Office of the Comptroller of the Currency

Washington, DC 20219

October 30, 2017

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Dear [ ]:

This letter responds to your April 13, 2017, letter to [ ] regarding the evaluation of a private flood insurance policy deductible when a commercial property includes multiple structures. This letter also responds to your April 26, 2017, letter to [ ] regarding the treatment of automatic extensions of a commercial credit facility and the treatment of a multi-tranche commercial credit facility under the federal flood insurance requirements.

April 13, 2017 Letter Regarding Evaluation of the Deductible in a Private Flood Insurance Policy

Your April 13, 2017, letter requests the Office of the Comptroller of the Currency's (OCC) guidance on evaluating the appropriateness of a private flood insurance deductible when there are multiple structures on a commercial property. As set forth below, after careful review of the issues raised in your letter, the OCC affirms its position previously communicated to [***Bank***] that a private flood insurance policy for which the deductible amount exceeds the insurable value of one or more of the buildings securing the loan does not, as a factual matter, provide coverage for that building in the event of a loss and therefore, would not comply with the statutory and regulatory requirement that, for a mortgage loan secured by a building in a Special Flood Hazard Area (SFHA), the building must be covered by flood insurance. In addition, the OCC does not believe that [***Bank's***] proposed alternative approach to evaluating a deductible in a private flood insurance policy, as described below, would provide flood insurance coverage consistent with those statutory and regulatory requirements.

Evaluating the Deductible in a Private Flood Insurance Policy

The flood insurance statute, 42 U.S.C. § 4012a, and the regulation, 12 CFR 22.3, prohibit the origination of a loan secured by a building that is located in an SFHA in a participating community, unless the building (and contents) securing the loan are covered by flood insurance.

When the collateral securing the loan includes more than one building, the lender should determine the total amount of insurance required on each building and add the individual amounts together. The total amount of required flood insurance is the lesser of the outstanding principal balance of the loan, the maximum amount of insurance available under the National Flood Insurance Program for the type of buildings, or the combined insurable value of the buildings. "The amount of total required flood insurance can be allocated among the secured buildings in varying amounts, but each building must have some coverage." (Q/A 14, Interagency Questions and Answers Regarding Flood Insurance, 74 Fed. Reg. 35914, 35936; July 21, 2009) (2009 Questions and Answers)

The interagency guidance also provides that a lender should determine the reasonableness of the deductible on a case-by-case basis, taking into account the risk that such a deductible would pose to the borrower and the lender (Q/A 17, 2009 Questions and Answers). To the extent that a flood insurance policy includes a deductible amount that exceeds the insurable value of one or more buildings securing the loan, as a factual matter, there would be no coverage for that building in the event of a loss. Such a result would be inconsistent with the statutory and regulatory requirement that a lender is prohibited from making a loan secured by a building in an SFHA where flood insurance is available unless the building is covered by flood insurance.

The Agencies[1] addressed the issue of low-value buildings in the 2009 Questions and Answers. As stated in Q/A 24, a lender is required to mandate flood insurance for buildings with limited utility or value, even if the borrower would not replace them if lost in a flood. Q/A 24 provides that in such a situation, the lender may consider ‘‘carving out’’ buildings from the security it takes on the loan. However, the lender should fully analyze the risks of this option. In particular, a lender should consider whether it would be able to market the property securing its loan, without the "carved out" building(s), in the event of foreclosure. Additionally, the lender should consider any local zoning issues or other issues that would affect its collateral. (Q/A 24, 2009 Questions and Answers)

Your letter notes that the OCC's approach to evaluating the deductible would result in the rejection of a flood insurance policy on a commercial property with $500,000 in coverage amount and a $5,000 deductible if the $5,000 deductible exceeded the value of the least valuable structure on the property, such as a $1,500 shed. As provided in Q/A 24 in the 2009 Questions and Answers, after fully analyzing the risks involved, a lender could "carve out" the low-value shed from the security it takes on the loan in the example provided in your letter.

