FHFA's New Aim At Lender-Placed Insurance

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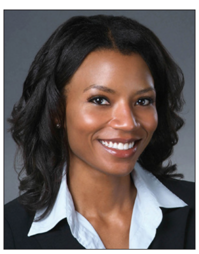

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On March 29, 2013, the Federal Housing Finance Agency (the FHFA) proposed consideration of new regulations for lender-placed insurance. The FHFA requested public input on two issues — sales commissions and reinsurance activities. The FHFA also indicated that it plans a broader review of lender-placed insurance issues.

These FHFA actions follow insurance regulatory efforts in California and New York to impose more stringent limitations. Lender-placed insurance has long-raised regulatory and litigation concerns, and the prospect of new FHFA regulations is an important issue for lenders.

What Is Lender-Placed Insurance?

In real estate lending transactions, standard loan documents obligate the borrower to maintain hazard insurance on real property improvements. If the borrower fails to maintain adequate insurance on that property, the lender is authorized to "force place" insurance to protect the interests of the lender on the property securing the loan. In the area of automobile loans, this type of insurance is typically called "collateral protection insurance" or "CPI."

For loans secured by real property, this type of insurance is typically called "lender-placed insurance" or "force-placed insurance." In either case, the lender purchases the insurance and then adds the premium to the balance of the loan, effectively charging the borrower.

The lender often outsources the administrative effort of tracking which loans have adequate insurance in place. Sometimes, lenders arrange to directly or indirectly receive commissions for placing such insurance.

Lender-placed insurance typically covers only the physical structure of a house and not its contents. This limitation is consistent with typical loan documents as well as with many statutory requirements.

In contrast, typical homeowners insurance will extend protection to both the structure as well as its contents. In addition, such privately purchased homeowners insurance may also provide liability coverage.

Pricing and Regulation

From the consumers' perspective, lender-placed insurance is generally more expensive than "regular," privately placed insurance. Like privately purchased insurance, rates for lender-placed insurance must comply with state insurance regulations, but lender-placed rates are generally higher than regular insurance rates because properties subject to lender-placed coverage usually represent a higher risk.

When a borrower suffers financial distress or lacks equity in a property, he or she may be less inclined to care for and protect the property. Properties subject to a notice of default or foreclosure proceedings often see a significantly higher risk of loss or damage than would be the case for property where the borrower has a large financial interest in the value of that property. The same is true for autos where the borrower is in default or owes more than the car is worth.

Typically, in a lender-placed insurance program, the insurer enters into an agreement with the lender to accept all risks in a loan portfolio for forced coverage where the borrower has not met the loan requirements of maintaining adequate insurance. Given the strong correlation between loan defaults (including failure to insure) and a higher risk of loss, lender-placed insurance rates will generally be higher than rates for regular insurance to reflect that higher risk.

As one exception to this general pricing rule, sometimes, homes in very high-risk zones may not be candidates for private insurance, or the "normal" premium for such property may be unusually high. In general, however, a borrower with lender-placed insurance is typically charged more premium dollars for less coverage.

But in contrast to normal borrower-purchased insurance, a high percentage of the "consumers" of lender-placed insurance never actually pay for coverage. They are in default on their loan obligations and will likely see their car repossessed or their home foreclosed for failure to honor their loan obligations.

In this respect, while forced coverage benefits the borrower by reducing their loan obligations where there is a casualty loss, often, those defaulting borrowers, either by choice, circumstance or both, may not care.

Another common circumstance in lender-placed insurance arises where the borrower purchased insurance but failed to provide evidence of that purchase. This situation often involves the force-placed insurer adding and then canceling coverage for the house or car.

Because lender-placed insurance is almost always more expensive per policy than individually underwritten insurance policies, lawyers and politicians question how much higher the rates should be. Several state regulators have recently pursued claims that the pricing for such insurance is unreasonable.

In October 2012, the California Insurance Department announced an agreement with Assurant, reportedly the nation's largest underwriter of lender-placed coverage, by which the insurer agreed to lower premiums by over 30 percent.

In March of this year, New York Gov. Andrew Cuomo announced a $14 million settlement with Assurant. In April, the New York State Insurance Department's superintendent announced a similar settlement with QBE, the second-largest provider of lender-placed coverage.

These regulatory announcements highlight some of the concerns related to force-placed insurance. The first concern stems from loss ratios. As the regulatory settlements demonstrate, lender-placed insurance is a profitable line of business because the ratio of premiums to losses is favorable to the insurer.

Another concern with force-placed coverage is that the borrower likely never shopped for a better deal. Consequently, the insurer did not have a market incentive to competitively price the individual borrower's policy.

The third common concern can arise from the close financial relationship between lenders arranging coverage and the insurance companies underwriting that coverage. Extra scrutiny is being focused on any financial benefits the lender may receive in connection with lender-placed insurance.

Litigation Exposure

In the 1990s, class action lawyers targeted lender-placed insurance by filing many suits across the country, which mostly resolved via settlements. In recent years, lawyers began filing a new wave of suits. The main arguments against lender-placed insurance relate to commissions, tracking service fees, overinsurance and statutory limitations, notice and disclosure issues, pricing and interest charges and backdating, among others.

