Statement of Birny Birnbaum

on behalf of

The Center for Economic Justice, The Consumer Federation of America, United Policyholders, The Center for Insurance Research, The National Fair Housing Alliance and The National Consumer Law Center (on behalf of its low-income clients)

Before the Senate Committee on Banking, Housing and Urban Affairs Subcommittee on Economic Policy

"Implementation of the Biggert-Waters Flood Insurance Act of 2012: One Year After Enactment."

September 18, 2013

Chairman Merkley, Ranking Member Heller and Members of the Subcommittee, thank you for the opportunity to speak about impact of the Biggert-Waters Act on the availability and affordability of flood insurance. My name is Birny Birnbaum and I am Executive Director of the Center for Economic Justice (CEJ). CEJ is a non-profit organization advocating on behalf of consumers on insurance, credit and utility issues. I have been asked to talk about force-placed flood insurance, a topic on which I have worked for many years as an insurance regulator, consumer advocate and consulting economist. My comments are presented on behalf of the Center for Economic Justice[1], the Consumer Federation of America[2] United Policyholders,[3] the Center for Insurance Research[4], the National Fair Housing Alliance[5] and the National Consumer Law Center (on behalf of its low-income clients)[6].

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[1] The **Center for Economic Justice** is non-profit consumer organization advocating on behalf of consumers on insurance, credit and utility issues. www.cej-online.org

[2] **Consumer Federation of America** is an association of nearly 300 nonprofit consumer organizations established in 1968 to advance the consumer interest through research, advocacy and education. www.consumerfed.org

[3] **United Policyholders** is a non-profit 501(c) (3) organization whose mission is to be a trustworthy and useful information resource and an effective voice for consumers of all types of insurance in all 50 states. www.uphelp.org

[4] **The Center for Insurance Research** is a non-profit consumer organization providing an independent voice for reform in debates about insurance, banks, financial services companies and related public policy issues around the nation. www.centerforinsuranceresearch.org

[5] Founded in 1988, **The National Fair Housing Alliance** works to eliminate housing discrimination and to ensure equal housing opportunity for all people through leadership, education and outreach, membership services, public policy initiatives, advocacy and enforcement. www.nationalfairhousing.org

[6] Since 1969, the nonprofit **National Consumer Law Center**® (NCLC®) has worked for consumer justice and economic security for low-income and other disadvantaged people through its expertise in policy analysis and advocacy, publications, litigation, expert witness services, and training. **www.nclc.org**

1. What is Force-Placed Insurance?

Federally-regulated lending institutions may not make, increase, extend, or renew any loan secured by improved real estate in a Special Flood Hazard Area (SFHA), as determined by the Federal Emergency Management Agency (FEMA), unless the improved property serving as collateral for the loan is covered by a minimum amount of flood insurance.[7]

Federal law also provides for force-placement of flood insurance in the event the borrower fails to maintain the required amount of flood insurance coverage.[8] The law places the responsibility on the lender / servicer to determine if a lapse in required flood insurance has occurred and to notify the borrower of such lapse in coverage prior to force-placing flood insurance.[9]

Among other responsibilities, a mortgage servicer is also required, through its servicing agreement with the owners of the mortgage loan, to ensure that required flood insurance coverage on the properties serving as collateral for the loan is in-force. This requirement involves two distinct activities – tracking insurance on loans being serviced and placing insurance when the borrower fails to maintain the required insurance coverage. The insurance placed by the servicer under these circumstances is called lender-placed flood insurance or force-placed flood insurance (FPIF). FPIF protects the lender's collateral in the event the borrower fails to maintain insurance protecting the collateral and enables the servicer to comply with federal requirements.

This division of responsibilities – insurance tracking for the servicer, provision of FPIF coverage under the master policy by the insurer – is well recognized in regulatory requirements and industry practice. For example, in the cover letter to an FPI rate filing in Florida earlier this year from the largest writer of force-placed insurance (FPI), American Security Insurance Company (ASIC) wrote:[10]

> Any type of real estate loan involving a commercial or residential structure requires the borrower to keep sufficient insurance coverage in force to satisfy the lender's interest should the structure (collateral) be destroyed or damaged. In order to make sure this requirement is met, most lenders have a department which keeps track of all the insurance policies covering properties for outstanding loans. If borrower provided coverage is cancelled or expired, the lender begins sending a series of follow-up letters to the borrower reminding the borrower of his obligation to keep insurance in force. If the borrower fails to comply, the lender will request issuance of the policy.

[7] 42 USC § 4012a(b)
[8] 42 USC § 4012a(e)
[9] 42 USC § 4012a(e)
[10] Filing No. 13-04125 with Florida Office of Insurance Regulation

1.1 Ensuring Continuous Insurance Coverage

Mortgage lenders and servicers are required to ensure that borrowers in SFHAs have continuous flood insurance coverage. To ensure there is no lapse in flood coverage, servicers purchase FPIF policies from insurers. The FPIF insurance policy sold to the servicer is a group insurance master policy. Group insurance means that the policy covers a group of properties and not just a single property like the homeowners insurance policy purchased by a borrower. A master policy means that the policy covers all eligible properties and, as a property becomes eligible for coverage, a certificate of coverage for the individual property is issued under the master policy.

The FPIF policy provides that coverage begins on any property in the servicer's covered mortgage loan portfolio at the instant that the borrower's voluntary policy ceases to provide the required coverage. This provision is called automatic coverage. The FPIF policy provides coverage, for example, if the borrower's voluntary flood insurance policy is canceled by the borrower or the NFIP, or lapses because of non-payment of premium. The FPIF policy provides coverage whenever the borrower's required insurance fails to remain in-force – even if the servicer or its vendor do not discover this failure of insurance coverage for days or weeks after the borrower's policy coverage has ended. The FPIF group policy covers all properties in the servicer's loan portfolio and provides coverage as needed.

