Comments of the

Center for Economic Justice[1]

Consumer Federation of America[2]

National Consumer Law Center[3]

Center for American Progress[4]

National Fair Housing Alliance[5]

National Association of Consumer Advocates[6]

Center for Responsible Lending[7]

and NEDAP[8]

To the Federal Housing Finance Agency (FHFA)

Lender Placed Insurance, Terms and Conditions, FHFA No. 2013-N-05

May 28, 2013

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1 www.cej-online.org
2 www.consumerfed.org
3 On behalf of our low-income clients. www.nclc.org
4 www.americanprogress.org
5 www.nationalfairhousing.org
6 www.naca.net
7 www.responsiblelending.org
8 www.nedap.org

The undersigned consumer organizations respond to FHFA's request for comment on proposed practice limitations and broader recommendations regarding lender-placed insurance (LPI).

1. Consumer Groups Support Direct Purchase by GSEs of LPI and Insurance Tracking Services and Support Prohibitions against Kickbacks from LPI Insurers/Vendors to Mortgage Servicers

Reverse Competition Leads to Excessive LPI Charges to Borrowers, Investors and Taxpayers

LPI markets are characterized by reverse competition in which LPI premiums paid by mortgage servicers and LPI amounts subsequently charged to borrowers and investors[9] are inflated because LPI insurers / LPI vendors[10] compete for the servicers' business by providing considerations – kickbacks – to the servicers and including the cost of these considerations in the LPI premiums and LPI amounts charged to borrowers and investors. The extent of the overcharges is demonstrated by the very low loss ratios (claims incurred divided by premiums earned) of LPI compared to loss ratios for homeowners insurance. LPI charges to borrowers and investors are at least twice the reasonable cost of providing LPI.

Servicers with a financial interest in the placement of LPI other than the protection of properties serving as collateral for the serviced loan have an irreconcilable conflict of interest between their interests in maximizing revenue from LPI charges and administering the LPI program in a manner that imposes the least burden on borrowers and investors. Given these conflicts and the financial gains to servicers, it is not surprising that LPI charges to borrowers are unreasonable and excessive.

Excessive LPI charges to borrowers and the government-sponsored enterprises (GSEs) are not only a source of servicer-induced foreclosures, but such excessive charges are also inconsistent with the mission and affordable housing goals of the GSEs.

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[9] "Investors" refers to the owners and/or guarantors of mortgages, who contract with mortgage servicers, including Fannie Mae and Freddie Mac, as well as private owners of mortgages and mortgage-backed securities.

[10] "LPI Insurers / LPI Vendors" refers to the entities, including insurance companies that provide LPI, insurance tracking and other "hazard outsourcing" services, described below. In some instances, the LPI insurer provides the insurance tracking and hazard outsourcing services. In other instances, an affiliate of the LPI insurer provides the insurance tracking and hazard outsourcing services. In yet other instances, the LPI vendor is a managing general agent who provides the insurance tracking and hazard outsourcing services and arranges for the LPI insurance policy. The largest mortgage servicers accounting for the vast majority of all serviced mortgage loans utilize Assurant (LPI insurer is also LPI vendor) and QBE (LPI insurer is affiliated with LPI vendor).

Addressing Reverse Competition: Direct Purchase and Prohibition against Kickbacks

There are two basic approaches to stop the inflated and excessive LPI charges to borrowers and investors. The first approach is for the GSEs and other investors to purchase LPI and insurance tracking services directly from LPI insurers and LPI vendors instead of reimbursing servicers for LPI and paying the servicer for insurance tracking through the servicing fee paid to servicers. This approach brings beneficially competitive market forces into play and will drive down the price of LPI immediately, as was demonstrated by the responses to Fannie Mae's March 2012 Request for Proposal for LPI and tracking services. The benefit of the direct purchase approach is that it harnesses market forces to discipline market participants and aligns the incentives of purchasers and providers.

The second approach is to prohibit mortgage servicers from accepting, and LPI insurers from giving, any form of consideration for the purchase and placement of LPI. Under this approach, a servicer is prohibited from having any form of financial interest in the placement of LPI other than protection of the property serving as collateral for a loan in the servicer's portfolio. This approach includes the two prohibitions cited in the FHFA request for comments – a prohibition on LPI commissions to a servicer-affiliated agent, broker or other affiliated entity and a prohibition against captive reinsurance agreements.

Other prohibitions necessary under approach two would include, but not be limited to, a servicer not accepting any below-cost or free services or cash payments under any guise from the LPI insurer/vendor and a servicer not placing any LPI issued by an affiliate of the servicer.

There are problems with approach two, the most important of which is that it does not change the reverse-competitive market structure and reduce or eliminate the dominant market position of the mortgage servicer. Consequently, LPI insurers / LPI vendors will continue to compete for servicer business by providing considerations to the servicers in new forms that are not explicitly prohibited or even in prohibited forms with the expectation that the occasional penalty for violation is a cost of business.

