Third Quarter 2005

Compliance Corner

FEDERAL RESERVE BANK OF PHILADELPHIA

Awash in Flood Regulations: Keeping Your Head and Portfolio Above Water

by Carletta M. Longo, Senior Examiner

The Asian tsunami last year; recent flash flooding due to springtime rains; and hurricanes Dennis, Emily, and Katrina have greatly raised our awareness of the destructive power of flooding. In light of this heightened awareness, this flood insurance recap should help banks ensure that their portfolios remain above water.

This article is the first of a two-part series summarizing the *Mandatory Purchase of Flood Insurance Guidelines*, published by the Federal Emergency Management Association (FEMA Guidelines). Part II of the series will appear in the Fourth Quarter 2005 issue of *Compliance Corner* and will focus on some of the more problematic areas encountered by bankers and regulators.

Overview of the National Flood Insurance Program

The National Flood Insurance Program (NFIP) was created by the National Flood Insurance Act of 1968. The NFIP provides an incentive for communities to adopt floodplain management ordinances (participating communities) to mitigate the effects of flooding on new or existing construction. The program also allows property owners in participating communities to purchase flood insurance for structures and contents.

From 1968 until the adoption of the Flood Disaster Protection Act of 1973 (1973 Act), the purchase of flood insurance was voluntary. However, the 1973 Act mandated flood insurance coverage for all properties located in special flood hazard areas (SFHA). In 1994, Congress revisited the mandatory purchase requirements and enacted the National Flood Insurance Reform Act of 1994 (Reform Act). The intent of the Reform Act was to improve compliance with the mandatory purchase requirements of the NFIP

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FEDERAL RESERVE BANK OF PHILADELPHIA

Truth in Savings Act Incorporates Overdraft Protection Rules

by Eddie L. Valentine, Supervising Examiner

The Second Quarter 2005 issue of *Compliance Corner* contained an article summarizing the *Interagency Guidance on Overdraft Protection Programs* (Interagency Guidance). This article addresses how some of the issues referred to in the Interagency Guidance have been incorporated into Regulation DD, which implements the Truth in Savings Act.

On May 19, 2005, the Federal Reserve Board published final amendments to Regulation DD and the official staff commentary to the regulation. These amendments address concerns about the uniformity and adequacy of information provided to consumers when they overdraw their deposit accounts.

The amendments, in part, address services sometimes referred to as "bounced check protection" or "courtesy overdraft protection," which are offered by many depository institutions to pay consumers' checks and allow other overdrafts when there are insufficient funds in the accounts. These are typically automated services provided to transaction account consumers as an alternative to a traditional overdraft line of credit.

The final rule creates a new section to the regulation that requires institutions that promote the payment of overdrafts in an advertisement to disclose on periodic statements total fees imposed for paying overdrafts and total fees imposed for returning items unpaid. These disclosures must be made for both the statement period and the calendar year-to-date. Certain other disclosures in advertisements of overdraft services are also included in the new section of Regulation DD.

This article provides a summary of the salient issues concerning the final amendments to Regulation DD pertaining to overdraft protection plans. The full text of the amendment is available on the Federal Reserve Board's website at <www.federalreserve.gov/boarddocs/press/bcreg/2005/20050519/default.htm>.

Disclosure of Overdraft Fees

Institutions must ensure that overdraft and returned-item fee disclosures are adequate and uniform and provided on a timely basis.

Periodic statements. To assist consumers in understanding the financial impact of overdrawing their accounts, the final rule requires institutions that promote the payment of overdrafts in an advertisement to separately disclose on periodic statements the total amount of fees or charges imposed on the deposit account for paying overdrafts and the total amount of fees charged for returning items unpaid. These disclosures must be provided for the statement period and for the calendar year-to-date for any account to which the advertisement applies.

To facilitate compliance, the staff commentary provides specific examples of when an institution is promoting the payment of overdrafts in an advertisement. For example, stating the overdraft limit for an account on a periodic statement or stating an account balance that includes available overdraft funds on an ATM receipt would be considered an advertisement triggering the required disclosures.

