Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Managing Flood Risk When '1000-Year' Floods Seem Common

By **Melissa Klimkiewicz and Brandy Hood**
September 12, 2017, 11:55 AM EDT


Melissa Klimkiewicz


Brandy Hood

Hurricane Harvey is the most significant in a recent series of catastrophic coastal and riverine floods impacting communities across the United States. This "1000-year flood" follows two consecutive years of "500-year" floods in Houston, and Houston is not alone.[1] Just ask Missourians about the "1,000-year" rainfall they experienced this spring,[2] the residents of coastal Georgia, the Carolinas and Virginia about Hurricane Matthew, or Louisianans about last August when a no-name storm triggered "1,000-year" rains, dumping over 2 feet of water on parts of Louisiana.[3] And, the extent of Hurricane Irma's devastation is still a major unknown. Of course, it doesn't take a "1,000-year" or "500-year" flood to wreak havoc on a community, as has become all too familiar for communities like Norfolk, Virginia, where it floods so often that the media has dubbed flooding a "certainty."[4] Indeed, flooding is the most common and expensive U.S. natural disaster,[5] with all 50 states having experienced floods or flash floods in the past five years.[6]

All of this may seem attenuated from the day-to-day business practices of mortgage lenders and servicers, but when communities flood, so do the residential and commercial properties that secure loans. And, when security properties flood, the risk of borrower default increases at the same time that the value of the collateral decreases. Uninsured (or underinsured) flood losses only exacerbate these issues. This risk is garnering increasing attention in the press, and Freddie Mac's chief economist issued a dire warning about the potential impact on the housing finance market just last year.[7] In light of these increasing risks, lenders should consider prioritizing flood risk management to ensure that they and their borrowers take the right steps to protect themselves.

Compliance With "Black Letter" Law

The first step toward managing this risk is ensuring compliance with existing laws and regulations. The federal banking agencies[8] implement the Flood Disaster Protection Act's (FDPA) mandatory purchase of flood insurance requirements ("mandatory purchase requirements") that are applicable to federally regulated financial institutions. The mandatory purchase requirements apply to loans secured by buildings located in special flood hazard areas (SFHA) in which flood insurance is available under the National Flood Insurance Program (NFIP). Each time a loan is made, increased, extended or renewed, a

flood determination must be made, and if the property is located in a SFHA, adequate flood insurance must be maintained throughout the life of the loan.[9] If coverage becomes inadequate, the flood insurance must be lender-placed in accordance with certain requirements.[10] Noncompliance with the highly technical mandatory purchase requirements can lead to exam findings, costly reviews of past practices (i.e., "look-backs"), civil money penalties, litigation, and reputational risk. Of course, where an institution has not fully satisfied the "black letter" law, the potential for scrutiny and negative consequences is amplified in the event of significant uninsured (or underinsured) flood losses.

Importantly, in addition to the mandatory purchase requirements, there are separate federal requirements for lender-placed flood insurance that is not required by the mandatory purchase requirements, flood insurance requirements that apply to Federal Housing Administration- and Veterans Affairs-insured or guaranteed loans and Fannie Mae- and Freddie Mac-owned loans, as well as additional requirements or limitations under some state laws. Private insurers or investors also may impose their own requirements.

Risk Doesn't Stop with Legal Compliance

Complying with "black letter" legal requirements still may not adequately manage an institution's risk because the law is limited and so is coverage available under the NFIP. For example, SFHAs, the areas in which flood insurance is required under the NFIP, include those properties located in "100-year flood zones" (i.e., an area determined to have a 1 percent chance of flooding in any given year). However, it is estimated that over 50 percent of the properties in Houston that Harvey likely damaged are not located in SFHAs,[11] meaning that the mandatory purchase requirements did not obligate those owners to buy flood insurance. And because most homeowners do not purchase flood insurance unless legally required to do so, a lender that only requires flood insurance on properties located in SFHAs may have significant risk of uninsured flood losses impacting the properties securing its loans. This is the case in Houston and elsewhere.

As another example, the mandatory purchase requirements only obligate a borrower to maintain coverage in an amount up to the lesser of the outstanding principal balance of the loan, the insurable value of the property, or the maximum amount of coverage available under the NFIP.[12] Under the NFIP, for most residential properties, building coverage is capped at $250,000 and contents coverage is capped at $100,000. For nonresidential properties, building coverage is capped at $500,000 and personal property coverage is capped at $500,000.[13] Because the cost to replace homes (or to even pay the cash value for structures that don't qualify for replacement cost value coverage) today often exceeds those limits, many properties that satisfy the mandatory purchase requirements may remain significantly underinsured. Thus, in the event of a devastating flood, even if a lender has ensured the legally required amount of flood insurance is in place, the borrower and institution may not be adequately protected because the borrower may still be left with inadequate coverage to rebuild.

Further, when disasters like Hurricane Harvey and Irma strike, lenders may offer forbearance options to borrowers in the affected area, but may still be on the hook for paying securities holders during that period (although the lenders are not receiving payments from the borrowers).[14] And, even where mortgage insurance is available in the event that foreclosure ultimately becomes necessary, the value of a lender's claims may be limited by the amount of uninsured flood damage the security properties have incurred.[15]

All of the foregoing discussion assumes an actual flood loss, but planned and proposed increases in flood insurance premiums exacerbate risks for both borrowers and loan holders, even if a flood never occurs.

According to at least one study, each $500 increase in flood insurance premiums leads to a $10,000 decrease in home value.[16] As flood insurance premiums increase, borrowers are less likely to be able to cover all of their monthly expenses, and therefore may be more likely to default on their loans. And, when these borrowers default, the underlying properties may inadequately secure the loans due to the diminution in value that the premium increase caused.

