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October 26, 1979

The Honorable Norman Y. Mineta  
Chairman, Subcommittee on  
Oversight and Review  
Committee on Public Works and  
Transportation  
House of Representatives

ASE03107



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Dear Mr. Chairman:

Subject: [How Do Federal Agencies Assure That  
Disaster Loan Recipients Maintain  
Mandatory Flood Insurance?] (CED-80-10)

As you requested on May 23, 1979, we examined the procedures used by selected Federal agencies to assure that disaster loan recipients maintain flood insurance when required as a condition for such loans. As your office agreed, we limited our review to the disaster loan programs of the Department of Agriculture's Farmers Home Administration (FmHA) and the Small Business Administration (SBA). You expressed concern that if these agencies did not assure that borrowers maintained flood insurance, not only would the Government's interest be jeopardized should there be another flood but loan recipients would also be barred from receiving further loans under the Disaster Relief Act of 1974 (Public Law 93-288, as amended).

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AGC00002

FmHA has adequate procedures to protect the Government's interest and assure borrower maintenance of required flood insurance. On the other hand, SBA, hampered by what it says are serious understaffing problems, essentially relies on the borrower to renew the insurance after the first year. The agency does not follow up to assure that the borrower has renewed the insurance, and, unlike FmHA, it does not have contingency procedures which allow it to pay the renewal premium when the borrower does not.

In addition, neither of these agencies nor the agency primarily responsible for coordinating disaster assistance and administering the national flood insurance program--the Federal Emergency Management Agency (FEMA)--had adequate information on

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- how many communities nationwide had suffered repeat flooding, 1/
- how many loans requiring mandatory flood insurance had been made in flood hazard areas, 1/ or
- how many borrowers required to buy flood insurance had failed to renew or had their insurance canceled before final repayment of their loans.

Consequently, we could not determine the extent of actual or potential losses to the Government and to borrowers from failure to maintain flood insurance.

Also, although neither FmHA nor SBA uses escrow accounts to collect flood insurance premiums on disaster loans, both agencies require the use of a "cobeneficiary" clause 2/ whereby both the borrower and lender are to be notified when the annual renewal premium is due. SBA told us, however, that despite this provision it often fails to receive the required notification from either FEMA or the insuring agent for SBA disaster loans. Consequently, SBA often does not know whether the borrower has renewed the required insurance.

We made our review at FEMA, FmHA, and SBA headquarters in Washington, D.C. We interviewed officials of those agencies and contacted representatives of the American Bankers Association, the Mortgage Bankers Association of America, and the U.S. League of Savings Associations. We reviewed legislation; agency policies, procedures, regulations, and guidelines; and gathered statistics on repeat flooding, flood

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1/FEMA officials told us that they can identify repeat flood claims made since January 1978 and plan to implement actions during 1980 to identify policies required by the Flood Disaster Protection Act of 1973. (See pp. 5 and 9.)

2/FmHA and SBA require disaster loan recipients to (1) list the lending agencies as mortgagees on the insurance policies when they obtain the required flood insurance and (2) endorse the policies so that the agencies are listed as joint beneficiaries in the event of loss. The use of this provision on insurance policies is referred to interchangeably as a "cobeneficiary," "loss payable," or "mortgage" clause. Both the borrowers and lenders (mortgagees) should then be notified when policy renewals are due.

insurance policies, and FmHA and SBA flood disaster loan activities since fiscal year 1975.

We coordinated our work with the internal audit groups of FEMA, SBA, and the Department of Agriculture. None of these groups had work underway which was similar to our work in developing this report. We discussed our findings with agency officials, whose comments are incorporated on page 11.

AGENCY RESPONSIBILITIES AND PROGRAMS  
AND FLOOD DISASTER LOAN ACTIVITIES

FEMA establishes Federal policy on the functions of executive agency civil emergency assistance and coordinates such assistance, including that rendered in connection with floods. 1/ FEMA also

- makes grants to State and local governments,
- issues regulations governing its programs and activities authorized by the Flood Disaster Protection Act of 1973 (Public Law 93-234) and the Disaster Relief Act of 1974, 2/ and
- issues regulations and guidelines governing the national flood insurance program which it administers. 2/

FmHA and SBA administer disaster loan programs authorized, respectively, by the Consolidated Farm and Rural Development Act, as amended (7 U.S.C. 1961), and the Small Business Act, as amended (15 U.S.C. 636(b)). These programs provide flood disaster loans, for the most part, directly to individuals or businesses rather than through insured

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1/Executive Orders 12127, March 31, 1979, and 12148, July 20, 1979, established FEMA and transferred to it the functions previously performed by the Federal Insurance Administration (FIA) and Federal Disaster Assistance Administration (FDAA) respectively.

