

The Consumer Financial Protection Bureau Should Rein in Mortgage Servicers' Use of Force-Placed Insurance

May 2012

The over-use and inflated pricing of force-placed insurance (FPI) by mortgage servicers is a growing problem for both borrowers and investors. Congress recognized this by including ameliorative provisions in the Dodd-Frank Act. Fannie Mae has revised its servicing guidelines in an attempt to address the problem. In addition, the 2012 national settlement between state attorneys general, federal agencies, and the five largest mortgage servicers mandates new practices that should reduce the use of force-placed insurance. But these improvements do not go far enough. They do not extend the same protections to all homeowners and they leave important issues unaddressed. *The Consumer Financial Protection Bureau (the Bureau) should exercise its authority, under Dodd-Frank, the Real Estate Settlement Procedures Act (RESPA), and the Truth in Lending Act (TILA), to require the continuation of existing homeowners insurance where possible, and to end kickbacks in the purchase of FPI where FPI is unavoidable.*

The Force-Placed Insurance Market Is Rife With Abuse

Mortgage companies routinely require borrowers to buy homeowners insurance in case the home securing the mortgage is seriously damaged or destroyed. Sometimes borrowers must also buy wind and flood insurance. FPI, also known as lender-placed insurance, is insurance placed on the borrower's home when the borrower fails to maintain their own insurance policy or provide evidence of insurance as required by the loan agreement.

FPI is a group credit insurance policy¹ 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 with sufficient funds to cover the FPI premium, some servicers will pay the premium from the escrow account. If the escrow account has insufficient funds to pay the premium, some servicers will pay the premium from the

¹ An insurance policy that covers a large group of people or properties, in contrast to a traditional homeowner's policy, which insures only one house.

escrow account and the premium shortfall (escrow deficiency) will be recovered from the borrower's future escrow payments. If the borrower does not have an escrow account, the servicer may establish one, pay the premium from the escrow account, and include the amount of the FPI premium in the escrow account analysis used to determine the borrower's escrow payment. When the FPI is placed, the borrower is generally named as insured in addition to the lender.

FPI 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 automatically 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.² Because the additional cost of FPI is normally added to a homeowner's mortgage payments, the high cost of this type of insurance can drive a borrower into default or prevent a borrower who is already in arrears from catching-up on missed payments.³ The difference in cost, however, is unjustified.

Excessive insurance costs also harm mortgage guarantors and investors, including the Government Sponsored Enterprises (GSEs), such as Freddie Mac and 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 (the 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 “loss ratio”—the ratio of claims paid on the consumer's behalf to the premiums paid by the consumer.⁵ FPI loss ratios have been very low for the past eight years (the period for which reliable data are available). From 2004 through 2010 FPI insurers wrote millions of FPI policies with an average loss ratio of 24.3%.⁶ This compares to an average loss ratio on voluntary homeowners insurance of 61.5% during the same period.⁷ The low loss ratio for FPI

² Jeff Horwitz, Ties to Insurers Could Land Mortgage Servicers in More Troubles, *American Banker*, Nov. 9, 2010.

³ 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, *American Banker*, Nov. 9, 2010.

⁴ See Jeff Horwitz, Fannie Seizing Control of Force-Placed Insurance from Banks, *American Banker*, Mar. 6, 2012 (discussing impact on investors and guarantors).

⁵ The ratio of incurred losses to earned premiums.

⁶ Center for Economic Justice analysis of Nat'l Assoc. of Insurance Comm'rs, Credit Life and Credit Accident and Health Insurance Experience data.

⁷ Nat'l Assoc. of Insurance Comm'rs, Report on Profitability by State by Line in 2010 (2011).

indicates 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 included expenses for loan-servicing activities that go beyond simply issuing insurance coverage to replace the homeowner's policy,⁸ giving servicers an incentive to impose more FPI, rather than taking less expensive alternatives.

Servicers 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, the cost of tracking is disproportionately borne by the relatively few homeowners who are charged for force-placed insurance, rather than distributing the cost evenly across the servicer's entire portfolio of loans (all of which probably require insurance), or treating the expense as part of the servicer's overhead.

Existing Regulation of Servicer Use of Force-Placed Insurance Is Inadequate

The task of regulating homeowners insurance, including FPI, is a matter of state law, pursuant to the McCarran-Ferguson Act.⁹ 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,¹⁰ but most states have been unwilling to address problems with force-placed insurance. The lack of interest from state insurance regulators, self-dealing by industry participants, and the absence of competition in the market for FPI have allowed servicers and insurers to turn this product into a cash-cow despite the threat it poses to homeowners. As a result, it is important that the Bureau exercise its authority over mortgage servicers.

In March 2012, Fannie Mae announced changes to its servicer guidelines in an attempt to reduce the cost of FPI.¹¹ But even if these changes are successful, they will only affect mortgages owned by Fannie Mae.