In contrast to the hypothetical situation in your letter in which the loan collateral includes one building with limited utility or value that could be "carved out" from the property securing the loan, in a situation in which the loan collateral involves multiple buildings that each have an insurable value that is less than the deductible, carving out such buildings from the collateral may not be a practical solution. For example, consider a scenario in which a bank makes a $1 billion loan to an entity. The borrower purchases a $100 million private flood insurance policy that covers 75 buildings, many of which are in a flood zone. The policy includes a deductible

[1] The "Agencies" include the OCC, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the National Credit Union Administration.

totaling $1.5 million to $2.5 million per building; 40 of the buildings taken as collateral have an insurable value of approximately $50,000 each.

A bank is responsible for evaluating a private flood insurance policy to determine whether it meets the general mandatory purchase requirement (i.e., amount and coverage) and whether it complies with safety and soundness requirements (i.e., adequately protects the bank's collateral). In this example, the fact that 40 of the buildings securing the loan have insurable values less than the deductible would mean that, although those 40 buildings may be listed on the policy schedule, there effectively would be no coverage for these buildings in the event of a loss. Such a result is not consistent with the statutory and regulatory requirements that a lender is prohibited from making a loan secured by a building in an SFHA unless the building is covered by flood insurance. In the example above, in order to comply with the statutory and regulatory requirements, the deductible would need to be modified to ensure that each building had some coverage.

Your letter requests the OCC's review of an alternative approach to evaluating the deductible in a private flood insurance policy. As outlined in your letter, this alternative approach would allow a bank to accept a deductible amount if the deductible amount is no more than 10 percent of the coverage amount and the aggregate insurable value of the structures and their contents on the commercial property is greater than the deductible amount.

Applying this approach to a hypothetical scenario, assume a $100,000,000 flood insurance policy covers 75 buildings with a deductible of $2.5 million; 35 of the buildings have an insurable value of $3 million each and 40 of the buildings have an insurable value of $50,000 each. In this example, the deductible amount of $2.5 million per building is less than 10 percent of the coverage amount of $100,000,000. The aggregate insurable value of the structures and their contents on the commercial property is $107,000,000 (35 buildings with a combined insurable value of $105,000,000 and 40 buildings with a combined insurable value of $2,000,000). Based on your proposed alternative approach, the bank could accept the policy even though the deductible amount is more than the insurable value of the 40 buildings valued at $50,000. This means that there would be no coverage for those 40 buildings in the event of a loss. Thus, since this approach would result in the acceptance of a flood insurance policy that would not provide payment in case of a loss on more than half of the buildings securing a loan, it is inconsistent with the flood insurance requirements set forth in the statute and the regulations.

<u>April 26, 2017 Letter Regarding Automatic Extensions and Multi-Tranche Credit Facilities</u>

Automatic Extensions

Your April 26, 2017, letter requests guidance on the treatment of automatic extensions of a commercial credit facility under the flood insurance law. Based on the OCC's review of this issue, the OCC concludes that an automatic extension of a credit facility that is agreed upon by the lender and the borrower at the origination of the loan and memorialized in the credit agreement does not constitute a "make, increase, extend or renew" (MIRE) event that would trigger the federal flood insurance requirements because the automatic loan extension was contemplated in the loan agreement.

Your letter indicates that some commercial credit facilities provide for one or more automatic extensions of the credit facility, which are agreed to by lenders and borrowers at the origination of the loan and memorialized in the credit agreement. For example, the credit agreement may have an initial loan term of three years and the borrower has the right to extend the agreement one or more times, each for an additional one-year period. Your letter sets forth the view that such automatic extensions are not new extensions of credit. Your letter further indicates that automatic extensions are an integral part of the origination of the loan, and that exercising the extension is at the borrower's option.

You have indicated that [***Bank***] currently treats automatic extensions as MIRE events that would be subject to the federal flood insurance requirements. You have requested guidance as to whether such treatment is required.

Based on the OCC's review of this issue, an automatic extension of a credit facility that is agreed upon by the lender and the borrower at the origination of the loan and memorialized in the credit agreement does not constitute a MIRE event that would trigger the federal flood insurance requirements because the automatic loan extension was anticipated in the original loan agreement.

Multi-Tranche Credit Facilities

Your April 26, 2017, letter also requests guidance as to whether a lender must consider any MIRE event and any cashless roll of which it becomes aware in any tranche of a multi-tranche credit facility, regardless of whether that lender participates in the affected tranche. As discussed below, the OCC would not expect a lender participating in one tranche in a multi-tranche credit facility to be responsible for taking direct steps to ensure compliance with flood insurance requirements in connection with a MIRE event or cashless roll that occurs in a tranche in which the lender does not participate.