Another problem with the second approach is that, even if the servicers stopped receiving kickbacks in any manner, there is no guaranty that LPI rates and charges to borrowers and investors would decline. LPI rates are regulated by the states and state insurance regulators must then require LPI insurers to file lower rates. State insurance regulators have a poor track record in this regard and have acquiesced to servicer kickbacks for decades.

Another consideration with the second approach is the need to audit servicers and LPI insurers/vendors for compliance with the prohibited practices. Ensuring compliance will require insurance regulators to examine LPI insurer expenses to a degree of detail that the insurance regulators have not done to date and will require the regulators of mortgage servicers to conduct detailed audits of mortgage servicer revenues and expenses.

FHFA Should Quickly Implement the Fannie Mae Direct Purchase Initiative

The two approaches – direct purchase and prohibited practices – are complementary. The direct purchase approach is clearly the superior of the two approaches because of the harnessing of market forces to protect consumers, investors and taxpayers. Coupling the prohibition against a servicer having a financial interest in the placement of LPI (other than protection of property) with the direct purchase approach provides a comprehensive framework for consumer, investor and taxpayer protection.

The most important, effective and timely action FHFA can take to address LPI overcharges to borrowers and investors is to implement the direct purchase program Fannie Mae had developed throughout 2012 and into 2013. Fannie Mae did a thorough job of researching the LPI market and allowing interested parties to bid for services. Fannie had a vendor in place when FHFA said no. By allowing Fannie Mae to implement the direct purchase program, FHFA will immediately reduce LPI charges to borrowers and investors and introduce beneficial competition into the LPI market.

An additional benefit of immediately implementing the Fannie direct purchase program will be an improvement in the quality of insurance tracking. Currently, 10% to 20% of LPI policies are falsely placed on borrowers who have required insurance. The false placements result in full refunds to borrowers, but during the time between the addition of LPI charges to a borrower's account and a refund credit to that borrower's account, the borrower can suffer significant hardship. Under the current LPI system, servicers have limited incentive to minimize false placements and investors have little or no ability to establish insurance tracking standards of performance. With the direct purchase approach, FHFA can establish insurance tracking standards that bring down false placements of LPI.

The public reasons offered by FHFA for stopping the direct purchase program after a vendor had been selected were a lack of data, a desire for a common approach for Fannie and Freddie, and a desire for an approach that will survive if Fannie and Freddie's role in the mortgage market is phased out. Any data needed by FHFA regarding LPI activities by the mortgage servicers with regard to Fannie mortgages are available from the mortgage servicers or the servicers' LPI vendors. The servicers / LPI vendors are able to provide information on LPI placements by investor/owner as well data on characteristics of the loans and borrowers. While the two LPI vendors who write virtually the entire LPI market may be unwilling to provide this data, FHFA can require the mortgage servicers who service Fannie and Freddie loans to acquire this data from the servicers' LPI vendors.

Immediately implementing the direct purchase LPI program for Fannie will assist FHFA with the other two stated concerns. The direct purchase approach has the potential to reduce charges to borrowers, investors and taxpayers for title insurance and mortgage guaranty insurance as well as LPI. Title and mortgage guaranty insurance markets are characterized by the same reverse competition as LPI markets and have seen routine kickbacks from the providers of title and mortgage guaranty insurance to lenders and servicers. As FHFA develops its common servicing platform (CSP) for Fannie, Freddie and, effectively, the entire mortgage industry, it is essential that a direct purchase capability for LPI and other insurance products be built into the CSP. By having an actual direct purchase program in operation for Fannie, the experience with direct purchase will inform the development of the CSP in a manner that could not occur if there was no operating direct purchase program.

If FHFA wants Fannie and Freddie to use the same approach for LPI, then the simple solution is to add Freddie to the Fannie direct purchase program. It is inconceivable that FHFA would prevent borrows, investors and taxpayers from saving hundreds of millions of dollars annually by preventing Fannie from addressing the problem and forcing Fannie to take the no-action approach of Freddie. Even in the event that the direct purchase program is initially limited to the Fannie portfolio, FHFA would be in a position to monitor the relative performance of the two GSEs with regard to LPI.

Comprehensive Standard to Prohibit LPI Kickbacks to Servicers

We urge FHFA to adopt both a broader and more specific practice standard than proposed for Fannie and Freddie servicers: Servicers and their affiliates are prohibited from having any form of financial interest in the placement of LPI other than protection of the property serving as collateral for loans in the servicer's portfolio. This general prohibition includes, but is not limited to, the following:

a. Servicers and their affiliates are prohibited from accepting any "commissions" or "administrative fees" in connection with the placement of LPI;

b. Servicers and their affiliates are prohibited from entering into any reinsurance agreement with the servicer's LPI insurer;

c. Servicers and their affiliates are prohibited from accepting any cash payment from the servicer's LPI insurer or LPI vendor.

d. Servicers and their affiliates are prohibited from accepting free or below cost insurance tracking, hazard outsourcing or other services from the LPI insurer or LPI vendor. Examples of hazard outsourcing services provided to servicers by LPI insurers and LPI vendors include, but are not limited to, new loan boarding, loss drafts and escrow administration.

e. A servicer is prohibited from placing LPI issued by an insurance company affiliated with the servicer.

