**Preliminary CEJ Proposal to Ford Foundation: Advocacy on Force-Placed Insurance**

**June 2012**

The Center for Economic Justice (CEJ), a 501(c)3 non-profit organization that advocates on behalf of consumers, seeks financial assistance to continue and expand our work helping mortgage borrowers by stopping mortgage servicing abuses associated with force-placed insurance (FPI). The advocacy project capitalizes on current, though belated, state insurance regulator interest to challenge FPI rates in New York, California, Texas and Florida. If CEJ is successful in reducing rates by just 20% in these states, the most vulnerable borrowers in these states will save over $500 million in insurance fees. CEJ will build on the success and precedent from these four states to reduce excessive rates in other states.

<u>Brief Overview of FPI</u>

FPI, also known as lender-placed insurance, is insurance placed on property serving as collateral for a loan when the borrower fails to maintain insurance on the property or provide evidence of insurance as required by the loan agreement.

FPI is a group credit insurance policy sold to the lender or loan servicer and names the lender or loan servicer as the insured. A FPI policy will generally provide coverage for all loans in the loan portfolio – automatic coverage on any property for which the borrower's voluntary market insurance coverage lapses at the moment the borrower's voluntary coverage ceases to be in-force. The lender or servicer pays the premium for the insurance when the coverage is placed and then bills the borrower for the FPI premium. If the borrower has an escrow account, the premium is deducted from the escrow account or, if the escrow account has insufficient funds to pay the premium, the escrow account is debited and the premium shortfall is added to the borrower's loan. If the borrower does not have an escrow account, the servicer establishes an escrow account, debits the escrow account the amount of the FPI premium and adds that amount to the loan. When the FPI is placed, the borrower is generally named as an additional insured.

FPI coverage provides coverage for properties in the loan portfolio whenever the borrowers' insurance ceases to be in-force – even if the loan servicer fails to discover the lapse in voluntary coverage until after the fact. If, for example, a borrower's insurance policy ceases to be in-force on January 31, and the servicer does not discover the absence of coverage until March 15, the FPI policy has provided coverage for the property as of January 31. When the servicer finally issues the FPI policy, the borrower will be charged from January 31. In circumstances such as this, a borrower may be incurring charges for FPI without knowing it.

FPI is much more expensive than regular, voluntary homeowners insurance--up to ten times more expensive.[1] Because the additional cost of FPI is normally added to a homeowner's mortgage payments, the high cost of FPI can drive a borrower into default or prevent a borrower who is already in arrears from catching-up on missed payments.[2] While there are some legitimate reasons for FPI to cost more than voluntary insurance,[3] most of the difference in cost is unjustified.

Excessive insurance costs also harm mortgage guarantors and investors, including Fannie Mae, because they bear the loss of defaults and the diversion of foreclosure proceeds that go to reimburse servicers for escrow expenses.[4] Stated differently, even if a borrower fails to pay the FPI premiums, the servicer recovers the FPI premiums from the owner of the loan (investor) who is responsible for paying servicer fees off the top of any foreclosure settlement.

The standard measure of consumer benefit for insurance products is the ratio of claims paid on behalf of the consumer to the premiums paid by the consumer – the loss ratio[5]. FPI loss ratios have been very low for the past eight years – the period for which reliable data are available. From 2004 through 2011, insurers issued almost $50 billion in FPI gross written premiums with an average loss ratio of about 25%. This compares to an average homeowners loss ratio over the period of over 60%[6]. The low loss ratios indicate that rates and premiums for FPI are significantly excessive; if the policies were priced to produce a 50% loss ratio, rates and premiums would have been half.

FPI is over-priced because the rates include expenses for loan-servicing activities not specifically related to simply issuing insurance coverage under a group policy as well as commissions to the loan servicer,[7] giving servicers an incentive to impose more FPI, rather than taking less expensive alternatives.

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[1] Jeff Horwitz, Ties to Insurers Could Land Mortgage Servicers in More Troubles, Am. Banker, Nov. 9, 2010.
[2] *See* Fannie Mae Servicing Guide Announcement SVC-2012-04 (Mar. 14, 2012) ("the cost of lender-placed policies may impact the borrowers' ability to reinstate their delinquent mortgage loans."). *See also* Jeff Horwitz, Ties to Insurers Could Land Mortgage Servicers in More Troubles, Am. Banker, Nov. 9, 2010.
[3] Force-placed insurance policies are not subject to underwriting.
[4] *See* Jeff Horwitz, Fannie Seizing Control of Force-Placed Insurance from Banks, Am. Banker, Mar. 6, 2012 (discussing impact on investors and guarantors).
[5] The ratio of incurred losses to earned premiums.
[6] Nat'l Assoc. of Insurance Comm'rs, Credit Life and Credit Accident and Health Insurance Experience Report (average for 2004-2010).
[7] Jeff Horwitz, Ties to Insurers Could Land Mortgage Servicers in More Trouble, Am. Banker, Nov. 9, 2010; Jeff Horwitz, Banks Face Thicket of Force-Placed Threats, Am. Banker, Jan. 18, 2012.