An institution that does not otherwise promote the payment of overdrafts would not trigger the requirement to provide aggregate fee disclosures on periodic statements solely by:

- Providing educational materials that do not specifically describe the institution's overdraft service.
- Promoting in an advertisement a traditional line of credit that is subject to the Board's Regulation Z, which implements the Truth in Lending Act.
- Engaging in an in-person discussion with a consumer.
- Making a disclosure required by federal or other applicable law.
- Including information on a periodic statement or providing a notice informing a consumer about a specific overdrawn item or the amount the account is overdrawn.
- Including in a deposit account agreement a discussion of the institution's right to pay overdrafts.
- Notifying a consumer that completing a requested transaction, such as an ATM withdrawal, may trigger an overdraft fee or providing a general notice that items overdrawing an account may trigger an overdraft fee.
- Communicating information about the payment of overdrafts in response to a consumer-initiated inquiry about overdrafts or deposit accounts generally. However, providing information about the payment of overdrafts in response to a balance inquiry made through an automated system, such as a telephone response machine, an ATM, or an institution's Internet site, is not a response to a consumer-initiated inquiry for purposes of this provision and would trigger the periodic statement disclosure requirements.

New account disclosures. Institutions must specify in new account disclosures the categories of transactions for which an overdraft fee may be imposed. An exhaustive list of transactions is not required; it is sufficient to state that the fee is imposed for overdrafts created by checks, in-person withdrawals, ATM withdrawals, or other electronic means, as applicable. This requirement applies to all institutions, including institutions that do not promote the payment of overdrafts in an advertisement.

Institutions must specify in new account disclosures the categories of transactions for which an overdraft fee may be imposed.

Advertising. To avoid confusion with traditional lines of credit, institutions that promote the payment of overdrafts are required to include certain disclosures in their advertisements about the service. These disclosures include the applicable fees or charges, the categories of transactions covered, the time period consumers have to repay or cover any overdraft, and the circumstances under which the institution would not pay an overdraft. Stating the available overdraft limit or the amount of funds available on a periodic statement would be considered an advertisement triggering the required disclosures.

The final rule provides safe harbors from the advertising requirements similar to those described above for the periodic statement disclosure requirements. For example, the advertising disclosure requirements would not apply to institutions when they provide educational materials, respond to a consumer-initiated inquiry about overdrafts or deposit accounts, or notify a consumer about a specific overdraft in their account.

Advertising disclosures are not required on ATM receipts because of space limitations. Similarly, advertising disclosures are not required for advertisements using broadcast media, billboards, or telephone response systems. These rules parallel an exemption in Regulation DD that applies to other types of advertising disclosures. Limited advertising disclosures are required on ATM screens, telephone response machines, and indoor signs.

Prohibition of Misleading Advertisements

The prohibition against advertisements, announcements, or solicitations that are misleading or that misrepresent the deposit contract is extended to communications with consumers about the terms of their existing accounts.

The staff commentary has been revised to provide the following five examples of advertisements that would ordinarily be deemed misleading:

- Representing an overdraft service as a line of credit
- Representing that the institution will honor all checks or transactions when the institution retains discretion at any time not to honor any transaction
- Representing that consumers with an overdrawn account are allowed to maintain a negative balance when the terms of the account's overdraft service require consumers to promptly return the deposit account to a positive balance
- Describing an overdraft service solely as protection against bounced checks when the institution also permits overdrafts for a fee in connection with ATM withdrawals and other electronic fund transfers that permit consumers to overdraw their accounts
- Describing an account as "free" or "no cost" in an advertisement that also promotes a service for which there is a fee (including an overdraft service), unless the advertisement clearly and conspicuously indicates that there is a cost associated with the service

Overdraft Protection Programs and the Truth in Lending Act

The amendments to Regulation DD recognize that an overdraft service is provided as a feature and a term of a deposit account and that the fees associated with the service are assessed against the deposit account. Consumer advocates and some others who commented on the proposed revisions to Regulation DD believe that certain overdraft services should be covered by Regulation Z.

The advocates believe that overdraft services compete with traditional credit products such as open-end lines of credit, credit cards, and short-term closed-end loans. These products are covered under Regulation Z and provide consumers with the cost of credit expressed as a dollar finance charge and an annual percentage rate. The advocates believe that Regulation Z disclosures would enhance consumers' understanding of the cost of overdraft services and their ability to compare costs of competing financial services.