When a lapse in coverage is discovered on a property in the mortgage loan portfolio, the FPIF insurer is instructed to issue a certificate of coverage retroactive to the date and time the borrower's coverage ceased to be in-force along with correspondence to the borrower on behalf of the servicer that such insurance has been issued and the charges for the FPIF has been added to the borrower's escrow account. The correspondence informs the borrower that the FPIF coverage will be canceled if the borrower provides the required evidence of insurance coverage. This process is largely automated and conducted by a single vendor providing insurance tracking services and FPIF insurance.

The FPIF insurance company bills the servicer on a periodic basis for all the insurance provided. In most instances, the servicer, in turn, assesses FPIF charges to individual borrowers, removes funds from the borrower's escrow to pay for the FPIF premium, debits the borrower's escrow if there are insufficient funds to pay the premium, or establishes an escrow account if one does not exist and debits the new escrow account for the amount of the FPIF premium. Again, while this is a servicer responsibility, some or all of these activities are performed by the FPIF insurance company or vendor on behalf of the loan servicer under a contract with the servicer.

If the borrower provides evidence that there was no lapse in required insurance coverage, the FPIF insurance company will refund the premium paid by the servicer and the servicer will refund the FPIF amounts charged to the borrower's loan.

1.2 FPIF GAP

Because almost all voluntary flood insurance is provided by the NFIP and because NFIP coverage is capped at a maximum amount of $250,000 for a residential structure, FPIF coverage is force-placed not only when a borrower is required to maintain flood insurance and has no flood coverage, but is also force-placed when the borrower has insufficient voluntary flood coverage in place. When a borrower has purchased a voluntary flood insurance policy, but the coverage provided by that policy is less than the amount of coverage required by the servicer, the servicer will force-place FPIF in the amount of the difference between the required amount of flood coverage and the amount of voluntary flood coverage. This excess FPIF is sometimes referred to as FPIF GAP.

1.3 Servicer Recovers FPIF Premiums Even In Event of Foreclosure

The mortgage servicer recovers the FPIF premium it has paid to the FPIF insurer, even in the event that a borrower defaults and there is a foreclosure or short sale because the FPIF premiums are paid by the owner of the loan (the investor) to the servicer out of the proceeds from the foreclosure or short sale.

1.4 Blanket FPIF Policies – No Servicer Charges to Individual Borrowers

In the most common type of FPIF program the servicer pays a premium to the FPIF insurance company and then assesses FPIF charges on individual borrowers. However, there is no statute or regulation requiring a servicer to charge a borrower for FPIF. In fact, there are FPIF products for which the servicer does not assess a separate charge to borrowers.

Under a typical FPIF program, the premium charges to the servicer are based on coverage issued under the FPIF master policy as directed by the servicer to the FPIF insurer. If all borrowers maintained required insurance, no coverage would be issued under the FPIF master policy and the servicer would not be charged a premium by the FPIF insurer. Under a blanket FPIF program, the FPIF coverage is based on the amount of outstanding loan balance at the end of the month, regardless of how many borrowers, if any, have a lapse in required voluntary insurance. With a blanket FPIF program, the servicer does not assess a separate FPIF charge to specific borrowers, but spreads the cost of the blanket FPIF coverage over the entire loan portfolio.

1.5 The NFIP's FPI Flood Product is Not Used

The NFIP offers a force-placed insurance product, called the Mortgage Portfolio Protection Program (MPPP).[11] The NFIP Manual states,

> When a mortgagee or a mortgage-servicing company discovers, at any time following loan origination, that there is no evidence of flood insurance on a property in a Special Flood Hazard Area (SFHA), then the MPPP may be used by such lender/servicer to obtain (force-place) the required flood insurance coverage. The MPPP process can be accomplished with limited underwriting information and with special flood insurance rates.[12]

MPPP rates are far higher than voluntary NFIP flood insurance rates. The chart below, with NFIP voluntary insurance rates and MPPP rates by rate category, shows MPPP rates are six times greater than voluntary NFIP rates for some rate categories.[13]

The MPPP is not used by mortgage servicers because the MPPP does not provide the automatic coverage of FPIF that servicers require in order to ensure continuous coverage.

Comparison of NFIP Single Family Rates to MPPP Rates

Rate Category	***NFIP Single Family***	***MPPP***
Emergency Program Building	$0.76	$4.32
Emergency Program Contents	$0.96	$4.36
A Zones Building to $60,000	$0.76 to $0.81	$4.32
A Zones Building, 60,000 to $250,000	$0.77 to $0.37	$2.19
A Zones Contents to $25,000	$0.96	$4.36
A Zones Contents, $25,000 to $100,000	$1.16 to $1.38	$2.10
V Zones Building to $60,000	$0.99 to $1.08	$6.43
V Zones Building, 60,000 to $250,000	$1.94 to $6.11	$6.43
V Zones Contents to $25,000	$1.23	$6.04
V Zones Contents, $25,000 to $100,000	$2.81 to $3.31	$6.04
A99 Zones Building to $60,000	$0.96 to $1.08	$1.12
A99 Zones Building, 60,000 to $250,000	$0.25 to $0.41	$0.67
A99 Zones Contents to $25,000	$1.46 to $1.65	$1.49
A99 Zones Contents, $25,000 to $100,000	$0.45 to $0.60	$0.60

[11] http://www.fema.gov/media-library-data/20130726-1912-25045-6307/10_mppp_may2013.pdf
[12] NFIP Manual, May 1, 2013, at pages MPPP 1-2.
[13] NFIP Manual, May 1, 2013 at pages Rate 1-2 and pages MPPP 1. Voluntary rates are from Table 2A Regular Coverage – Pre FIRM Construction Rates. Rates are expressed as annual cost per $100 of coverage.