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AGC00460

2/Former FIA flood insurance program guidelines, hereafter referred to in this report as FEMA regulations or guidelines, were transferred to a new title 44, Code of Federal Regulations, in June 1979. Transfer of former FDAA regulations was pending at the conclusion of our review.

or guaranteed loans involving private lending institutions. Each agency establishes its own policies and regulations governing its disaster loan activities, including regulations to implement the Flood Disaster Protection Act of 1973. This act requires flood insurance where appropriate. Our recent report to the Senate Committee on the Budget contains additional details concerning these disaster programs. 1/

Both FmHA and SBA make flood disaster loans subject to the 1973 act's requirement that loans for acquiring, constructing, reconstructing, repairing, and improving privately owned facilities are to be conditioned by the borrowers' agreement to obtain and maintain flood insurance. As noted above and on pages 5 and 6, however, these agencies' loans are governed by the respective agencies' regulations and not by FEMA regulations because FEMA lacks authority to issue such regulations. FmHA made 824 flood disaster loans between July 1, 1974, and July 31, 1979, totaling \$32.1 million. In the same period, SBA made an estimated 93,384 loans totaling an estimated \$772 million. 2/

Once a flood disaster loan is made, FmHA can service (monitor) it through more than 1,750 county offices throughout the United States. SBA, on the other hand, services its loans through about 100 field offices. Although the exact number of flood loans serviced by individual FmHA and SBA offices is not readily available, the difference in the total number of such loans made by each agency is substantial. This difference illustrates workload constraints which SBA says limit its ability to monitor whether borrowers maintain required flood insurance on its flood disaster loans. (See pp. 6 and 7.)

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1/"Farmers Home Administration and Small Business Administration Natural Disaster Loan Programs: Budget Implications and Beneficiaries" (CED-79-111, Aug. 6, 1979).

2/These estimates are derived by taking 40 percent of the total number and 20 percent of the total amount of all SBA physical disaster loans during this period (233,461 loans, \$3.86 billion). SBA provided these estimated percentages but could not give us actual figures within the time allotted to respond to your request.

LEGISLATIVE AND AGENCY  
ADMINISTRATIVE REQUIREMENTS

Effective March 2, 1974, the Flood Disaster Protection Act of 1973 requires that flood insurance be maintained for the duration of Federal direct, insured, or guaranteed loans made for acquisition or construction purposes in flood hazard areas where flood insurance under the National Flood Insurance Act of 1968 is available (42 U.S.C. 4012a). After July 1, 1975, such loans cannot be made in flood hazard areas unless the community participates in the national flood insurance program. The 1973 act, as amended in 1977, does not specify whether Federal agencies can make a second disaster loan to an individual who has not maintained mandatory flood insurance for a previous flood disaster loan. Portions of 42 U.S.C. 4012a state:

"\* \* \* no Federal officer or agency shall approve any financial assistance for acquisition or construction purposes \* \* \* unless the building \* \* \* is \* \* \* during the anticipated economic or useful life of the project, covered by flood insurance \* \* \*: Provided, that if the financial assistance provided is in the form of a loan or an insurance or guarantee of a loan, the amount of flood insurance required \* \* \* need not be required beyond the term of the loan."

The Disaster Relief Act of 1974 stipulates that certain applicants who previously received assistance under that act and failed to maintain required insurance shall not receive subsequent assistance under the act for the uninsured property or part thereof (42 U.S.C. 5154(b)). However, as currently written, this provision refers only to State and local government applicants, as well as certain public or private nonprofit organizations, not to individuals.