The Federal Reserve Board's adoption of final rules under Regulation DD does not preclude a future determination that Regulation Z disclosures for overdraft protection programs would also benefit consumers.

The Federal Reserve Board's adoption of final rules under Regulation DD does not preclude a future determination that Regulation Z disclosures for overdraft protection programs would also benefit consumers. The Board expressly stated in its proposal that further consideration of the need for coverage under Regulation Z may be appropriate in the future.

Final Thoughts

The new provisions of Regulation DD are not effective until July 1, 2006. However, institutions offering overdraft protection programs should begin now to develop policies and procedures that comply with the Regulation DD amendments.

If you have any questions about this article, please contact either Supervising Examiner Eddie L. Valentine (eddie.valentine@phil.frb.org) or Supervising Examiner John D. Fields (john.d.fields@phil.frb.org) through the Regulations Assistance Line at (215) 574-6568. □

Compliance Alert: Agencies Issue Interim Final Rules for FACT Act Medical Information Provision

On June 10, 2005, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision published interim final rules to implement section 411 of the Fair and Accurate Credit Transactions Act of 2003 (FACT Act).

The rules create exceptions to the statute's general prohibition on creditors obtaining or using medical information pertaining to a consumer in connection with any determination of the consumer's eligibility, or continued eligibility, for all credit, except as permitted by regulations or the FACT Act. The exceptions permit creditors to obtain or use medical information in connection with credit eligibility determinations where necessary and appropriate for legitimate purposes. The interim final rules also specify the circumstances in which creditors may share medical information with affiliates without becoming consumer reporting agencies.

The interim final rules are effective March 7, 2006. The complete text of the rules can be found at <www.federalreserve.gov/boarddocs/press/bcreg/2005/20050606/default.htm>. ☐

Awash in Flood Regulations: Keeping Your Head and Portfolio Above Water *...continued from page CC1*

and to increase participation nationwide by those borrowers who own mortgaged homes or businesses in SFHAs and have not purchased or maintained flood insurance coverage.

While the mandatory purchase requirements apply only to buildings located in SFHAs in participating communities, NFIP flood insurance is available for all properties located in participating communities. This fact is especially significant because, historically, approximately 25 percent of the NFIP claims paid have actually been for properties located outside of an SFHA.

A mortgage lender may require a borrower to carry flood insurance, even if the building serving as security for a loan is located outside an SFHA. Lenders and property owners may wish to exercise additional caution in areas subject to flooding due to storm water, where the NFIP has used approximate methods to map SFHAs, or in remote locations where no SFHAs have been designated by FEMA. In January 1989, the NFIP began offering a low-cost preferred risk policy for buildings located outside of SFHAs.

Mandatory Purchase Requirements

Lenders cannot make, increase, extend, or renew any loan secured by improved real estate located in an SFHA in a participating community (a designated loan) unless the property securing the loan is covered for the life of the loan by flood insurance. There is no waiting period for flood insurance to go into effect when it is in connection with a loan origination or the renewal or extension of an existing loan. In most other instances, there is a 30-day waiting period before the insurance goes into effect.

Whether a designated loan is for consumer or commercial purposes is irrelevant, and the extension of credit may take several forms, including origination, refinancing, consolidation, or renewal. The mandatory purchase requirement applies to any designated loan, including fixed rate, variable rate, or balloon loans.

The requirement to obtain flood insurance also applies regardless of the type of security interest taken, including a mortgage indenture, judgment note, cognovit note, or any other type of security or trust agreement. The mandatory purchase provisions even apply to those loans where real estate is secured out of an abundance of caution, typically found in commercial transactions. The Reform Act mandates flood insurance coverage even if the SFHA designation is first identified after settlement but during the term of the loan, because of remapping or other reasons.

Flood insurance is also required on designated home equity or second mortgage loans regardless of the lien priority. The location of the secured property, not the use of funds received on a home equity or second mortgage, governs whether flood insurance is required.

The flood insurance requirement does not apply to (i) any state-owned property covered under a policy of self-insurance satisfactory to the director of FEMA, which publishes and periodically revises the list of states falling within this exemption, or (ii) property securing any loan with an original principal balance of $5,000 or less and a repayment term of one year or less.