2. FPI Premium Have Quadrupled Since 2007

Mortgage servicers place FPI not only for flood coverage, but also for hazard coverage, when a borrower's voluntary homeowners insurance lapses. Insurers selling FPI report their experience to state insurance regulators annually in the Credit Insurance Experience Exhibit supplement to Statutory Annual Financial Statements. The data are not broken out separately for FPI flood versus FPI hazard. While the data reflect the experience of the largest writers of the market, some insurers writing FPI have failed to submit required CIEE reports. I estimate the CIEE data reflect about 90% to 95% of the total FPI market.

The CIEE data show huge increases in gross written premium (GWP), net written premium (NWP) and earned premium (EP)[14] from 2004 through 2011 and continued high premium levels in 2012. The data also show that the ratio of claims paid to premiums collected by FPI insurers has been very low – averaging about 25%.[15]

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[14] Gross written premium is the total amount of premium charged to servicer policyholders on coverage issued in a particular year before any refunds. Net written premium is the total amount of premium charged to servicer policyholders on coverage issued in a particular year after refunds for cancellations. Earned premium is the premium associated with exposures during a particular year. For example, if coverage was issued on July 1 with an annual premium charge of $5,000 and assuming the coverage was not canceled and refunded, the gross and net written premium would be $5,000. The earned premium would be six months of the annual policy – from July through December of the year – for a total of $2,500 in the year the coverage was issued and $2,500 in the following year.

[15] Paid loss ratio equals dollars of claims paid in a particular year divided by net written premiums in that year. Earned loss ratio equals incurred losses in a particular year divided by earned premiums in that year. Incurred losses are the insurer's estimate of the ultimate amount of claim dollars that will be paid on coverages issued – exposures – in that year. Paid loss ratio is a cash flow measure, while incurred loss ratio is generally a better measure to evaluate the reasonableness of rates.

FPI Nationwide Experience, 2004-2012

Year	GWP	NWP	EP	Paid LR	Incurred LR
2004	$1,485	$796	$807	33.5%	33.1%
2005	$1,832	$919	$850	40.4%	53.5%
2006	$2,163	$1,074	$988	29.5%	29.0%
2007	$3,058	$1,647	$1,402	16.0%	20.5%
2008	$4,000	$2,209	$1,999	20.1%	23.3%
2009	$5,181	$3,049	$2,641	16.0%	20.7%
2010	$5,915	$3,223	$3,248	15.7%	17.3%
2011	$5,692	$3,450	$3,256	22.5%	24.7%
2012	$5,115	$2,870	$3,187	30.5%	30.8%
2004-12	$34,442	$19,238	$18,378	22.4%	25.3%

2.1 FPI Market Dominated by Two Insurer Groups

At least 90% of the FPI premium is written by just two insurers – Assurant and QBE. Assurant and QBE provide FPI and insurance tracking services to the largest mortgage servicers. Assurant alone provides tracking and FPI for about 70% of all outstanding mortgages.[16] The remaining FPI premium is written primarily through managing general agents who administer FPI and insurance tracking to the remaining thousands of community banks, credit unions and small lender/servicers.

[16] Assurant Earnings Call Transcript, 2013 Q2 in which Assurant reports tracking 35 million loans – about 70% of the roughly 50 million mortgage loans outstanding. http://seekingalpha.com/article/1573552-assurant-inc-aiz-management-discusses-q2-2013-results-earnings-call-transcript

2.2 FPI Premiums are Far Greater Than Those for Voluntary Insurance, but Loss Ratios Are Lower

FPI premium charges are significantly higher than voluntary insurance premium charges for the same property. Assurant has testified that FPI premiums average about twice those of voluntary premiums,[17] but there are numerous examples of FPI premiums being three, four or more times greater than voluntary insurance premiums. Insurers selling FPI argue that the higher premium charges are justified:

- Lack of individual underwriting, take-all-comers means FPI is much riskier than homeowners insurance for which the voluntary insurer can underwrite and reject individual properties.
- FPI exposures are concentrated in catastrophe-prone areas and, consequently, more susceptible to catastrophe losses.
- FPI expenses are greater than expenses for homeowners insurance because of the special activities associated with administering an FPI policy.
- FPI expenses are greater than expenses for homeowners because many or most FPI coverages are canceled before the full term of coverage.

If these arguments are true, we would expect to see higher loss ratios for FPI than voluntary homeowners insurance. With average FPI premiums twice that of average homeowners insurance, the same percentage for expenses produces twice as many expense dollars. We would not expect twice as many expense dollars for FPI than for homeowners since there is no individual property underwriting – which means no expenses for property inspection, obtaining credit histories, CLUE (claims history reports), obtaining information from the policyholder about the amount and types of coverages as well as other acquisition expenses not found with FPI.

If we assume FPI poses greater risk and, consequently, produces greater claims and the expense percentage of FPI is less than the expense percentage of homeowners – even with the lower FPI expense percentage producing more expense dollars per covered property – we would expect that claim payments for FPI would be a greater percentage of premium than they are for homeowners insurance. Stated differently, based on the industry explanation for higher FPI rates, we would expect higher FPI loss ratios than homeowners loss ratios. And we would also expect greater volatility in FPI loss ratios than homeowners loss ratios if FPI is more susceptibility to catastrophe events.