In connection with the implementation of the LPI kickback prohibition, we urge FHFA to develop an audit protocol, including data collection requirements, for servicers. We also urge FHFA to actively engage with state insurance regulators to ensure LPI rates are thoroughly reviewed and established at reasonable, but not excessive, levels.

FHFA should also require servicers to advance the cost of insurance premiums on existing, voluntary policies when the voluntary policy would lapse for non-payment of premium by the borrower rather than force-placing insurance after allowing the existing policy to lapse and regardless of whether the borrower has an existing escrow account with the servicer. Doing so will substantially reduce the need for LPI. Such a requirement is consistent with Fannie Mae's servicing guidelines and is authorized by the uniform mortgage contract used by Fannie Mae and Freddie Mac. This will protect both the investor and the homeowner by avoiding the excess cost of force-placed insurance.

2. Description of Lender-Placed Insurance (LPI)

Mortgage loan agreements include a requirement that the borrower maintain insurance to protect the property serving as collateral for the loan and, if the borrower fails to maintain the required insurance or fails to provide required evidence of insurance, the lender, through the servicer, may place insurance on the property serving as collateral for the loan and charge the borrower for this insurance.

Among other responsibilities, the mortgage servicer is required, through its servicing agreement with the owners of mortgage loan, to maintain continuous insurance coverage on the properties serving as collateral for the loan. 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 insurance (LPI) or force-placed insurance. LPI protects the lender's collateral in the event the borrower fails to maintain insurance protecting the collateral.

There are a variety of activities associated with the requirement of servicers to ensure continuous insurance coverage. Most of these activities are the responsibility of the servicer and not the insurance company providing the LPI. Table 1 lists activities associated with the continuous insurance requirement of servicers and whether the activity is the responsibility of the servicer or LPI insurance company.

It is important to distinguish between the entity responsible for the activity in Table 1 and the entity actually carrying out the activity. Servicers typically contract with an outside vendor for most or all of the servicer responsibilities in Table 1 and that vendor is typically the insurance company providing the LPI insurance or an affiliate of the LPI insurance company.

Table 1
LPI-Related Servicing and Insurance Activities

Activity	Servicing vs. Insurance
Tracking Insurance	
Loading Insurance Information into Database	Servicing
Maintaining/Monitoring Insurance Tracking 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 LPI Premium	Servicing
Setting up Escrow when necessary for LPI	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 LPI Claims	**Insurance**

The servicers are responsible for insurance tracking to monitor loans to ensure borrowers are maintaining the required insurance. The voluntary insurance requirements include:

- sufficient coverage amount to repair or replace the property if destroyed;
- cover the relevant perils, including fire, wind and flood, for example; and
- been issued by an insurance company with acceptable financial strength, as measured by a minimum financial strength rating by a credit rating agency.

A mortgage servicer is likely to have LPI policies for normal hazards (such as fire) and for other perils excluded from a standard homeowners policy, such as flood or wind. All residential property insurance policies (homeowners and dwelling fire) exclude flood as a covered peril (or cause of loss) and borrowers in designated flood areas are required by lenders to purchase a flood insurance policy from the federal government's National Flood Insurance Program. In many coastal states, insurers have excluded wind (hurricane) coverage from the standard residential property insurance policy in certain parts of the state and, consequently, borrowers must purchase a wind-only policy from a state-operated insurance program, like the Texas Windstorm Insurance Association.

2.1 LPI is a group master policy

The LPI 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 LPI insurance 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 LPI policy provides coverage, for example, if the borrower's homeowners insurance policy is canceled by the borrower or the insurance company or lapses because of non-payment of premium. To ensure that the property serving as collateral for its loans is always protected by insurance, the LPI 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 LPI group policy covers all properties in the servicer's loan portfolio and provides coverage as needed.

When the insurance tracking vendor notifies the LPI insurance company that there is a lapse in coverage on a property in the mortgage loan portfolio, the LPI insurer issues a temporary binder of insurance 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 binder has been issued and the premium for the LPI has been added to the borrower's loan amount. The correspondence informs the borrower that the LPI 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 LPI insurance.

The LPI insurance company bills the servicer on a periodic basis for all the insurance provided during that period. The servicer then passes along the LPI premium charges to individual borrowers, removes funds from the borrower's escrow to pay for the LPI 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 LPI premium. Again, while this is a servicer responsibility, some or all of these activities are performed by the LPI insurance company or vendor on behalf of the loan servicer.