If a borrower will not voluntarily obtain flood insurance and a lender is unable to force-place coverage, the lender must deny the loan. A lender cannot accept a borrower's assurance that he or she will obtain flood insurance coverage in the future. Closing a designated loan without flood insurance in place constitutes a violation of Regulation H.

The Reform Act requires lenders to escrow flood insurance premiums for homes in SFHAs only when taxes, other forms of insurance, or any other payments are also required to be escrowed. Lenders must ensure that the building and any applicable personal property securing a designated loan are covered by flood insurance for the term of the loan.

Lenders must ensure that the building and any applicable personal property securing a designated loan are covered by flood insurance for the term of the loan.

Finally, the duties of a lender with respect to flood insurance requirements for a particular loan cease upon the sale of the loan, unless the seller agrees to retain responsibility for complying with the Reform Act's requirements under a loan servicing agreement with the transferee.

Flood Hazard Determinations

Lenders must use FEMA's standard flood hazard determination form (SFHDF) when determining whether the building or mobile home offered as security for a loan is or will be located in an SFHA in which flood insurance is available. The completed SFHDF should be retained in either paper copy or electronic form for the period of time the bank owns the loan. The SFHDF is available on FEMA's website at <www.fema.gov/pdf/nfip/sfhdf.pdf>.

Reliance on Third Parties in Determining a Building's Location

The Reform Act places the ultimate responsibility to require flood insurance on the lender, yet it allows for limited reliance on third parties to the extent that the information they provide is guaranteed. Lenders may reasonably seek assistance from third parties that have demonstrated their knowledge concerning flood map information. For regulatory purposes, reasonable reliance upon such services in the making of a lender's determination is regarded as acceptable only to the extent that such person guarantees the accuracy of the information as provided under the statute. A financial institution cannot rely on the assurances or statements of a borrower that the structure in question is or is not in an SFHA.

Some third party flood vendors also provide life-of-loan services that monitor the flood hazard status of the building for the term of the loan. Third party life-of-loan services are designed to discover a change in flood hazard status, thereby minimizing administrative burden for the lender or servicer. The law does not require a lender to subscribe to life-of-loan monitoring; however, the lender is required to ensure that appropriate flood insurance is maintained during the term of the loan.

Required Notifications

Lenders must notify the borrower in writing of the requirement to purchase flood insurance for new and existing loans. For new loans, lenders are required to notify the borrower that the building is in an SFHA within a reasonable time, defined by federal regulation as at least 10 days prior to the loan closing.

If, during the term of the loan, it is determined that the building securing the loan is in an SFHA, the lender is required to notify the borrower within a reasonable time. The law provides for the force placement of flood insurance 45 days after the borrower is notified of deficient flood insurance coverage.

Additionally, if a loan is sold or if there is a change of servicer, lenders must notify the insurance company or agent that wrote the flood insurance policy of a change of lender or servicer within 60 days after the effective date of the change.

Required Coverage

The Reform Act establishes required coverage as the lesser of the following:

- The maximum amount of NFIP flood insurance coverage available
- The outstanding principal balance of the loan
- The value of the property minus the value of the land

The current maximum coverage limits for residential property are $250,000 for buildings and $100,000 for contents and, for nonresidential property, $500,000 for buildings and $500,000 for contents.

The Reform Act applies to real estate improvements, such as buildings and mobile homes, but not to land. Since the NFIP does not provide insurance coverage for land, the location of the building in relation to the SFHA determines the applicability of the mandatory purchase provisions. Some portion of the building itself, and not just a portion or portions of the land, must be located in an SFHA for the mandatory purchase provisions to apply.

As specified in the Reform Act, contents coverage is not required unless personal property, in addition to a building, secures the loan. Since residential mortgages rarely include personal possessions as part of the loan security, lenders are not required to compel borrowers to purchase contents coverage. However, when a commercial loan on a building includes inventory and other trade or business movable property as security for the loan, that property must be covered by flood insurance under contents coverage. Lenders are encouraged to advise borrowers to include contents coverage for personal property and inventory when it is prudent to do so.