In the absence of explicit language in the 1973 act addressing the issue of subsequent flood disaster loans to individuals in the event of a repeat disaster, Federal agencies use various interpretations of 42 U.S.C. 4012a when providing assistance. FEMA regulations (24 C.F.R. 2205 (1978)), for example, do not specify whether an individual is eligible to receive assistance after a second flood if he had not maintained insurance required for previous assistance. When administering flood disaster loans, SBA apparently interprets 42 U.S.C. 4012a strictly. The director of SBA's Office of Disaster Loans told us that SBA denies additional loans to individuals who failed to maintain

insurance. FmHA more liberally allows subsequent loans to such persons.

FEMA guidelines (43 Fed. Reg. 7142 (1978)) on flood insurance requirements specified by 42 U.S.C. 4012a are more precise concerning the procedures which Federal lending agencies should follow to assure that borrowers maintain the insurance throughout the duration of the loans. These guidelines, first issued in 1974 after the 1973 Flood Disaster Protection Act took effect, state that (1) the act's insurance requirement is intended " \* \* \* to conform as closely as practicable to normal commercial lending practices \* \* \*," (2) lenders are expected to see that flood insurance is maintained for the duration of the loans, and (3) lenders have the option of either renewing policies if borrowers do not or calling the loans.

FEDERAL AGENCY PROCEDURES AND CONFORMITY  
TO COMMERCIAL LENDING PRACTICES

Neither FmHA nor SBA uses escrow accounts when administering emergency and physical disaster loan programs. According to representatives of the U.S. League of Savings Associations and the American Bankers Association, private lenders' use of escrow accounts for flood hazard insurance premiums depends on individual State banking laws and local practice. State legislation generally does not require escrow accounts for insurance, and their use by individual lending institutions is optional. Both FmHA and SBA require a cobeneficiary clause on borrowers' flood insurance policies so that the agencies are also to be notified when annual renewal premiums are due--a practice consistent with that of private lenders.

The director of SBA's Office of Disaster Loans cited the policy issue involving interest earned on escrow accounts as one reason why agency procedures do not require them. The issue centers on whether SBA could establish a uniform national policy on paying interest, given the inconsistency in State banking laws. Only nine States require that borrowers receive interest earned on escrow payments, and three other States encourage the payment of interest. In addition, Federal laws do not require that SBA escrow borrowers' insurance payments on direct loans.

The disaster loan director also said that the administrative costs of servicing loans with insurance policies, as well as inadequate staff to service flood loans, are reasons why his agency does not require followup to assure that

borrowers maintain flood insurance. SBA's lack of followup is consistent with its procedures since 1972 for servicing loans with hazard insurance; namely, it relies on borrowers to maintain such insurance. SBA has gathered no data on the extent of flood insurance policy cancellations by disaster loan recipients.

Previously we noted the large estimated number of flood-related disaster loans made since 1975 by SBA as compared to those made by FmHA. (See p. 4.) In addition to this heavy workload, SBA's disaster loan director also pointed out that his agency has been only partially successful during the last several fiscal years in receiving its requested level of loan-servicing staff for all programs. Our recent report on SBA loan programs noted, however, that since 1976 the agency has not filled all the positions authorized by the Congress. 1/

FmHA procedures, on the other hand, not only call for county office followup near the expiration date of the first year's policy but also authorize the agency to pay the borrower's premium for the next year should the borrower fail to do so. FmHA then seeks reimbursement from the borrower. Unlike SBA's, FmHA procedures are consistent with FEMA guidelines. Neither FmHA nor SBA, however, calls a loan for failure to maintain insurance.

Both FmHA and SBA require a cobeneficiary clause in flood disaster policies so that they are to be alerted when borrowers are notified that annual renewal premiums are due. SBA's disaster loan director told us that his agency continues to experience difficulties in receiving notification of premium renewals from insuring agents or through FEMA. Consequently, SBA often does not know if the borrower has renewed. According to the director, SBA seeks such information from FEMA in order to prevent borrowers with lapsed policies from obtaining further SBA loans when a repeat disaster occurs.

A representative of the U.S. League of Savings Associations told us that savings and loan organizations generally place the lending institutions' names on flood insurance policies to protect their financial interests.

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1/"Efforts To Improve Management of the Small Business Administration Have Been Unsatisfactory--More Aggressive Action Needed" (CED-79-103, Aug. 21, 1979, p. 20).