As described in your letter, a multi-tranche commercial credit facility is a loan arrangement containing more than one type of loan or tranche. Each loan within the overall credit facility is made to the same borrower or group of related borrowers, but the loans may have different lenders and different terms and conditions. For example, a credit facility might have one tranche that is a revolving line of credit with a one-year maturity date and one or more additional tranches that are fixed loans with different interest rates and different maturity dates. Various lenders may participate in each tranche. Generally, the tranches share the same collateral and there is one credit agreement that describes and governs all the tranches. There is also typically one lead lender that acts as the administrative agent for the credit facility and its tranches.

Your letter also indicates that under most multi-tranche credit facility agreements, a MIRE event can occur within a particular tranche without any requirement to notify and obtain the consent of the lenders not participating in that tranche. Lenders may also participate in a "cashless roll," which is an exchange of an existing loan for a new or amended loan without any transfer of cash. A cashless roll may be used to replace or supplement existing tranches but not to increase the total amount of committed debt.

Your letter requests guidance as to whether a lender must consider any MIRE event and any cashless roll of which it becomes aware in any tranche of the entire multi-tranche credit facility, regardless of whether that lender participates in the affected tranche. As discussed below, the OCC would not expect a lender participating in one tranche in a multi-tranche credit facility to be responsible for taking direct steps to ensure compliance with flood insurance requirements in connection with a MIRE event or cashless roll that occurs in a tranche in which the lender does not participate.

As described in your letter, a multi-tranche credit facility is analogous in many respects to a loan syndication or participation. Q/A 4 in the 2009 Questions and Answers addressed enforcement of the mandatory purchase requirements when a lender participates in a loan syndication or participation. Q/A 4 provides in relevant part:

> Although the agreement among the lenders may assign compliance duties to a lead lender or agent, and include clauses in which the lead lender or agent indemnifies participating lenders against flood losses, each participating lender remains individually responsible for ensuring compliance with the Act and the Regulation. Therefore, Agencies will examine whether the regulated institution/participating lender has performed upfront due diligence to ensure that both the lead lender or agent has undertaken the necessary activities to ensure that the borrower obtains appropriate flood insurance and that the lead lender or agent has adequate controls to monitor the loan(s) on an ongoing basis for compliance with the flood insurance requirements. Further, the Agencies expect the participating lender to have adequate controls to monitor the activities of the lead lender or agent to ensure compliance with the flood insurance requirements over the term of the loan.

Similar to a loan syndication or participation, a multi-tranche credit facility involves one credit agreement that describes and governs all the tranches. In addition, similar to a loan syndication or participation, a multi-tranche credit facility typically has one lead lender that acts as the administrative agent for the credit facility and its tranches.

In accordance with the guidance in Q/A 4, the OCC expects that a lender participating in a multi-tranche credit facility will perform upfront due diligence to ensure that the lead lender has adequate controls to monitor the loan on an ongoing basis for compliance with the flood insurance requirements. Even though each lender participating in a tranche in a multi-tranche credit facility remains individually responsible for ensuring compliance with the flood insurance requirements, this obligation can be achieved through the upfront due diligence and ongoing monitoring for compliance with flood insurance requirements by the lead lender/administrative agent. Therefore, as stated above, the OCC would not expect a lender participating in one tranche in a multi-tranche credit facility to be responsible for taking direct steps to ensure compliance with flood insurance requirements in connection with a MIRE event or cashless roll that occurs in a tranche in which the lender does not participate.

We trust this letter is helpful in addressing your concerns. As the Agencies move forward to revise the 2009 Questions and Answers, the OCC will recommend that the Agencies address the issues raised in your letter concerning evaluation of the deductible in a private insurance policy as well as lender participation in a multi-tranche credit facility by including new Q/As on these topics.

Please contact [ ] at [ ] if you have additional questions or would like to discuss this matter further.

Sincerely,

signed

Donna M. Murphy
Deputy Comptroller for Compliance Risk Policy
Compliance and Community Affairs

signed

Charles M. Steele
Deputy Chief Counsel