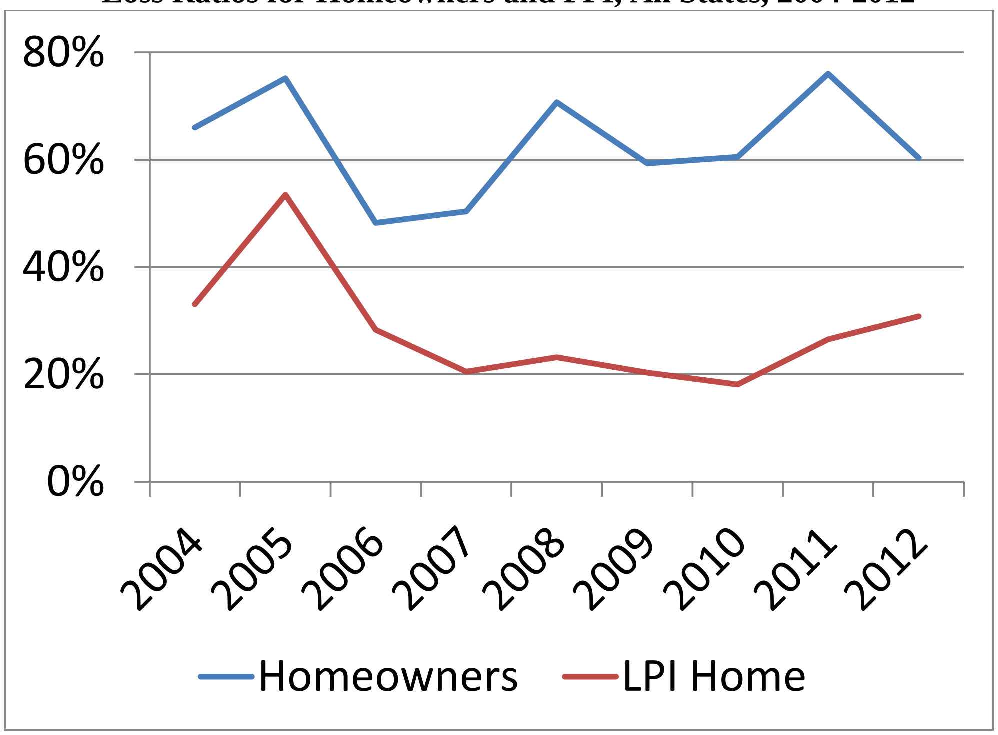
[17] See presentation of John Frobose of Assurant at http://www.naic.org/documents/committees_c_120809_public_hearing_lender_placed_insurance_presentation_frobose.pdf

The loss ratio results from 2004 through 2012 show FPI loss ratios have been far less than homeowners loss ratios.[18]

Loss Ratios for Homeowners and FPI, All States, 2004-2012

Year	Homeowners	FPI Home
2004	66.0%	33.1%
2005	75.2%	53.5%
2006	48.2%	29.0%
2007	50.4%	20.5%
2008	70.7%	23.3%
2009	59.3%	20.7%
2010	60.5%	17.3%
2011	75.4%	24.7%
2012	60.4%	30.8%
2004-2012	63.0%	25.3%

Loss Ratios for Homeowners and FPI, All States, 2004-2012



[18] Data Sources: LPI Home, NAIC Credit Insurance Experience Exhibit data compiled by Birnbaum. Homeowners 2004-2011, *NAIC Report on Profitability by State by Line in 2011*; Homeowners 2012, compilation by Birnbaum of State Page data provided by NAIC. The NAIC does not endorse any calculations performed on data it provides.

The table below shows that in Florida – the state with the greatest catastrophe risk and the largest amount of FPI premium – FPI loss ratios were far less than homeowners loss ratios in years with and without catastrophe events. The table also shows homeowners and FPI loss ratios for all states except Florida. Again, the FPI loss ratios are far below the homeowners loss ratios. Of particular note are the years 2011 and 2012. While the homeowners loss ratio jumped in 2011 because of major catastrophe events, the FPI loss ratio remained low in 2011. And in 2012, the year of Superstorm Sandy, despite flood being covered by FPI but not by homeowners insurance, the FPI loss ratio remained far below the homeowners loss ratio.

Homeowners and FPI Loss Ratios, Florida Only and All States Ex Florida, 2004-12

	FL HO	FL FPI	All State Ex FL HO	All States EX FL FPI
2004	303.0%	75.2%	52.2%	28.0%
2005	153.6%	102.5%	60.2%	47.9%
2006	32.6%	29.6%	58.7%	28.9%
2007	25.6%	11.4%	63.0%	22.2%
2008	33.9%	10.6%	86.6%	26.7%
2009	38.4%	11.7%	72.5%	24.7%
2010	38.1%	7.2%	72.5%	23.1%
2011	35.9%	9.9%	90.8%	32.6%
2012	31.6%	13.3%	72.2%	40.3%
2004-2012	61.4%	13.6%	70.9%	30.0%

3. Reverse Competition in FPI Markets Leads to Excessive Charges to Borrowers

Reverse competition describes a market structure in which consumers/borrowers exert little or no market power over prices. Instead of competing for individual consumers, insurers compete for the entities with the market power to steer the ultimate consumer to the insurer. Insurers compete for the servicer's business by providing considerations to the servicer, with the cost of such considerations passed on to the borrower. Greater competition for the lender's business leads to higher prices of credit-related insurance, including FPI, to the borrower. This form of competition, which results in *higher* prices to consumers, is called reverse competition.

3.1 Consumers Are Especially Vulnerable to Excessive FPI Charges

The incentives and potential for excessive FPI charges are great. Consumers do not request the insurance, but are forced to pay for it. The cost of FPI is much higher than a policy the borrower would purchase on his or her own. Servicers have financial incentive to force-place the insurance because the premium includes commission and other consideration for the servicer.