In some cases they require borrowers' names to appear on policies as a condition of the loans. On the other hand, a representative of the American Bankers Association told us that most member banks with which he is familiar prefer to let the borrowers deal directly with insuring agents when flood hazard loans are involved. According to another representative, in such cases banks nevertheless require, as a condition of the mortgages, that the banks be listed on the policies as mortgagees and/or cobeneficiaries. In this way, banks should also be notified when premiums are due. He noted that such practice protects the banks because they have the option of paying the premiums or calling the loans if the borrowers fail to renew.

A representative of the Mortgage Bankers Association of America told us that he could not comment about whether there was any consistency in member banks' practices in terms of taking out flood insurance policies in their names as opposed to requiring borrowers to take out the insurance.

EXTENT OF POLICY CANCELLATIONS AND  
ACTUAL OR POTENTIAL LOSSES TO THE  
GOVERNMENT AND UNINSURED BORROWERS  
UNKNOWN

Although 42 States and 45 percent of U.S. counties have experienced more than one flood or disaster-related flooding between January 1, 1968, and July 28, 1979, none of the agencies we contacted had readily available information needed to determine the actual or potential losses to the Government and to uninsured borrowers who canceled their mandatory flood insurance before paying off their disaster loans. FEMA's data, for example, is not yet refined enough to identify how many of the approximately 16,700 communities containing flood hazard areas and participating in the national flood insurance program have been affected by repeat flooding.

FEMA's Office of Disaster Response and Recovery is trying to refine its county-level data on repeat flooding to more precise community-level information. Using FIA data, the Office has the current capability to identify repeat flood loss claims made in a community since January 1978. FIA likewise cannot determine how many of the approximately 1.6 million policies issued under the national flood insurance program through August 1979 resulted from the 1973 act's requirement for mandatory insurance. FEMA has corrective actions planned during 1980 to identify policies required by that act.

Furthermore, neither FmHA nor SBA maintains centralized information on how many disaster loans requiring flood insurance have been made since the law went into effect in March 1974. During fiscal years 1975-79 (as of July 31), these agencies approved a total of approximately 94,000 flood-related emergency, home- and business-repair loans totaling about \$804 million. 1/ Information on how many of these loans required flood insurance is available at FmHA and SBA field offices and is not routinely reported through their agencies' central management information systems.

As you suggested in your letter, the Government's financial interests in flood disaster loans, as well as the individual taxpayer's eligibility for future disaster assistance, can be jeopardized by the borrower's failure to maintain insurance. How often this occurs, how many loans and borrowers are affected, how much the Government and uninsured borrowers have lost to date, and how large potential losses might be, however, are all unknown.

#### CONCLUSIONS

As noted before, neither the Flood Disaster Protection Act of 1973 nor the Disaster Relief Act of 1974 is explicit about second loans for individuals who have failed to maintain required insurance on previous loans. In the absence of such instruction, FEMA, FmHA, and SBA establish their own policies and regulations on subsequent assistance. Thus, there is some inconsistency in the three agencies' practices. If appropriate legislative and oversight committees feel the need for a more consistent national policy on disaster loans to individuals affected by repeat floods, congressional action is needed.

The Federal Government currently lacks adequate information at the community and borrower levels on the extent of flood insurance policy cancellations, repeat floods, and losses incurred by or likely to accrue to the Government and to uninsured borrowers. FEMA has certain corrective actions planned to remedy this situation. Given the known incidences of repeat flooding at the county level throughout the Nation during the last decade, flood insurance policy cancellation could develop into a financial disaster for uninsured borrowers, particularly in view of SBA's policy of denying them second loans following repeat flooding.

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1/See p. 4.

FmHA has adequate procedures to protect the Government's interest by assuring that flood insurance is maintained where required. SBA practices, however, appear less than adequate. The agency does not have contingency procedures similar to FmHA's, which allow it to pay the insurance premium if the borrower fails to renew.

SBA should be monitoring borrowers' flood insurance to protect the Government's investment in such loans. Revising agency procedures to require such monitoring could reduce the likelihood of borrowers canceling insurance and would make SBA policy consistent with FEMA guidelines and FmHA practices. Lack of monitoring procedures could be justified only if SBA determined that the administrative costs of monitoring loans would substantially exceed the Government's actual or potential uninsured losses.