If the borrower provides evidence that there was no lapse in required insurance coverage, the LPI insurance company will refund the premium paid by the servicer and the servicer will refund the LPI amounts charged to the borrower's loan. The LPI insurance company or vendor typically performs the individual borrower refund activities on behalf of the servicer. Testimony at a recent hearing before the New York Department of Financial Services indicates that 10% to 20% of LPI insurance is flat-cancelled, which means the LPI policy was erroneously placed. False placement results in significant LPI charges to borrowers for some period of time and these improper charges can put borrowers in severe financial stress before the charges are reversed.

2.2 Servicer Recovers LPI Premiums Even In Event of Foreclosure

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

2.3 LPI Coverage is Limited

LPI coverage is that of a dwelling fire policy, typically providing only hazard protection. Coverages typically included in a homeowners policy and generally not included in the LPI policy are liability, theft, personal property and additional living expense (ALE) in the event of a claim. The absence of coverage for personal property and ALE can result in a significant difference in claim costs from a catastrophe event between LPI and homeowners policies.

2.4 LPI Rates and Premium Charges

Unlike individual homeowners insurance, there is no individual underwriting of properties with LPI. Any property in the portfolio is eligible for coverage and the rate for every property is the same, with the exception that, in a few states, LPI insurers use rating territories.

Historically, rates for LPI have historically been very simple because there is no individual underwriting of properties. Rates for LPI insurance are an amount per $100 of coverage. The premium is determined simply by multiplying the rate times the amount of coverage in $100s. If the rate is $1.20 per $100, the premium on a property with $300,000 of coverage is $3,600. In the past couple of years, the large LPI insurers have introduced additional rating factors, including, for example, original loan to balance ratio.

The coverage amount is determined in one of three ways – the coverage amount on the last known voluntary policy, the replacement cost of the property or the unpaid principal balance.

Premium charges for LPI insurance are typically significantly higher – two to three times higher on average – than premium charges for a voluntary homeowners policy, even though the homeowners policy has greater coverage (e.g., for liability, personal property and additional living expense).

3. LPI Markets Are Highly Concentrated and LPI Rates Are Excessive

There has been dramatic growth in the amount of LPI insurance countrywide since 2004 with a quadrupling of gross written premium from $1.5 billion in 2004 to over $5.9 billion in 2010. Table 2 shows the gross, net and earned LPI premium countrywide from 2004 through 2012. Gross written premium is the total amount of premium on coverage issued during the year before refunds. Net written premium is the total amount of premium on coverage issued during the year net of refunds. Earned premium is the premium associated with the coverage in-force during the years and better reflects the coverage exposure than net written premium. The data are compiled from the Credit Insurance Experience Exhibit (CIEE) to the Statutory Annual Statement filed by insurance companies with state insurance regulators. The CIEE was revised, effective with 2004 reporting, to more accurately capture LPI property activities of insurers.[11] The table shows significant differences between gross and net written premiums, indicating a high percentage of LPI premium is refunded to servicers.

Table 2
Gross, Net and Earned LPI Premium, All Companies, All States, 2004 – 2012
($ Millions)

	Gross WP	Net WP	Earned Premium
2004	$1,485	$796	$807
2005	$1,832	$919	$850
2006	$2,163	$1,074	$988
2007	$3,058	$1,647	$1,402
2008	$4,000	$2,209	$1,999
2009	$5,181	$3,049	$2,641
2010	$5,915	$3,223	$3,248
2011	$5,692	$3,450	$3,256
2012	$5,115	$2,870	$3,187
2004-2012	$34,442	$19,238	$18,378

[11] The CIEE is the best source of data on LPI as it is the only data report by insurers that breaks out lender-placed home insurance from other types of insurance, including other types of lender-placed insurance. The CIEE captures over 90% of the LPI market. A few insurers writing LPI have not reported their experience in the CIEE, including American Modern and Zurich, when Zurich was the underwriter for the ZC Sterling Agency before QBE purchased ZC Sterling. If American Modern were included, the additional premium would likely be less than 2% of the reported totals. The Zurich / ZC Sterling data would have added premium primarily in the 2006 to 2008 time frame. In addition the data for then-Balboa Group insurers Meritplan Insurance Company and Newport Insurance Company for 2005 and 2006 are questionable. Meritplan IC reports experience for years 2004, 2005 and 2007 through 2012, but no experience for 2006. Newport IC reports identical experience for years 2005 and 2006.

Table 3 shows that Assurant and QBE/Balboa have historically written almost all LPI premium.[12] The major players historically were Assurant and Balboa. QBE entered the market by purchasing ZC Sterling and, in 2011, QBE purchased the Balboa LPI business from Bank of America.