State attorneys general took a step toward reducing abuses by including restrictions on the use of FPI in their national settlement with the five largest mortgage servicers.¹² Under the settlement, when a borrower who has been paying for a voluntary insurance policy via an escrow account stops making escrow payments, the servicer must advance the cost of the premiums for the voluntary policy *instead* of allowing the policy to lapse and replacing it with a more expensive force-placed policy. Under this rule, servicers will not be allowed to use FPI unless an existing, voluntary policy is cancelled for reasons other than non-

⁸ Jeff Horwitz, Ties to Insurers Could Land Mortgage Servicers in More Trouble, *American Banker*, Nov. 9, 2010; Jeff Horwitz, Banks Face Thicket of Force-Placed Threats, *American Banker*, Jan. 18, 2012.

⁹ 15 U.S.C. §§ 1011-1015.

¹⁰ Jeff Horwitz, Flurry of Subpoenas Raises Force-Placed Stakes, *American Banker*, Jan. 27, 2012; Jeff Horwitz, California Aiming to Lower Force-Placed Insurance Premiums, *American Banker*, Mar. 14, 2012.

¹¹ Fannie Mae Servicing Guide Announcement SVC-2012-04 (Mar. 14, 2012).

¹² See www.nationalmortgagesettlement.com.

payment or the borrower fails to purchase a policy. While this change is a significant improvement, the settlement only applies to mortgages serviced by a limited number of companies.

The Dodd-Frank Act also addresses force-placed insurance by adding several protections to the Real Estate Settlement Procedures Act (RESPA). As amended, RESPA requires servicers to give borrowers proper notice before force-placing insurance, to cancel FPI when the borrower obtains their own policy, and to refund any charges for FPI assessed for periods when both policies were in effect. As part of RESPA, Dodd-Frank's requirements apply to nearly all residential mortgages but Dodd-Frank did not include the much more important provisions of the settlement agreement.

New Regulations Should Promote the Continuation of Existing Homeowners Insurance, Prevent Price Abuses, and Offer Other Key Protections

In addition to implementing the requirements of Dodd-Frank, the Bureau should use its authority under RESPA and TILA to adopt regulations imposing requirements similar to those found in the settlement and Fannie Mae's guidelines to protect the majority of all homeowners.

1) Require servicers to advance the cost of insurance premiums rather than allowing voluntary policies to lapse. The Bureau should require servicers to advance the cost of property insurance premiums on existing, voluntary policies when the borrower stops making payments, rather than force-placing insurance after allowing the existing policy to lapse—regardless of whether the homeowner has been paying the policy through an escrow account. Doing so will substantially reduce the need for FPI.

This rule is consistent with Fannie Mae's servicing guidelines and is authorized by the uniform mortgage contract used by Fannie Mae and Freddie Mac. The rule is feasible, regardless of whether the homeowner pays for insurance through an escrow account, because insurance companies routinely notify servicers when the premiums have not been paid. The standard "lender loss payable" endorsement to homeowners insurance policies calls for the insurer to alert the servicer when the borrower misses a payment.

At that point, the servicer should be required to warn the borrower that, if the required payments are not made, the servicer will begin paying the insurance premium and will bill the borrower for the cost. If the borrower still fails to pay the premium, the lender loss payable endorsement and the standard mortgage contract permit the servicer to keep the policy in effect by paying the premiums.¹³ This protects the homeowner and the investor by avoiding the excess cost of force-placed insurance.

¹³ In the rare event that the homeowner has stopped paying one policy because he or she has purchased a policy from a different company and failed to timely notify the mortgage servicer, the servicer will be creating duplicative coverage by advancing premiums on the old policy. In this circumstance, it would be reasonable for the homeowner to bear the loss by reimbursing the servicer for the advanced (but duplicative) premiums because the duplication was caused by the homeowner's failure to notify the servicer of the change in insurers. But there is no evidence that this situation is anything but rare.

2) Prohibit servicer practices that inflate the cost of force-placed insurance. For situations when FPI is unavoidable, such as when the homeowner's policy is cancelled or cannot be renewed for reasons other than non-payment, or when the homeowner fails to purchase a policy, the Bureau should adopt regulations limiting who servicers may obtain coverage from and the costs servicers may pay. Fannie Mae's guidelines are a good start towards an industry standard that should be mandated for all servicers, with some modifications described below. Directing these regulations at the servicer, rather than the insurer, will enable the Bureau to protect homeowners without regulating the business of insurance. Specifically:

- Servicers must ensure that the FPI carriers they use are filed and admitted in the same state as the insured property.
- Use of excess and surplus lines coverage should be banned. Surplus lines policies do not have the same protections as those from admitted carriers, including review and approval of the policy form and rates and coverage by the guaranty fund. There is no reason for use of surplus lines carriers—such insurance should only be written when the coverage is not available in the admitted market. FPI is available in the admitted market.
- Servicers may not ask homeowners to reimburse any portion of a FPI premium attributable to any commission earned on that policy by the servicer or any related entity, costs associated with insurance tracking or administration, or any other costs beyond the actual cost of the FPI policy premium.
- No servicer or affiliate of the servicer may:
 - accept a rebate, inducement, commission, a policyholder dividend, retrospective premium adjustment, profit sharing, or similar return of premium, or other insurance coverages at inadequate rates from someone providing the servicer with FPI or their affiliate; or
 - accept insurance tracking or any other services from someone providing the servicer with FPI or their affiliate, without paying a fair market price for such services, the cost of which may not be included in the cost of insurance premiums or billed to homeowners.
- The coverage amount on any FPI policy shall be either 100% of the insurable value of the improvements or the last known coverage amount for the borrower's voluntary property insurance policy.
- Neither servicers nor their affiliates should be allowed to provide coinsurance, or any other provision that yields the same result as a coinsurance, to someone providing the servicer with force-placed insurance or their affiliate.