Current SBA staffing levels apparently place major constraints on the agency's ability to adequately service existing loans in many of its program areas. Nevertheless, the agency's policy of relying on individual borrowers to maintain required flood insurance does not adequately protect the Government's substantial investment in SBA flood disaster loans to date.

RECOMMENDATIONS TO THE ADMINISTRATOR,  
SMALL BUSINESS ADMINISTRATION

We recommend that the Administrator (1) determine the extent of flood insurance cancellation by disaster loan recipients since the Flood Disaster Protection Act of 1973 took effect, (2) examine the writeoffs of uncollectable loans since that time due to repeat flooding, and (3) estimate the annual costs of monitoring SBA flood disaster loans. We also recommend that unless the costs of loan servicing substantially exceed actual or potential uninsured losses, the Administrator revise agency procedures to require that each flood disaster loan threatened by the borrower's failure to renew be serviced annually.

We further recommend that if the agency revises its procedures, the Administrator adopt contingency provisions similar to FmHA's which would permit SBA to pay the borrower's insurance, should he fail to do so, and to seek reimbursement from the borrower.

AGENCY COMMENTS AND OUR EVALUATION

FEMA, FmHA, and SBA officials who provided oral comments on a draft of this report expressed general agreement with our findings and conclusions. In commenting on our recommendations to the Administrator, Small Business Administration, the director of the Office of Disaster Loans noted that even if SBA revises its procedures as we have recommended, the fundamental problem of inadequate loan-servicing staff in the field will remain.

The SBA disaster loan director also pointed out that our recommendation to have SBA adopt procedures allowing it to pay the insurance renewal premium if the borrower does not might actually be a disincentive to the borrower to renew, resulting in a situation which could, in his opinion, be counterproductive to the objectives of the Flood Disaster Protection Act of 1973. While we recognize the possibility that agency payment of borrowers' renewal premiums might be a disincentive, we also believe that FmHA's approach to protecting the Government's investment in flood disaster loans and seeking reimbursement from the borrower is still preferable to SBA's approach of not servicing those loans threatened by borrowers' failure to renew.

The SBA's disaster loan staff indicated that our recommendation to examine policy cancellations appears feasible. However, the staff stated that examining loans that are uncollectable due to repeat flooding and estimating costs of disaster loan servicing may be extremely difficult because of (1) the possibility that there may be factors in addition to the repeat flood which caused an uncollectable loan to be written off and (2) the difficulty of computing or isolating costs of flood loan servicing from all other loan-servicing activities. Although we believe such information is important for a properly administered program, the limited scope of our review did not include an assessment of these potential difficulties.

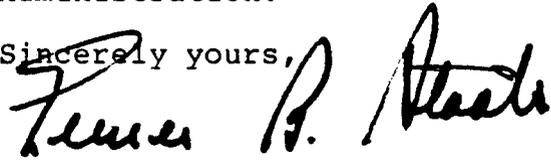
RECOMMENDATIONS TO THE SUBCOMMITTEE

We recommend that the subcommittee, in conjunction with the appropriate legislative committee, examine whether there is a need for a more specific or uniform national policy governing subsequent loans to individuals who fail to maintain flood insurance required by a previous loan. Should such a policy be necessary, legislation will need to be introduced to amend either 42 U.S.C. 4012a or the Disaster Relief Act of 1974, as amended.

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As arranged with your office, this report will be released 7 days after the issuance date unless you publicly release its contents before then. At that time, we will send copies of this report to the Chairman, Senate Committee on Environment and Public Works; the Chairman, Subcommittee on Housing and Urban Affairs, Senate Committee on Banking, Housing and Urban Affairs; the Chairman, Subcommittee on Housing and Community Development, House Committee on Banking, Finance and Urban Affairs; the Director, Office of Management and Budget; the Director, Federal Emergency Management Agency; the Administrator, Farmers Home Administration; and the Administrator, Small Business Administration.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "James B. Stacks". The signature is written in dark ink and is positioned to the right of the typed name.

Comptroller General  
of the United States