Table 3
Assurant and QBE LPI Net Written Premium and Market Share, All States, 2004-2012
($ Millions)

	Assurant	QBE/Balboa	Assurant Share	QBE/Balboa Share
2004	$543	$237	68.2%	29.8%
2005	$641	$242	69.7%	26.4%
2006	$851	$210	79.2%	19.5%
2007	$1,219	$418	74.0%	25.4%
2008	$1,640	$563	74.2%	25.5%
2009	$1,745	$1,294	57.2%	42.4%
2010	$1,810	$1,402	56.2%	43.5%
2011	$2,022	$1,419	58.6%	41.1%
2012	$2,186	$666	76.2%	23.2%
2004-2012	$12,658	$6,451	65.8%	33.5%

Figure 1 shows the largest states by percentage of total countrywide LPI premiums from 2004 to 2012. Over the past five years, the largest state for LPI premiums, by far, has been Florida.

[12] In this table, Assurant refers to all the insurance company members of the Assurant group writing LPI home insurance, including American Security Insurance Company, Standard Guaranty Insurance Company, Voyager Insurance Company, American Bankers Insurance Company of Florida and American Reliable Insurance Company. QBE/Balboa refers to LPI business written by Balboa Insurance Company, Meritplan Insurance Company, Newport Insurance Company, QBE Specialty Insurance Company and QBE Insurance Corporation. Data compiled by CEJ.

Figure 1
Top States by Share of LPI Premium, 2004 – 2012

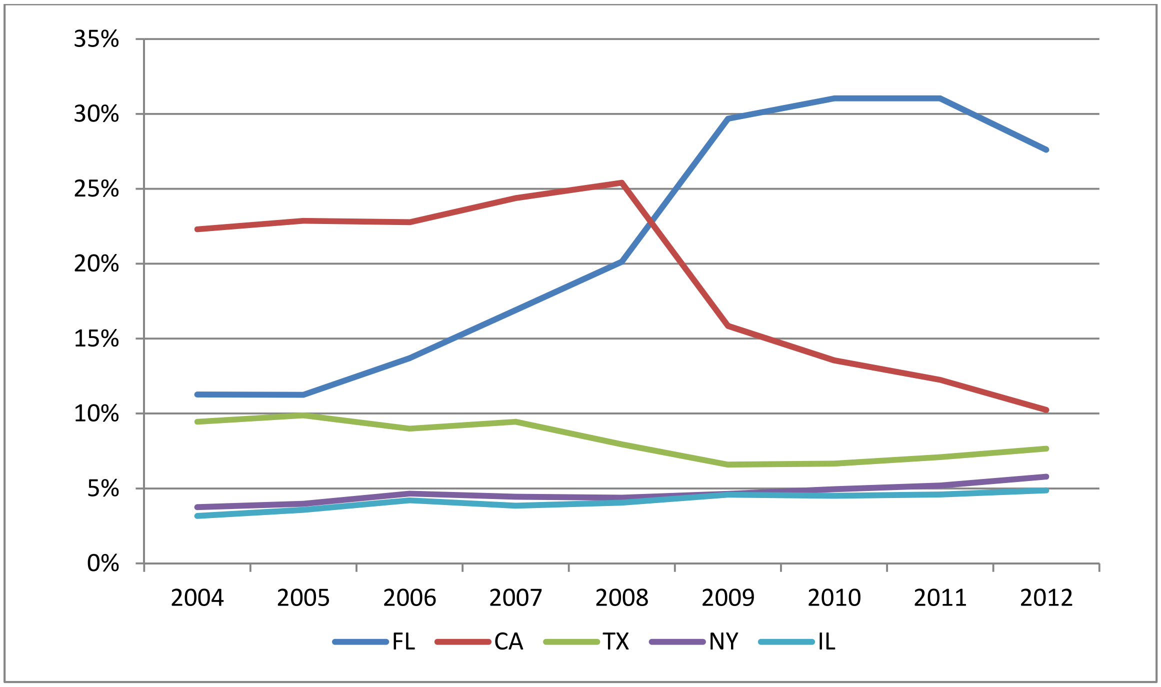

Table 4[13] and Figure 2 show the loss ratios – incurred claims divided by earned premiums – for homeowners insurance and LPI over the past eight years. LPI loss ratios are consistently much lower than homeowners insurance loss ratios, meaning that far fewer dollars as a percentage of premium paid by consumers are returned to consumers in claim benefits for LPI than for homeowners insurance. In testimony before the NAIC, an Assurant representative stated that the average LPI premium is about twice the average homeowners premium[14], despite LPI providing significantly less coverage than a homeowners policy. The LPI insurers argue that higher LPI premiums are justified by the greater risk of LPI compared to homeowners insurance, but if that were the case, we would expect higher risk to be reflected in higher, not lower, loss ratios. The very low loss ratios are consistent with argument that LPI charges to borrowers are inflated because of unreasonable expenses included in those charges.