Commissions

For decades, some lenders pursued commissions on the insurance they force placed. Sometimes, lenders sought commissions directly, but most realized that insurance laws generally require an insurance broker's license to receive commissions.

The recent insurance regulator announcements argue that even where commissions are lawfully received by licensed brokers, the lender-subsidiary brokers have not done enough work to "merit" the amount of commission paid. Lenders can legitimately argue that but for the actions of defaulting borrowers, no effort would be required by the lender to place insurance.

But class action complaints have alleged that commissions are a form of kickback and are not allowed by loan agreements. In one such class action case in the mid-1990s, plaintiffs argued that the commissions paid to an agency affiliated with Home Savings were unlawful.

Home Savings' efforts to defeat certification and to avoid liability via summary judgment were not successful. The parties reached a settlement that included a permanent injunction limiting commissions. Two decisions upheld commissions paid in this context, Brannon v. Boatmen's National Bank of Oklahoma, 976 P.2d 1077 (Okla. Civ. App. 1998) and Kenty v. Bank One, 92 F.3d 384 (6th Cir. 1996) (abrogated on other grounds).

After resolution of many similar cases in the 1990s and early 2000s, litigants filed new suits against major lenders and force-placed insurers, including Bank of America, JP Morgan Chase, Balboa and QBE.

In one Los Angeles case, there is a pending class certification motion. While there is legal support for receiving commissions, the practical realities of current regulatory scrutiny and class action exposure strongly suggest that the prudent lender should avoid commissions.

Tracking Service Fees

Outsourcing is an important part of modern business operations, and it is not surprising that lenders often outsource the task of tracking whether borrowers are in compliance with the insurance obligations imposed by their loans. Class action plaintiffs' attorneys have argued that lenders should bear the cost of such outsourcing.

The practice, however, has often been for the insurer to provide tracking services as a part of the overall agreement to provide insurance coverage. Where tracking services are provided, the insurer generally monitors the existence of coverage, sends notice letters where coverage has not been established and then arranges to have insurance provided in the absence of borrower-placed coverage.

The class plaintiffs' bar contends that having tracking included in the premium is "wrongful." They generally ignore the facts that most borrowers with lender-placed insurance policies breached their contracts to maintain insurance and signed a written agreement allowing the lender to purchase insurance in the event of a default.

Courts examining this issue have split on whether tracking costs represent a legitimate basis for a defaulting borrower to complain.

For example, in Porch v. General Motors Acceptance Corporation, 642 N.W. 2d 473 (Minn. Ct. App. 2002), the court concluded that the tracking fee was not excessive and was authorized by the loan agreement.

But in Gibson v. World Savings and Loan Association, 103 Cal. App. 4th 1291 (2002), the court allowed plaintiffs to pursue their claims, ruling that the tracking costs included a number of services that exclusively benefited the lender.

Overinsurance and Statutory Limitations

The large majority of states regulate the amount of insurance a lender may require. For example, California Civil Code Section 2955.5 prohibits a lender from requiring insurance that exceeds the replacement cost of improvements on property.

In the 1980s and 1990s, some insurers placed coverage, especially in California, based on the balance of the loan. But a fire insurance policy insures the structure, not the land on which that structure sits.

In California and other parts of the country, the value of the house may be no higher than the value of the dirt itself. Insuring at 60 or 70 percent of the appraised property value thus may result in too much insurance being placed. A challenge for lenders in this area arises when property values fluctuate.

In the area of auto loans, collateral protection insurance issues have been addressed via a model act adopted by the National Association of Insurance Commissioners and adopted by many states in varying forms. These regulations focus less on the value of the collateral but more on other forms of coverage that may serve to benefit the lender but would not benefit a defaulting borrower.

Notice and Disclosure, Pricing and Interest

Early class actions in the area of lender-placed insurance focused on disclosure issues. In some cases, the disclosures did not detail that interest would accrue on the premium advance by the lender to pay for insurance coverage.

In response, lenders generally broadened disclosures to make sure that borrowers have more notice of the consequences of a failure to maintain insurance. Loan documents now universally require that the borrower maintain insurance and universally disclose that coverage will be forced if the borrower defaults.

Backdating

In theory, a lender could identify in real time whether coverage was in place for a given property. In practice, "real time" coverage tracking is complicated by borrowers who ignore letters seeking evidence of insurance coverage, mail delays and other timing factors. Thus, there are gaps in coverage.

Lender-placed insurance programs have historically allowed the insurer to "backdate" coverage to the last known date of coverage to make sure that there are no gaps in insurance for a property. Backdating applies across the board, but generally would not apply where there is a known loss.

If a defaulting borrower abandons a house, it often takes a lender weeks or months to discover that the house has been vandalized or otherwise damaged. Backdating coverage thus provides a benefit to both the lender and the borrower in that coverage for an undiscovered loss can be available, even where there was a coverage lapse.

FHFA Next Steps

The FHFA indicates that it plans a broader review of lender-placed coverage. More litigation and legislation impacting lenders, borrowers and insurers on lender-placed insurance seems certain.

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