of determinations completed by seven flood determination companies (from Appendix 1) between 1997-2003. A housing unit is a house, an apartment, a mobile home or trailer, a group of rooms, or a single room that is occupied, or, if vacant, is intended for occupancy as separate living quarters.

SOURCE: For total housing units, Bureau of the Census, Population Division, Table HU-EST2002-01 - State Housing Unit Estimates. Available at <http://eire.census.gov/popest/data/household/HU-EST2002-01.php>. Accessed November 17, 2003.

## 15. ACRONYMS

AIR	American Institutes for Research
CBRS	Coastal Barrier Resource System
CIDR	Compliance Information and Document Request
CMP	Civil Money Penalty
CRA	Community Reinvestment Act
CRS	Community Rating System
DHS	U.S. Department of Homeland Security
Fannie Mae	Federal National Mortgage Association
Farmer Mac	Federal Agricultural Mortgage Corporation
ERR	Environmental Review Record
FCA	Farm Credit Administration
FCS	Farm Credit System
FDIC	Federal Deposit Insurance Corporation
FEMA	Federal Emergency Management Agency
FFIEC	Federal Financial Institutions Examination Council
FHA	Federal Housing Administration
FIA	Federal Insurance Administration
FIRM	Flood Insurance Rate Map
FRB	Board of Governors of the Federal Reserve System
Freddie Mac	Federal Home Loan Mortgage Corporation
GAO	General Accounting Office
Ginnie Mae	Government National Mortgage Association
GSE	Government-sponsored enterprise
HUD	U.S. Department of Housing and Urban Development
IG	Office of Inspector General (FEMA)
LODR	Letter of Determination Review
LOMA	Letter of Map Amendment
LOMR	Letter of Map Revision
MPPP	Mortgage Portfolio Protection Program
NCUA	National Credit Union Administration
NFDA	National Flood Determination Association
NFIP	National Flood Insurance Program
OCC	Office of the Comptroller of the Currency
OFHEO	Office of Federal Housing Enterprise Oversight
OPA	Otherwise Protected Areas
OTS	Office of Thrift Supervision
RHS	Rural Housing Service
SBA	Small Business Administration
SFHA	Special Flood Hazard Area
SFHD	Standard Flood Hazard Determination
USDA	U.S. Department of Agriculture
VA	U.S. Department of Veterans Affairs
WYO	Write-Your-Own Company

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