Borrowers are vulnerable to excessive charges for FPI because the borrowers / consumers exert no market power in the setting of these rates. In addition, there is no downward market pressure on rates; the vendors/insurers offering FPI do not compete on the basis of price, but on the basis of services provided to the lender and compensation and other considerations provided to the lender or its affiliates.

Fannie Mae is a government-sponsored enterprise that purchases mortgages originated by others. Fannie Mae is the largest single owner of mortgages in the United States and contracts with mortgage servicers to service the tens of millions of mortgage loans Fannie owns. Fannie pays a fee to mortgage servicers for each mortgage loan serviced. In addition, when a mortgage owned by Fannie goes into default and the mortgaged property is foreclosed, Fannie pays any outstanding FPI premium due on the defaulted loan to the servicer. In a 2012 request for proposal for insurance tracking and FPI, Fannie Mae also describes the problem with unreasonable expenses included in FPI premium charges.

> After extensive internal review, Fannie Mae believes that current Lender Placed Insurance costs are not market competitive and can be improved through unit price reductions and fee transparency to the benefit of both the taxpayers and homeowners.
>
> Current Situation
> Fannie Mae's current Lender Placed Insurance situation is as follows:
>
> 1. Homeowners are required to maintain voluntary hazard insurance on Fannie Mae insured properties.

2. Lender Placed Insurance must be acquired by mortgage Servicers when a property is no longer eligible for Voluntary Insurance, or when the Servicer cannot obtain proof of adequate Voluntary Insurance from the homeowner, irrespective of whether or not that homeowner is current or delinquent on the loan.

3. The cost of Lender Placed Insurance is higher than the cost of voluntary hazard insurance. Homeowners are billed for the Lender Placed Insurance premiums. However, if the homeowner does not pay the premium (for example, if the property has already been vacated), then Servicers pass on the premium costs to Fannie Mae.

4. Servicers are responsible for providing tracking services, per Fannie Mae Guidelines. Many large Servicers have chosen to outsource the Insurance Tracking and associated administrative process to third parties, the largest of which are affiliated with Lender Placed Insurers.

5. Lender Placed Insurers often pay commissions/fees to Servicers for placing business with them. The cost of such commissions/fees is recovered in part or in whole by the Lender Placed Insurer from the premiums, which the Servicers pass on to Fannie Mae.

6. The existing system may encourage Servicers to purchase Lender Placed Insurance from Providers that pay high commissions/fees to the Servicers and provide tracking, rather than those that offer the best pricing and terms to Fannie Mae. Thus, the Lender Placed Insurers and Servicers have little incentive to hold premium costs down. In addition, Fannie Mae is often paying twice for Insurance Tracking services; once via the servicing fee that Fannie Mae pays to Servicers, and again via the Lender Placed Insurance premiums, since those premiums may include or subsidize the costs of tracking services (to the extent that insurers are providing such services).

In appropriate Circumstances, Lender Placed Insurance is necessary and important to the preservation of Fannie Mae assets. However, much of the current Lender Placed Insurance cost borne by Fannie Mae results from an incentive arrangement between Lender Placed Insurers and Servicers that disadvantages Fannie Mae and the homeowner.

3.2 Unreasonable Expenses

Because of reverse competition, borrowers are charged excessive FPI amounts because of unreasonable expenses included in the FPI premiums paid by the mortgage servicer to the FPI insurer. To compete for servicer business, FPI insurers must provide considerations to the lender. This cost of these considerations – payments by the FPI insurer to the servicer or expenditures by the FPI insurer to subsidize the servicer's cost for non-FPI activities – inflate the FPI premium beyond the reasonable costs of providing the insurance. Unreasonable expenses included in FPI rates include:

- Tracking/Servicing Activities Unrelated to the Provision of FPI
- FPI Commissions
- Captive Reinsurance Administrative Costs
- Affiliate Transactions at Above-Market Prices

3.2.1 Tracking and other Servicer Activities

Table 1 provides a list of FPI-related activities and identifies the activities as associated with servicing a portfolio of loans versus the issuance and administration of the FPI master policies and individual property coverages.

Although most of the activities in Table 7 are servicing activities, most or all of these activities are typically performed by the FPI vendor for the servicer. Some of these services may be billed separately from the FPI premium, but some portion of the FPI insurer's expenses are for performing servicer activities not a part of the provision of FPI. Such expenses are unreasonable to include in FPI premium charges to borrowers.

Table 1
FPI-Related Servicing and Insurance Activities

Activity	Servicing vs. Insurance
Tracking Insurance	
Loading Insurance Information into Database	Servicing
Contacting Borrowers, Problems with Insurance	Servicing
Customer Service Borrowers Insurance Evidence	Servicing
Contacting Insurers/Agents Insurance Evidence	Servicing
Placing Insurance	
Notifying Insurer to Issue Binder or Policy	Servicing
Issuing Temporary Binder	Insurance
Determining Coverage Amount	Servicing
Servicer Payment to Insurer	Insurance
Billing Borrower for FPI Premium	Servicing
Setting up Escrow when necessary for FPI	Servicing
Refunds to Servicer	Insurance
Refunds to Borrower	Servicing
Issuing Permanent Policy	Insurance
Customer Service about Insurance Placement	Servicing
Customer Service about Borrower Refunds	Servicing
Customer Service about FPI Coverage	Servicing
Customer Service about FPI Claims	Insurance

3.2.2 Commissions to Servicer-Affiliated Producers

Testimony at the 2012 New York Department of Financial Services hearing on FPI revealed that "commissions" paid to servicer-affiliated producers are not justified by any service provided by these producers and represent a kickback to the servicer for placing the FPI. When asked what activities the servicer-affiliated producers perform to justify the commissions, the responses included:

- Soliciting FPI providers
- Reviewing FPI form letters and other documents
- Third-party broker commissions are commonplace
- Broker commissions are an accepted and approved practice
- FPI broker commissions are similar to those in other lines of insurance
- Manage the FPI rating program
- Manage the FPI vendor relationship
- Quality review of the FPI vendor
- Commissions are a cost of doing business

The classic role of the insurance producer is to help the policyholder determine her insurance needs and shop the market for the insurance product that meets the policyholder's needs while seeking the most competitive price for the product. Such activities simply do not exist in FPI because there are only two national providers of the necessary package of insurance and related services and there is no price competition among the insurers. Soliciting new business consists of asking typically two vendors for proposals – and such activity is a rare event for most servicers.

