NAIC National Association of Insurance Commissioners & The Center for Insurance Policy and Research
CIPR newsletter

Lender-Placed Insurance

By Eric Nordman, CPCU, CIE, Director, Regulatory Services Division and the CIPR

The subject of lender-placed property insurance has become a hot topic in recent months. Perhaps it is our economic challenges, particularly the housing bubble, that has made the subject more pertinent.

◆ Introduction

Lender-placed insurance is also known as creditor-placed insurance or force-placed insurance. It is a property insurance policy placed by a bank or mortgage servicer on a home when the homeowners' own property insurance may have lapsed or where the bank deems the homeowners' insurance coverage insufficient. All mortgages require borrowers to maintain adequate insurance on their property. The requirement in mortgages generally specifies maintenance of "hazard insurance." While hazard insurance is a term used in banking circles, insurers generally refer to homeowners insurance, property insurance or fire insurance.

Borrowers can fail to maintain the required coverage for a variety of reasons—cancellation, a withdrawal by their existing insurer or even just a simple oversight. However, if a property insurance policy lapses or is canceled and the borrower does not secure a replacement policy, most mortgages allow the lender to purchase insurance for the home and "force-place" it. These standard provisions allow the lender to protect its financial interest in the property (its collateral) if a calamity occurs.

◆ How Does Lender-Placed Insurance Work?

The typical mortgage contract requires the borrower to maintain property insurance coverage at all times. The preferred method for this to occur is for the borrower to purchase a homeowners policy and include the lender as an additional insured. When the borrower fails to provide the required coverage, the mortgage contract allows the lender to secure coverage for its interest in the underlying collateral (the home).

The coverage provided by the lender-placed insurer is typically issued under a master policy where the mortgage lender is listed as the named insured and each borrower is considered an additional insured and a certificate holder. In some regards, the coverage is broader than homeowners insurance coverage. In other ways, coverage is more limited. There is no individual underwriting of the risks. Every uninsured property in the mortgage lender's portfolio is eligible for coverage. There are generally no exceptions or exclusions related to the insurability of the property or vacancy.

To keep track of all the information to figure out who has met obligations to maintain property insurance, the mortgage lenders often hire third-party tracking firms. The mortgage lenders delegate certain duties to these firms. Included are responsibilities for tracking the status of applicable property insurance and communicating with borrowers when coverage lapses occur. Sometimes an apparent coverage lapse is simply a communication error.

It is the tracking firm's responsibility to work with the borrower to secure proof that coverage exists, if it does. This process can involve phone calls or letters to advise the borrower that proof-of-coverage is lacking. Many discrepancies are cleared up with a single communication. Others take multiple communications. Some borrowers are found to have a gap in coverage that is filled by the lender-placed property insurance. If the borrower eventually proves that he/she had the applicable coverage, the lender-placed insurer cancels the coverage in its entirety without a charge.

◆ What Are the Issues?

Recent discussion has focused on the rates charged for lender-placed insurance policies and whether insurers and lenders are making excess profits on this line of business. Typically, the lender-placed insurance premiums are higher than the property insurance the borrower could have purchased on his/her own. There is some debate about the order of magnitude of these higher premiums.

In addition to being more expensive, the lender-placed insurance policy also has more limited coverage. For example, the coverage is typically limited to the dwelling and other structures such as detached garages and outbuildings. Personal property (contents) and liability risks are not covered. Moreover, if a borrower does not pay the lender-placed insurance policy premium, he/she could be at risk of foreclosure. Compensation arrangements are also being reviewed.

A key regulatory concern with the growing use of lender-placed insurance is "reverse competition," where the lender chooses the coverage provider and amounts, yet the consumer is obligated to pay the cost of coverage. Reverse competition is a market condition that tends to drive up

(Continued on page 18)

prices to the consumers, as the lender is not motivated to select the lowest price for coverage because the cost is borne by the borrower. Normally, competitive forces tend to drive down costs for consumers. However, in this case, the lender is motivated to select coverage from an insurer looking out for the lender's interest rather than the borrower's interest.

◆ REGULATORY ACTIVITIES

Insurance regulators in California, Florida, New York and Texas recently held public hearings to learn more about these products and practices. There is currently a New York state investigation looking into whether insurers are charging too much and if certain insurance companies are succeeding by what are essentially kickbacks to lenders. A public hearing on lender-placed insurance was held May 17, 2012, at the New York State Department of Financial Services. After the hearing, New York Gov. Andrew M. Cuomo and Superintendent of Financial Services Benjamin M. Lawsky announced that lender-placed insurers operating in New York must lower the premiums they charge. "Our hearings suggest a lack of competition, high prices and low loss ratios, all of which hurt homeowners," Lawsky said in a news release announcing the decision.

The NAIC has also begun reviewing lender-placed insurance, as the practice has become more common in this weakened economy. On Aug. 9, 2012, the NAIC Property and Casualty Insurance (C) Committee and the Market Regulation and Consumer Affairs (D) Committee held a public hearing to further discuss the use of lender-placed insurance and the effect of the practice on consumers. The hearing took place at the NAIC 2012 Summer National Meeting in Atlanta, GA. Presentations, testimony and audio of the public hearing are available on the NAIC website.[1]

There were a variety of presentations and testimony at the NAIC public hearing. Industry proponents described how lender-placed insurance differs from other lines of business. It is not underwritten so that insurers take all risks presented by lenders. Proponents mentioned high concentration of catastrophe risk as an issue, in addition to automatic, continuous and retroactive coverage provisions. Industry proponents stressed that lender-placed insurance is an important risk-management tool for lenders that provides value to homeowners. It helps lenders satisfy regulatory requirements promulgated by federal regulatory agencies and facilitates the secondary market for mortgage-backed securities. It protects federal taxpayers and protects other policyholders and state taxpayers by keeping substantial numbers of policies out of residual market plans. Industry advocates disputed the notion that lender-placed insurance operates in a market characterized by "reverse competition."

Consumer representatives maintained that lender-placed insurance exhibits characteristics of "reverse completion," where the entity selecting the insurer is not the entity paying for the product. They suggested that there were unnecessary placements and inadequate disclosure to consumers regarding such transactions. Consumer representatives maintained that rates are excessive, as were some ancillary charges to borrowers. They maintained that the rates and charges were based on unreasonable expenses and unreasonable actuarial analysis and assumptions. They complained about sales through surplus lines insurers not subject to state solvency and market regulatory standards. They believe the use of captive reinsurance is a tool to allow lenders or producers to garner additional profits at the expense of borrowers. They asked regulators to look into the use of schedule rating, as well as the introduction of some new rating factors and changes to policy forms favoring lenders. They noted that there were both gaps and overlaps in regulation.

◆ NEXT STEPS

The NAIC public hearing was helpful in informing regulators and attendees about the lender-placed insurance products and people's perspectives about them. The hearing surfaced some differences of opinion regarding the products and their performance in the marketplace. There are some discrepancies contained in the testimony between parties. The Property and Casualty Insurance (C) Committee and the Market Regulation and Consumer Affairs (D) Committee plan to review the testimony, see if the facts line up with what was said and discuss possible next steps.

[1] www.naic.org/committees_c.htm.

NAIC Central Office
Center for Insurance Policy and Research
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197
Phone: 816-842-3600
Fax: 816-783-8175

http://www.naic.org http://cipr.naic.org

The National Association of Insurance Commissioners (NAIC) is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC staff supports these efforts and represents the collective views of state regulators domestically and internationally. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S. For more information, visit www.naic.org.