What Can Lenders Do to Mitigate Their Risk?

There a number of options that lenders can consider to mitigate their flood-related risks going forward. These may include, for example:

- Ensuring that their compliance management systems adequately account for legal requirements related to flood insurance. Lenders should catalog all applicable laws and regulations; implement policies, procedures and job aids to ensure compliance; and track updates to the law, regulator expectations and industry best practices. In addition, they should monitor and test their compliance, ensure effective self-correction and proper reporting of violations, and provide ongoing training. Further, because vendors provide significant assistance with flood compliance, lenders should implement appropriate vendor management controls.

- Analyzing their new originations and existing portfolios for concentrations of flood risk. This may include measuring the risk of flooding in the geographic areas in which security properties are located through the use of historically based SFHAs and/or forward-looking flood risk assessment methodologies. It also may include determining the extent to which NFIP coverage may leave security properties uninsured, or modeling the potential impact of anticipated insurance premium increases on willingness or ability to repay;

- Considering various options for reducing risk, to the extent undesirable concentrations of risk are identified. This may include, for example, requiring more flood insurance coverage than the institution is legally obligated to require, or requiring flood insurance where no coverage is legally required (e.g., in "500-year" flood zones). Or, it may include decisions about the areas in which security properties may be located or the interest rates charged for loans with higher-flood risk collateral. In making such policy determinations, however, a lender must ensure that the loan documents and applicable law permit the changes, and that fair lending and other risks — which may be quite significant — are managed.

- Offering flood mitigation-related products, such as loans to lift homes or other structures above potential flood depths and financing community-based mitigation efforts.

The bottom line is that flood risks appear to be increasing each year, with flood damage and related costs growing at an alarming rate — often in areas where floods aren't supposed to occur. As a result, now may be the time for lenders to re-evaluate their flood risk policies to determine whether they adequately protect both themselves and their borrowers.

Melissa Klimkiewicz is a partner and Brandy Hood is an associate in the Washington, D.C., office of Buckley Sandler LLP. They frequently advise mortgage lenders and servicers on flood insurance compliance and risk issues.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] See, e.g., Washington Post, Harvey is a 1,000-year flood event unprecedented in scale (Aug. 31, 2017), available at https://www.washingtonpost.com/news/capital-weather-gang/wp/2017/08/31/harvey-is-a-1000-year-flood-event-unprecedented-in-scale/?tid=pm_local_pop&utm_term=.efd4703fa8d4; Washington Post, Houston is experiencing its third '500 year' flood in 3 years. How is that possible? available at https://www.washingtonpost.com/news/wonk/wp/2017/08/29/houston-is-experiencing-its-third-500-year-flood-in-3-years-how-is-that-possible/?utm_term=.821a407dbadf.

[2] See, e.g., USA Today, 1-in-1000 year rainfall caused Missouri floods (May 21, 2017), available at https://www.usatoday.com/story/weather/2017/05/12/1-1000-year-rainfall-caused-missouri-floods/101599498/.

[3] See, e.g., nola.com, Louisiana Flood of 2016 resulted from '1,000-year' rain in 2 days (Aug. 17, 2016), available at http://www.nola.com/weather/index.ssf/2016/08/louisiana_flood_of_2016_result.html.

[4] See, e.g., New York Times, When Rising Seas Transform Risk Into Certainty (Apr. 18, 2017), available at https://www.nytimes.com/2017/04/18/magazine/when-rising-seas-transform-risk-into-certainty.html?mcubz=3&_r=0.

[5] FEMA, The National Flood Insurance Program, available at https://www.fema.gov/national-flood-insurance-program; see also id.

[6] FEMA, Flooding in the Past Five Years, available at https://www.fema.gov/media-library/assets/images/103646.

[7] Freddie Mac, Insight, Life's a Beach (Apr. 26, 2016), available at http://www.freddiemac.com/research/insight/20160426_lifes_a_beach.html.

[8] For purposes of this article, "federal banking agencies" include the Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corp.; Farm Credit Administration and National Credit Union Administration.

[9] 42 U.S.C. § 4012a(b); see also, e.g., 12 C.F.R. § 22.3.

[10] 42 U.S.C. § 4012a(e); see also, e.g., 12 C.F.R. § 22.7.

[11] CoreLogic, Media Advisory: CoreLogic Analysis Shows More Than 50 Percent of Properties in Houston at High and Moderate Risk of Flood Are Not in Designated Flood Zones (Aug. 28, 2017), available at http://www.corelogic.com/about-us/news/media-advisory-corelogic-analysis-shows-more-than-50-percent-of-properties-in-houston-at-high-and-moderate-risk-of-flood-are-not.aspx.

[12] Id.

[13] NFIP Manual, Rate 1, available at https://www.fema.gov/media-library-data/1491846079273-

28adf8361db1633c5445e716c15b0f58/05_rating_508_apr2017_v2.pdf.

[14] See, e.g., Ginnie Mae Mortgage-Backed Securities (MBS) Guide 5500.3, Rev. 1, Ch. 34.

[15] See, e.g., 24 C.F.R. § 203.379(a); HUD Handbook 4000.1 IV.A.2.a.ii.(A).

[16] National Association of Realtors, Homeowner Flood Insurance Affordability Act (Jan. 6, 2015), available at https://www.nar.realtor/topics/national-flood-insurance-program-nfip/homeowner-flood-insurance-affordability-act; see also Newsday, Long Island flood insurance premiums rise up to 18 percent a year (Feb. 25, 2017), available at http://www.newsday.com/business/li-flood-insurance-premiums-rising-up-to-18-a-year-1.13174031.