Reviewing FPI form letters and other communication templates is the servicer's responsibility. A servicer-affiliated producer performing such review is performing servicer activity which should not be compensated for through FPI insurance premiums.

The fact that third-party broker commissions are commonplace or a standard industry practice in FPI or other lines of insurance is no justification for such commissions in the FPI market. There have been a variety of standard industry practices by servicers and insurers that were unfair and abusive to consumers – and which were not justified by virtue of many servicers or insurers engaging in the same practice. In the servicing realm, recent settlements between states and servicers have identified a number of unfair industry practices, such as robosigning foreclosure documents. In the insurance realm, steering of business based on contingent commissions, unfair use of retained asset account and abusive sales of financed single premium credit insurance, were industry standard practices, to name a few.

Other justifications cited by industry witnesses –managing the FPI vendor relationship and quality review of the FPI vendor – are responsibilities of the servicer and, to the extent the servicer-affiliated producer is performing these activities, the commissions to these producers represent a kickback of the FPI premiums to subsidize servicer activities.

In summary, industry witnesses have provided no justification for any FPI commissions to servicer-affiliated producers. Fannie Mae's new policy – to not reimburse servicers for any portion of FPI premiums paid as commission to servicer-affiliated producers – provides further evidence that no commissions to servicer-affiliated producers are warranted.

3.2.3 Captive Reinsurance

Captive reinsurance arrangements – in which the FPI insurer reinsures a portion of FPI business with a reinsurance company owned or affiliated with the servicer – are simply profit-sharing mechanisms designed to provide additional considerations to the servicer. These arrangements serve no substantive risk management purpose and, consequently, serve no purpose for the consumers/borrowers of FPI.

The arrangements should be prohibited because they create a conflict of interest between the servicer and the borrower. By having a financial interest in the price and placement of FPI through a captive reinsurance program, the servicer has a glaring conflict with the interest of the borrower for lower-cost FPI. Testimony of industry witnesses – "we can see that there might be a perception of a conflict, but it does not affect our practice" – does not address or eliminate the actual conflict of interest. The person who has a conflict of interest does not eliminate the conflict simply by saying, "I'm not affected by these financial incentives."

Regardless of whether the captive reinsurance arrangements are prohibited, the expenses associated with administering the arrangements should be excluded from FPI rates because these expenses provide no benefit for the borrower. The administrative expenses for captive reinsurance arrangements are likely substantial; the 2011 American Security Insurance Company statutory annual statement shows dozens of such arrangements.

3.2.4 New York DFS Settlement with Assurant, Balboa and QBE

In October 2011, the New York Department of Financial Services (NYDFS) launched an investigation into the force-placed insurance industry and conducted public hearings in May 2012. The NYDFS investigation revealed[19]:

- The premiums charged to homeowners for force-placed insurance are two to ten times higher than premiums for voluntary insurance, even though the scope of the coverage is more limited.

[19] April 5, 2013 letter from Superintendent Benjamin Lawsky to other state insurance regulators at http://www.dfs.ny.gov/about/press2013/Force-Placed_Letter.pdf

- The loss ratios for force-placed insurance seldom exceed 25 percent. Nevertheless, rate filings made by insurers with DFS reflected loss ratio estimates of 55 to 58 percent.

- Insurers and banks have built a network of relationships and financial arrangements that have driven premium rates to inappropriately high levels ultimately paid for by consumers and investors.

- Force-placed insurers have competed for business from banks and mortgage servicers through "reverse competition": i.e., rather than competing for business by offering lower prices, insurers have created incentives for banks and mortgage servicers to buy force-placed insurance with high premiums by enabling banks and mortgage services, through complex arrangements, to share in the profits associated with the higher prices.

The Consent Orders with Assurant, QBE and Balboa included requirements for minimum loss ratio standards and for rate filings to ensure those standards are met. The Consent Orders also contained specific prohibitions, including:

- The FPI insurer shall not issue FPI on mortgaged property serviced by a servicer affiliated with the FPI insurer.
- The FPI insurer shall not pay FPI commission to a servicer or entity affiliated with the servicer.
- The FPI insurer shall not engage in captive FPI reinsurance agreements with affiliates of the servicer.
- The FPI insurer shall not pay contingent commissions based on underwriting profitability or loss ratios.
- The FPI insurer shall not provide free- or below-cost outsourced services to servicers, lenders or their affiliates.
- The FPI insurer shall not make any payments to servicers, lenders or their affiliates in connection with securing business.

On April 5, 2013 New York Superintendent of Financial Services Benjamin Lawsky wrote to other state insurance regulators describing the New York DFS investigation and settlements and urging the other state regulators to utilize the settlement provisions as a template for the states to use "to help root out the kickback culture that has pervaded the force-placed insurance industry and lower rates for hard-working homeowners."[20]

[20] http://www.dfs.ny.gov/about/press2013/Force-Placed_Letter.pdf

4. Other Problems with FPI Flood: Excessive Retroactive Billing and Unnecessary Placement

4.1 Excessive Retroactive Billing

Mortgage servicers are responsible for tracking insurance coverage on the loans they service. When there is a lapse in a homeowner's insurance coverage, the servicer, typically through an insurance tracking vendor, notifies the force-placed insurer. It is the servicer's responsibility to identify lapses in insurance and notify homeowners of these lapses in a timely fashion.