3) Define force-placed insurance as including flood, excess flood, wind-only and excess wind-only insurance. Flood and wind insurance are expensive insurance products sometimes required in addition to standard hazard insurance. Any regulation regarding FPI should protect homeowners from abuses of these products as well.

4) Limit the time period for which a servicer can charge for retroactive coverage. As explained above, the FPI may come into force without knowledge of the loan servicer

or borrower. While automatic coverage is necessary for the servicer to meet investor guidelines and is an important consumer protection, a servicer should not benefit from its incompetence at tracking the presence of insurance. The CFPB should prohibit servicers from charging borrowers for more than 45 days of coverage prior to the date of FPI placement. In this way, the servicer becomes responsible for the FPI premium if the servicer fails to effectively track coverage over an extended period of time.

The Bureau has Authority to Issue These Regulations Under RESPA and TILA

1. Real Estate Settlement Procedures Act (RESPA)

RESPA authorizes the Bureau to “prescribe such rules and regulations, [and] make such interpretations . . . as may be necessary to achieve the purposes of [the Act].”¹⁴ One of the purposes of RESPA is: “to effect certain changes in the settlement process for residential real estate that will result . . . in a reduction in the amounts home buyers are required to place in escrow accounts established to insure the payment of real estate taxes and insurance[.]”¹⁵ The original RESPA was later amended to address mortgage servicing and the administration of escrow accounts. Title 12 U.S.C. § 2605(g) says “If the terms of any federally related mortgage loan require the borrower to make payments to the servicer of the loan for deposit into an escrow account for the purpose of assuring payment of taxes, insurance premiums, and other charges with respect to the property, **the servicer shall make payments from the escrow account for such taxes, insurance premiums, and other charges in a timely manner as such payments become due.**” Accordingly, the Bureau is authorized to make rules regarding the payment of insurance premiums through escrow accounts.

Dodd-Frank added new subsections 2506(k) and (m), which impose restrictions on the use of FPI. The purpose of these new provisions is to ensure that FPI is not imposed unnecessarily or unreasonably and to ensure that costs are reasonable, without intruding on state regulation of insurance. Because RESPA gives the Bureau authority to adopt rules needed to accomplish this purpose, the Bureau has authority to regulate the circumstances under which servicers obtain and impose FPI.

2. Truth in Lending Act (TILA)

Title 15 U.S.C. § 1639(p)(2) authorizes the Bureau to make regulations prohibiting acts or practices in connection with mortgages that the Bureau finds to be unfair or deceptive. Specifically:

The Bureau, by regulation or order, shall prohibit acts or practices in connection with—

(A) mortgage loans that the Bureau finds to be unfair, deceptive, or designed to evade the provisions of this section; and

¹⁴ 12 U.S.C. § 2617(a).

¹⁵ 12 U.S.C. § 2601(b).

(B) refinancing of mortgage loans that the Bureau finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.

This provision “is not limited to acts or practices by creditors, nor is it limited to loan terms or lending practices.”¹⁶ Before authority for implementing TILA was transferred from the Federal Reserve Board (FRB) to the Bureau, the FRB interpreted this provision as authorizing it to issue regulations regarding mortgage servicing.¹⁷ At that time, the FRB looked to the FTC Act for guidance in determining whether practices were unfair or deceptive. There is ample evidence that certain servicer practices regarding FPI are unfair and deceptive. Accordingly, the Bureau has the authority to issue rules regulating servicers’ use of FPI and should do so.

Conclusion

Although FPI has a valid role in mortgage servicing, the Bureau should adopt regulations governing its use in order to eliminate abusive practices. The Bureau should ban kickbacks to servicers and other practices that inflate the cost of FPI premiums and should limit how long a servicer may charge for retroactive coverage. Most importantly, servicers should not be allowed to impose FPI (including wind and flood coverage) on borrowers when they could, instead, advance payments to maintain the borrower’s existing homeowners insurance policy. These changes will extend to all borrowers’ protections that Fannie Mae has incorporated into its servicing guidelines and that the five major servicers have agreed to in their 2012 national servicing settlement.

¹⁶ 73 Fed. Reg. 42,522, 44,529 (July 30, 2008).

¹⁷ *See id.* (announcing Reg. Z § 226.36, which imposes restrictions on certain servicing practices).