[13] Loss ratios are incurred losses to earned premiums. Data Sources: LPI Home, NAIC Credit Insurance Experience Exhibit data compiled by CEJ. Homeowners 2004-2011, *NAIC Report on Profitability by State by Line in 2011*; Homeowners 2012, compilation by CEJ of preliminary annual statement state page data by CEJ.

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

Table 4
Loss Ratios for Homeowners and LPI, All States, 2004-2012

Year	Homeowners	LPI 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%

Figure 2
Loss Ratios for Homeowners and LPI, All States, 2004-2012

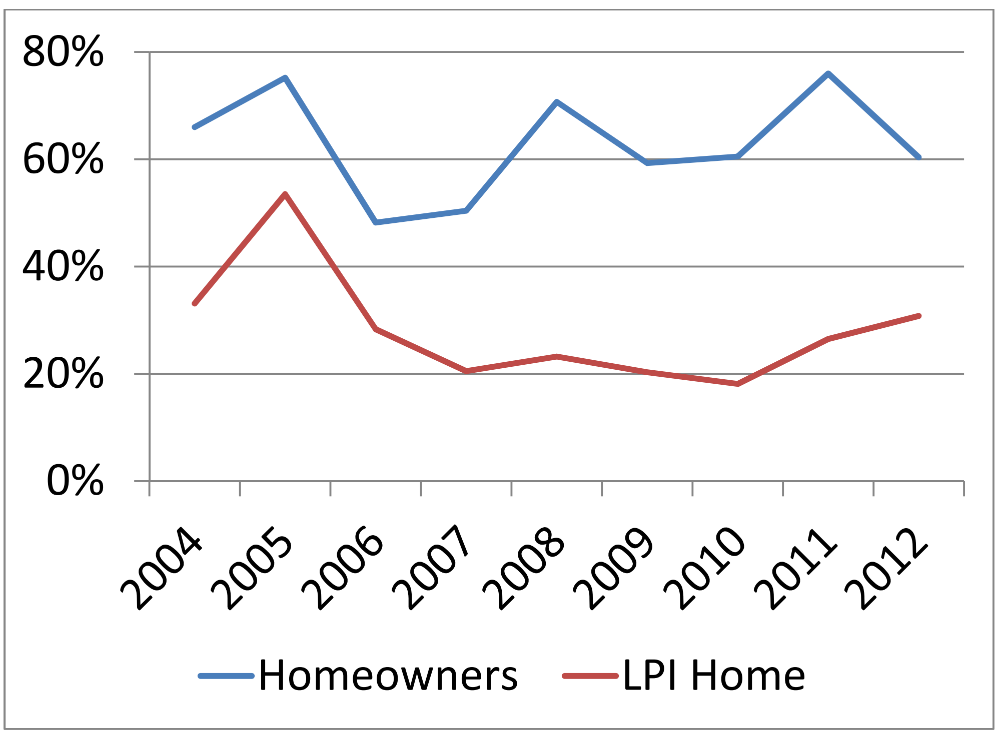

Table 5 shows that in Florida – the state with the greatest catastrophe risk and the largest amount of LPI premium – LPI loss ratios were far less than homeowners loss ratios in years with and without catastrophe events. Table 5 also shows homeowners and LPI loss ratios for all states except Florida. Again, the LPI 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 LPI loss ratio remained low in 2011. And in 2012, the year of Superstorm Sandy, despite flood being covered by LPI but not by homeowners insurance, the LPI loss ratio remained far below the homeowners loss ratio. Tables 4 and 5 refute the argument that LPI rates must be higher than homeowners rates because of greater catastrophe exposure. While the lack of underwriting individual properties may certainly lead to a riskier portfolio, the absence of coverage for contents and additional living expenses certainly reduces the catastrophe exposure of LPI compared to homeowners insurance.

Table 5
Homeowners and LPI Loss Ratios, Florida Only and All States Ex Florida, 2004-12

	FL HO	FL LPI	All State Ex FL HO	All States EX FL LPI
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%

4. Reverse Competition in LPI 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 LPI, to the borrower. This form of competition, which results in *higher* prices to consumers, is called reverse competition.

4.1 Consumers Are Especially Vulnerable to Excessive LPI Charges

The incentives and potential for excessive LPI charges are great. Consumers do not request the insurance, but are forced to pay for it. The cost of LPI 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 commissions and other consideration for the servicer.

Borrowers are vulnerable to excessive charges for LPI 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 LPI do not compete on the basis of price, but on the basis of services provided to the lender and compensation and other consideration 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 LPI premium due on the defaulted loan to the servicer. In a recent request for proposal[15] for insurance tracking and LPI, Fannie Mae also describes the problem with unreasonable expenses included in LPI 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.

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[15] Excerpt in Appendix C

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."