Regulatory requirements and industry practice make clear that that insurance tracking is a responsibility of the mortgage servicer. Among other things:

a. Federal law requires federally regulated or insured lenders / servicers to monitor loans for the continuous presence of required flood insurance on properties located in a Special Flood Hazard Area[21] and federal regulation requires mortgage servicers to provide notices in specified time frames before charges for hazard FPI and prohibits placing FPI if a borrower has an escrow account on her loan and payment of premium will keep the voluntary policy in force.[22]

b. Notices to borrowers regarding required hazard or flood insurance are sent on mortgage servicers' letterhead; and

c. Fannie Mae has determined that insurance tracking is a servicer responsibility whose costs should not be included in FPI charges to borrowers.

Mortgage servicers purchase FPI coverage from insurers through a master policy covering all properties serving as collateral for serviced loans. The master policy provides automatic coverage if and when the borrower's voluntary hazard or flood insurance coverage lapses and that coverage comes into force the instant the voluntary insurance coverage lapses.

Once a lapse in voluntary coverage is discovered by the servicer and FPI coverage is issued under a FPI master policy, the FPI insurer charges a premium to the servicer. The servicer, after sending required notices to affected borrower and failing to receive evidence of voluntary insurance, charges the borrower for FPI. Servicers charge borrowers for FPI at some point after the lapse in coverage, but charge for coverage beginnings at the date of the lapse. Consequently, servicers retroactively charge borrowers for the coverage that was automatically in-force the instant the borrower's voluntary hazard or flood insurance coverage lapsed.

[21] 42 U.S.C. § 4012a (e)
[22] Regulation X (12 C.F.R.) §§ 1024.34, 1024.37.

It is not unreasonable that the servicer (or insurance tracking vendor) may not instantly discover a lapse in coverage, resulting in retroactive charges for a short period of time--perhaps up to 60 days from the lapse. ***It is unreasonable, however, for a servicer to fail to discover a lapse in coverage for an extended period of time, fail to notify the borrower in a timely fashion, and to then retroactively charge for lengthy periods of time.*** A 60-day period gives the servicer or vendor sufficient time to discover a lapse in coverage and notify the before imposing any FPI charges. If the servicer fails to identify the lapse in coverage within this reasonable period of time, the servicer – not the borrower – should bear the responsibility for the cost of the FPI.

4.1.1 An Example of Excessive Retroactive Billing for FPI Flood

On January 30, 2012, Mr. and Mrs. Leghorn[23] were notified by their servicer that temporary FPI flood coverage had been placed for a 90-day period beginning on December 12, 2009. This notice arrived ***more than two years*** after the alleged lapse in coverage. On March 6, 2012, the servicer charged the Leghorns for FPI flood coverage for the full year from December 12, 2009 to December 12, 2010 – almost 27 months after the lapse in coverage and almost 15 months after the coverage had expired, but only 36 days after the notice of problems with evidence of required insurance.

The servicer then sent a notice the next day, March 7, 2012, to the Leghorns stating that it required evidence of flood insurance for the period from December 12, 2010 through December 12, 2011. Thirty days later, on April 6, 2012, the servicer charged the Leghorns for FPI flood for the period December 12, 2010 through December 12, 2011 – almost 16 months after the lapse in coverage and almost four months after the coverage had expired. Both of these charges were unreasonable because the charges were made long after 60 days from the date of lapse of the voluntary flood policies and long after the Leghorns could make use of the information in the required notices

Retroactive charges for extended periods of coverage are unfair to borrowers for at least two reasons. First, the lengthy retroactive charges render the notice requirements for FPI meaningless. The purpose of the notice requirements is to empower the borrower to take action to avoid FPI charges. When a borrower receives the FPI notices long after she can take any action to avoid the FPI charge, the notice is meaningless. Second, a lengthy retroactive charge means that the servicer has failed to do a reasonable job of tracking voluntary insurance coverage. Since tracking is the servicer's responsibility, it is unfair for the servicer to charge the borrower for the servicer's failure.

[23] See complaint in *Leghorn, et al v. Wells Fargo Bank, N.A.*, Case No. 4:13-CV-00708-JCS (N.D. Cal.).

4.2 Unnecessary FPI Flood Placement

Servicers have unnecessarily placed FPI Flood on borrowers because of errors in tracking the need for flood insurance and errors in tracking the presence of voluntary flood insurance. Hundreds of Oregonians have been wrongly charged for FPI Flood because of servicer's false determination that the borrower requires flood insurance. Borrowers are forced to challenge the flood determination and have paid hundreds of dollars to hire surveyors and otherwise provide evidence refuting the servicer's flood determination. The number of such challenges in Oregon has more than doubled over the past several years.[24]

A concern raised by Oregonians is that penalty increases in the Biggert-Waters Act for lenders who fail to ensure that homes in SFHAs have flood insurance has caused lenders and servicers to place FPIF in more situations when flood insurance is not actually required.