Force Placement of Flood Insurance

The Reform Act places responsibility on both lenders and servicers to force place flood insurance if it is determined that the building securing the loan is not adequately insured. The law also grants statutory authority to a lender (or servicer) to purchase flood insurance for the building if it is in an SFHA and to charge a premium to the borrower.

If at any time during the term of a designated loan the lender or servicer determines that the building securing the loan is not covered by flood insurance or is covered by insurance in an amount less than that required by law, the lender or servicer must first notify the borrower of the need to carry adequate flood insurance. The law does not specify the precise wording of the notice; however, the notice must state that the borrower should, at the borrower's expense, obtain flood insurance that is not less than the amount required under the law.

If the borrower fails to purchase flood insurance within 45 days after notification, the lender or servicer must purchase the insurance on behalf of the borrower and charge the borrower for the cost of premiums and fees incurred. The 30-day waiting period does not apply to force-placed policies.

The force-place provisions also apply to home equity and second mortgage loans. A secondary lien holder that force places coverage only to the extent of its loan will not protect its interest if a first mortgagee claims priority to any insurance proceeds. Force placement of insurance by a second mortgagee requires coordination with the first mortgagee, as well as with the insurance provider and insurer on the first mortgage, if one exists.

Regulatory Penalties for Violations of Regulation H
The Reform Act requires the Federal Reserve Board and other regulatory agencies to impose civil money penalties when they find a pattern or practice of violations. The law provides penalties related to designated loans for which a lender fails to do the following:

- Require the purchase of insurance
- Escrow flood insurance premiums, when required
- Provide the required notices
- Force place insurance

The individual penalty amount is $350 per violation, with a ceiling of $100,000 per institution during any calendar year. Penalties assessed will be deposited in the National Flood Mitigation Fund created by the Reform Act. Other remedial sanctions consist of unsatisfactory bank ratings, supervisory actions, and ultimately, cease and desist orders being issued against lending institutions.

Final Thoughts
Compliance examiners will continue to review the flood insurance practices of Third District state member banks to ensure compliance with the applicable provisions of the law. A sample of loan files will be reviewed to verify that (i) determinations are made in a timely manner and documented on the SFHDF, (ii) notifications are provided in a timely manner, and (iii) adequate flood insurance is maintained during the term of the loan.

Each review will be tailored to the activities of the institution. For example, if an institution purchases servicing rights, the review probably will include a review of the contractual obligations placed on the institution by the owner of the loans. Similarly, if the institution uses a third party to service loans, the contract with the third party may be reviewed to ascertain that the flood insurance requirements are identified and that compliance responsibilities are adequately addressed.

If the institution transfers the servicing of loans to another entity, it must show it provided notice of the new servicer's identity to the FEMA designee within the prescribed timeframe. Additionally, if the institution uses a third party to perform flood zone determinations, it can expect a review of its contractual provisions to verify that compliance requirements are identified and covered, including the extent of the third party's guarantee of work.

Institutions should review the guidance carefully to ensure that their loan portfolios are adequately protected. The FEMA guidelines are available in PDF format on FEMA's website at <www.fema.gov/nfip/mpurfi.shtm>.

If you have any questions regarding flood insurance guidelines, please contact Senior Examiner Carletta M. Longo (carletta.longo@phil.frb.org) or Supervising Examiner John D. Fields (john.d.fields@phil.frb.org) through the Regulations Assistance Line at (215) 574-6568. □

CRA *Alert:* Banking Agencies Issue Final Community Reinvestment Act Rules

On July 19, 2005, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency approved final Community Reinvestment Act (CRA) rules that are intended to reduce regulatory burden on community banks while making CRA evaluations more effective in encouraging banks to meet community development needs.

The final rules raise the small bank asset size threshold to institutions with less than $1 billion in assets without regard to holding company affiliation. Accordingly, the new rules reduce the data collection and reporting burden for intermediate small banks, banks with assets between $250 million and $1 billion and, at the same time, encourage meaningful community development lending, investment, and services by these banks.

The rules are effective September 1, 2005. The final rules can be found at <www.federalreserve.gov/boarddocs/press/bcreg/2005/20050719/default.htm>. □