4.2 Unreasonable Expenses

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

- Insurance Tracking Expenses
- Expenses for Activities Unrelated to the Provision of LPI, such as Loss Drafts or Escrow Administration
- LPI Commissions to Servicer-Affiliated Insurance Agents
- Captive Reinsurance Agreements
- Affiliate Transactions at Above-Market Prices

4.2.1 Tracking and other Servicer Activities

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

Although most of the activities in Table 1 are servicing activities, most or all of these activities are typically performed by the LPI vendor for the servicer. Some of these services may be billed separately from the LPI premium, but some portion of the LPI insurer's expenses are for performing servicer activities not a part of the provision of LPI. Such expenses are unreasonable to include in LPI premium charges to borrowers.

As in Table 1, the Fannie Mae RFP draws a clear distinction between insurance tracking and the provision of LPI insurance. The LPI requirements in the RFP are limited to issuance of insurance, settlement of claims under the policy and customer service regarding claims. The LPI critical performance indicators are for speed of unearned premiums refunds, insurance placement and claim settlement. The key performance indicators are claims call answer speed, damage inspection speed, estimated repair cost verification speed and call center abandonment rate.

Expenses for other loan servicing activities, including, for example, insurance tracking, customer service related to insurance tracking and billing borrowers for LPI, are expenses associated with the servicing the entire loan portfolio and are not reasonable to include in LPI premiums charged to 2%-3% of borrowers.

4.2.2 Commissions to Servicer-Affiliated Producers

At the 2012 LPI hearing before the New York State Department of Financial Services, mortgage servicers testified about commissions paid to servicer-affiliated insurance agents (also known as producers). Testimony at this hearing 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 LPI. When asked what activities the servicer-affiliated producers perform to justify the commissions, the responses included:

- Soliciting LPI providers
- Reviewing LPI form letters and other documents
- Third-party broker commissions are commonplace
- Broker commissions are an accepted and approved practice
- LPI broker commissions are similar to those in other lines of insurance
- Manage the LPI rating program
- Manage the LPI vendor relationship
- Quality review of the LPI 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 LPI because historically there were only three national providers of the necessary package of insurance and related services and there is no price competition among the insurers.

Reviewing LPI 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 LPI insurance premiums.

The fact that third-party broker commissions are commonplace or a standard industry practice in LPI or other lines of insurance is no justification for such commissions in the LPI 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 accounts 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 LPI vendor relationship and quality review of the LPI 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 LPI premiums to subsidize servicer activities.

In summary, industry witnesses provided no justification for any LPI commissions to servicer-affiliated producers.

4.2.3 Captive Reinsurance

Captive reinsurance arrangements – in which the LPI insurer reinsures a portion of LPI 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 LPI or the investors.

Table 6 shows information about four captive reinsurance arrangements managed by American Security Insurance Company. The amount of reinsurance premium ceded ranges from about $29 million to over $360 million. Paid losses plus known case (loss) reserves are only 4% to 5% of premium ceded. Even adding the reported amounts for IBNR (incurred but not reported) reserves – reserves for claims the reinsurer does not know about but expects will occur and which, in all four cases, are significantly greater than paid claims plus known reserves – claims plus all reserves are only 10-13% of premium ceded. The captive reinsurance arrangements are very profitable for the servicer's captive reinsurer.

Table 6
American Security IC Captive Reinsurance, Selected Reinsurers
Schedule F, Part 3, Ceded Reinsurance, 2011 Annual Statement
($ 000)

	Pelatis	Banc One	HSBC	Alpine Indemnity (PNC)
Reinsurance Premium Ceded	$30,535	$363,012	$28,686	$34,052
Paid Losses	$692	$7,708	$682	$701
Known Case Reserves	$883	$6,596	$757	$696
Known LAE Reserves	$56	$422	$48	$45
IBNR Loss Reserves	$2,327	$27,476	$2,201	$1,934
IBNR LAE Reserves	$179	$1,853	$132	$151
Paid Losses + Known Reserves	$1,631	$14,726	$1,487	$1,442
Percentage of Premium Ceded	5.3%	4.1%	5.2%	4.2%
Paid Losses + All Reserves	$4,137	$44,055	$3,820	$3,527
Percentage of Premium Ceded	13.5%	12.1%	13.3%	10.4%

Pelatis is affiliated with Select Portfolio Servicing, Inc. BancOne is affiliated with Chase. Alpine Indemnity is affiliated with PNC Financial Services.

The scale of the captive reinsurance agreements is described in the 2012 Assurant 10K SEC Filing. Assurant has four business segments. Assurant Specialty Property is the segment responsible for LPI. The 2012 10K states:

> "The Company utilizes ceded reinsurance for loss protection and capital management, business dispositions, and in the Assurant Solutions and Assurant Specialty Property segments, for client risk and profit sharing."
> ($ Thousands)

	2012	2011	2010	Total
Premiums Ceded	$2,011,211	$2,002,304	$1,882,233	$5,895,748
Policyholder Benefits Ceded	$1,025,890	$501,411	$410,654	$1,937,955
Gain to Policyholders	$985,321	$1,500,893	$1,471,579	$3,957,793

These data from the Assurant 10K show that over the 2010 to 2012 period, Assurant passed almost $6 billion of premium to captive reinsurance companies, but collected just $2 billion in claim payments. The "gain to policyholders" is the $4 billion gain over the period to the servicers or lenders who are the LPI policyholders.