Servicers also outsource insurance tracking and other loan servicing activities to the insurance companies. It is likely that these additional services are underpriced and otherwise subsidized by excessive FPI rates and premiums. As a result, rather than distributing the cost of insurance tracking evenly across the servicer's entire portfolio of loans (all of which probably require insurance), or including the expense as part of the servicer's overhead, the cost of tracking is disproportionately borne by the relatively few homeowners who are charged for FPI.

The task of regulating homeowners insurance, including FPI, is a matter of state law, pursuant to the McCarran–Ferguson Act.[8] While most FPI is sold by admitted carriers subject to some oversight of rates and policy forms, some FPI is sold by surplus lines insurers whose rates and policy forms are not subject to approval by state insurance regulators. California and New York are currently investigating servicers' insurance practices,[9] but most states have been unwilling to address problems with FPI. The lack of interest from state insurance regulators, self-dealing by industry participants, and the absence of competition in the market for FPI has allowed servicers and insurers to turn this product into a cash-cow despite the threat it poses to homeowners.

A significant event affecting FPI was the settlement between state attorneys general and mortgage servicers, which included standards for FPI. Unfortunately, the standard for cost is only that rates be "commercially reasonable." This is not a standard found in state insurance regulation and is almost certainly inadequate to drive down the price of FPI to an actuarially adequate, but not excessive level.

Another significant event is the March 2012 Fannie Mae announcement of changes to its servicer guidelines in an attempt to reduce the cost of FPI.[10] These changes need to be translated into actuarial and insurance-regulatory standards to achieve substantial price reductions for borrowers with FPI.

<u>CEJ's Leadership Role and Unique Capabilities on FPI</u>

CEJ's activity on FPI has had a significant impact to date.

- Working on the NAIC creditor-placed insurance model act in the mid 1990's
- Pushing insurance regulators to collect data on FPI in the early 2000's
- Presenting reports to insurance regulators on the overcharges of FPI starting in 2006
- Identifying problems with the regulation of FPI to Congress during the debate over creation of the Consumer Financial Protection Bureau

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[8] 15 U.S.C. §§ 1011-1015.
[9] Jeff Horwitz, Flurry of Subpoenas Raises Force-Placed Stakes, Am. Banker, Jan. 27, 2012; Jeff Horwitz, California Aiming to Lower Force-Placed Insurance Premiums, Am. Banker, Mar. 14, 2012.
[10] Fannie Mae Servicing Guide Announcement SVC-2012-04 (Mar. 14, 2012).

- Educating and advising the CFPB on FPI
- Providing assistance and technical expertise on FPI to state-based consumer organizations, such as the Neighborhood Economic Development Advocacy Project in NY.
- Testifying before Congress on problems with the regulation of FPI.
- Identifying problems with FPI to the Federal Insurance Office as the sole consumer member of the Federal Advisory Committee on Insurance.
- Developing coalitions with and providing technical advice on to national organizations on FPI, including the NCLC, CFA.
- Testimony before the New York Department of Financial Services on FPI.

CEJ is uniquely qualified to address rate issues associated with FPI because of Birny Birnbaum's 20 years of experience working on credit-related insurance issues and the various loan products with which credit-related insurance is sold:  mortgages, auto loans, credit cards and other unsecured consumer loans.  Birny has been accepted as an expert on economic and actuarial issues for credit-related insurance rates in numerous administrative and judicial proceedings, including a recent class action alleging overcharges for FPI in Florida.

Financial assistance will enable Birnbaum to travel to the key states to participate in administrative proceedings to challenged FPI rates and will enable CEJ to fund an attorney with experience in administrative law to:

- Prepare legal and administrative briefs to challenge FPI rate and form filings in New York, California, Texas and Florida;
- Serve as legal counsel during administrative hearings challenging FPI rate and form filings, including preparation of required briefs, presentation of Birnbaum as a witness and cross examination of industry witnesses; and
- Perform state-by-state research in other states to identify the actions needed for an administrative challenge to FPI rates and policy forms;

In addition, Birnbaum and the attorney will network with local organizations to develop these local organizations' capacity and capability to monitor and challenge unfair and overpriced FPI and other credit-related insurance products.  CEJ will also increase its advocacy before federal banking regulators as these regulators – the CFPB in particular – develop mortgage servicing rules with FPI provisions.