Another cause of unnecessary FPIF placements is servicers placing FPIF when the servicer could maintain the voluntary flood policy simply by advancing the premium for the borrower who has not had an escrow account or for borrowers with escrow accounts but without sufficient funds to in the escrow account to pay the voluntary flood insurance premium due. When a servicer force-places FPIF, the servicer debits an existing escrow account for the amount of the FPI premium or, in the case of a borrower without an escrow account, creates an escrow account and then debits that new escrow account for the amount of the FPIF premium. Consequently, instead of simply advancing funds to keep the voluntary policy in place, the servicer advances – and charges the borrower – a far greater amount for the FPIF coverage. As discussed below, some help is on the way in 2014 to address this problem

5. The Coming Explosion in FPI Flood

The number of FPIF placements has surely increased this year and will increase even more as the Biggert-Waters Act is implemented. The increase in FPIF placements will be driven by at least three factors. First, many more borrowers will now be required to purchase flood insurance due to new flood maps from FEMA. With more borrows required to purchase flood insurance will come more FPIF placements. Second, the Biggert-Waters-required NFIP rate hikes will raise NFIP premiums for borrowers in a range from significant to massive. As NFIP premiums become unaffordable and borrowers are unable to maintain NFIP coverage, servicers will force-place FPIF. Of course, this is no solution for borrowers since FPIF rates are also very high. Third, as lenders / servicers face greater penalties from Biggert-Waters for failing to ensure required flood insurance is in place, servicers will be likely err on the side of too many FPIF placements.

[24] "FEMA, lenders wrongly charge Oregon homeowners flood insurance," April 5, 2013, *The Oregonian* at http://www.oregonlive.com/forest-grove/index.ssf/2013/04/fema_lenders_wrongly_charge_or.html

Borrowers faced with massive flood insurance premium increases are harmed not only because of the added costs to maintain their mortgage loans, but because the value of their property – and their ability to sell their home – is hugely diminished. I estimate, based on a borrower seeing an increase in NFIP premium from $600 to $6,000 annually will lose over $80,000 in home value.[25]

5.1 Important Consumer Protections Not in Force until Mid-2014

In January of this year, the Consumer Financial Protection Bureau promulgated a mortgage servicing rule which requires mortgage servicers to advance the funds for a voluntary insurance policy – instead of force-placed FPI – if the borrower has an escrow account in place and if payment of the voluntary insurance premium will keep the voluntary policy in force. This important provision does not, however, protect those borrowers who pay their insurance premiums directly to the insurer and who do not have an escrow account. This provision comes into force in January 2014.

The Biggert-Waters Act includes a provision requiring all lenders to create an escrow account for flood insurance, if flood insurance is required. That provision does not come into force until mid-2014. Together with the CFPB rule, this requirement for creating an escrow for flood insurance should greatly reduce the placements of FPIF. However, these consumer protections do not address the affordability issues associated with increased NFIP rates.

5.2 Little Consumer Protection for Excessive and Unreasonable FPIF Rates

For many years, the state insurance departments with responsibility to ensure FPIF rates are reasonable and not excessive failed to protect consumers from excessive rates and kickback arrangements between FPIF insurers and mortgage servicers. In recent years, the New York Department of Financial Services has been the leader in identifying and addressing FPI abuses and excessive rates. But, even the NY DFS's fine efforts are focused more on FPI hazard than FPI flood. The settlements between NY DFS and FPI insurers – which include rate filing and minimum loss ratio requirements – do not cover FPI flood. California and Florida are two other states which have taken action to address excessive FPI rates with California obtaining rate cuts of about 30% from FPI insurers. Other states have not taken action to force FPI rate cuts. And the majority of states have approved a new filing by Assurant which allows the servicer to choose the "commission" it wants to receive and increases the rates charged as the "commission" increases. Most state insurance regulators have approved this "pick-your-kickback" filing.

While the CFPB mortgage servicing rule addressed one aspect of unnecessary FPI placements, the rule does nothing to address unreasonable and excessive rates.

[25] The calculation is based on a 30-year mortgage at 5%. With a $600 annual premium, the borrower is paying $50 per month, which supports a loan amount of about $9,300. With a $6,000 annual premium, the borrower is paying $500 per month which supports a loan amount of about $93,000. With the $6,000 annual NFIP premium, a home buyer would be able pay about $84,000 less for the home and still have the same monthly payment as a home purchase with a $600 NFIP annual premium.

5.3 Fannie Mae Direct Purchase of FPI Best Option for Quick Consumer Relief

Earlier this year, Fannie Mae – after issuing a request for proposal in March 2012 – was about to purchase FPI and insurance tracking directly from FPI providers instead of reimbursing servicers. By purchasing the FPI and insurance tracking directly, Fannie would be able to create price competition for its business – and end the reverse competition that drives up FPI rates. Fannie estimated millions of dollars in annual savings to borrowers and taxpayers as a result of the direct FPI purchase program.

Just as Fannie was awarding the contract for the direct purchase FPI and insurance tracking, the Federal Housing Finance Agency (FHFA) – the agency that is the conservator for Fannie Mae and Freddie Mac – directed Fannie ***not*** to go forward. Instead, the FHFA left the existing reimbursement system in place. In March of this year, FHFA issued for comment a proposal that Fannie and Freddie would continue to reimburse servicers for FPI, but would not reimburse certain expenses, including commissions to servicer-affiliated insurance agents and proceeds from servicer-affiliated captive reinsurance agreements. FHFA has not taken action to date to finalize or implement those proposals and the status quo remains in place for FPI and Fannie Mae and Freddie Mac.

Because Fannie and Freddie own or guaranty over half of the mortgages outstanding today, action by Fannie and Freddie to address FPI flood can impact millions of borrowers. Consequently, FHFA is the singular position to address problems with FPI flood by:

1. Allowing Fannie (and Freddie) to implement the direct purchase FPI and insurance tracking program that was ready to go at the beginning of the year;
2. Addressing excessive retroactive billing by refusing to reimburse a servicer (or insurance tracking vendor) for any ***retroactive*** FPI charges for more than 60 days of coverage and for any period of time after 60 days from the lapse in coverage; and
3. Requiring servicers to advance payment for voluntary insurance policies that are at risk of cancellation for non-payment of premium instead of placing FPI, regardless of whether the borrower has an existing escrow account.