LPI is not only profitable for Assurant's mortgage servicer clients, but very profitable for Assurant. LPI accounts not only for the almost all of the profit for the Assurant Specialty Property Segment of Assurant, but for the majority of overall Assurant profit.

> "Lender-placed insurance products accounted for approximately 71% of Assurant Specialty Property's (ASP) net earned premiums for full year 2012 and 70% for full year 2011. The approximate corresponding contributions to segment net income in these periods were 90% and 100%, respectively."

The 10K reports that ASP accounted for 28.4% and 26.7% of all Assurant revenue in 2012 and 2011, but 56.6% and 58.0% of all Assurant net income, respectively. The ASP return on equity was 25.4% and 27.8% in 2012 and 2011, respectively. The ASP returns on equity were more than twice as great as the returns on equity of Assurant's other business segments.

The captive reinsurance 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 LPI through a captive reinsurance program, the servicer has a glaring conflict with the interest of the borrower for lower-cost LPI. Testimony of industry witnesses at the NY hearings – "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 saving, "I'm not affected by these financial incentives."

Expenses associated with administering the arrangements should be excluded from LPI amounts charged to borrowers because these expenses provide no benefit for the borrower. The administrative expenses for captive reinsurance arrangements are likely substantial; the 2011 and 2012 American Security Insurance Company statutory annual statement show dozens of such arrangements.

4.2.4 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[16]:

- 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.
- 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.

In March and April, 2013, NYDFS entered into consent orders with Assurant, Balboa and QBE regarding LPI practices.[17] The Assurant and QBE Consent Orders included the following findings:

[16] 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
[17] Assurant: http://www.dfs.ny.gov/about/press2013/assur-order-130321.pdf
Balboa: http://www.dfs.ny.gov/about/ea/ea_201304181_balboa.pdf
QBE: http://www.dfs.ny.gov/about/ea/ea_201304181_qbe.pdf

> "The high cost of force-placed insurance, including ASIC's and ABIC's [QBE's] force-placed policies, is due at least in part to relationships between mortgage servicers and their affiliates and payments by force-placed insurers, including ASIC and ABIC [QBE], to such servicers and their affiliates. While servicers choose the force-placed product for their mortgage loan portfolio, the high premiums are charged to homeowners, and in the event of foreclosure, costs are passed onto investors.[18]
>
> Some lenders and/or mortgage servicers have affiliated insurance agencies or brokers that receive commissions from force-placed insurers for services the agencies or brokers purportedly provide. To the extent those agencies or brokers provide any services, most of those services are not ones that insurance agencies or brokers typically provide.[19]
>
> In some cases, ASIC and ABIC pay [QBE has paid] commissions to insurance agencies and brokers that are affiliates of mortgage servicers. Typically, the commissions are ten to twenty percent of the premium written on the servicer's mortgage loan portfolio, a percentage that is in line with standard property and casualty commissions. The evidence from the Investigation indicates that the affiliated agencies and brokers do little or no work for the commissions ASIC and ABIC pay [QBE has paid] them. ASIC, ABIC and their affiliates do [QBE has done] much of the work associated with force-placed insurance, including tracking insurance coverage and communicating with homeowners. These arrangements could create an incentive for mortgage servicers to purchase higher priced force-placed insurance and for mortgage servicers to place more homeowners into force-placed insurance, because their affiliates earn more commissions as premiums increase.[20]
>
> Commissions paid to affiliates of servicers is a form of reverse competition; when insurers compete for servicers' business by offering higher commissions to servicers' affiliates, there is no incentive to reduce force-placed insurance premium rates. Commissions are paid to affiliates of servicers because they are a cost of staying in the market, not for any particular work the affiliates perform.[21]
>
> Empire Fire and Marine and QBE Insurance have paid contingent "profit" commissions to QBE FIRST when loss ratios were kept below a certain figure, which has ranged from 34% to 45.6% -- both significantly below the expected loss ratios Empire Fire and Marine and QBE Insurance filed with the Insurance Department. This creates a troubling incentive for QBE FIRST to keep loss ratios as low as possible. As discussed above, Empire Fire and Marine's and QBE Insurance's loss ratios have consistently been below the figure that triggers the contingent commission."[22]

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[18] Assurant consent order, par. 2; QBE consent order par. 4.
[19] Assurant consent order, par. 4; QBE consent order par. 6.
[20] Assurant consent order, par. 11.
[21] Assurant consent order, par. 12, QBE consent order, par. 17.
[22] QBE consent order, par. 15.

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