

Mortgage Lending Protection: Weaving it all together



By Anne Anderson and Ryan Barber

Goodbye, Status Quo

The subprime debacle and its resultant impact are challenging certain long-standing assumptions about lending, particularly the idea that a cascade of loan defaults is unlikely. With almost one fifth of American homeowners facing negative equity¹ and significant foreclosure², financial institutions worldwide face complications from debt collateralized by real estate.

As a consequence of economic hardship, a growing number of borrowers are either unable or unwilling to maintain insurance for their property. This creates significant financial risk for lenders. Insurance recoveries may be substantially reduced or non-existent in the event a catastrophe such as fire, flood or windstorm damages the collateral property. In addition to the consequence of these traditional perils, lenders may also find themselves exposed to liability in connection with escrow payments for taxes, insurance, or compliance with secondary market requirements such as FHA or VA loan guarantees.

The insurance industry has responded to these issues by offering insurance products that will protect a lender's collateral in the event that borrowers allow coverage to lapse or ultimately default on a loan. The key to effectively implementing this risk strategy is to align the suite of mortgage lending products to respond seamlessly.

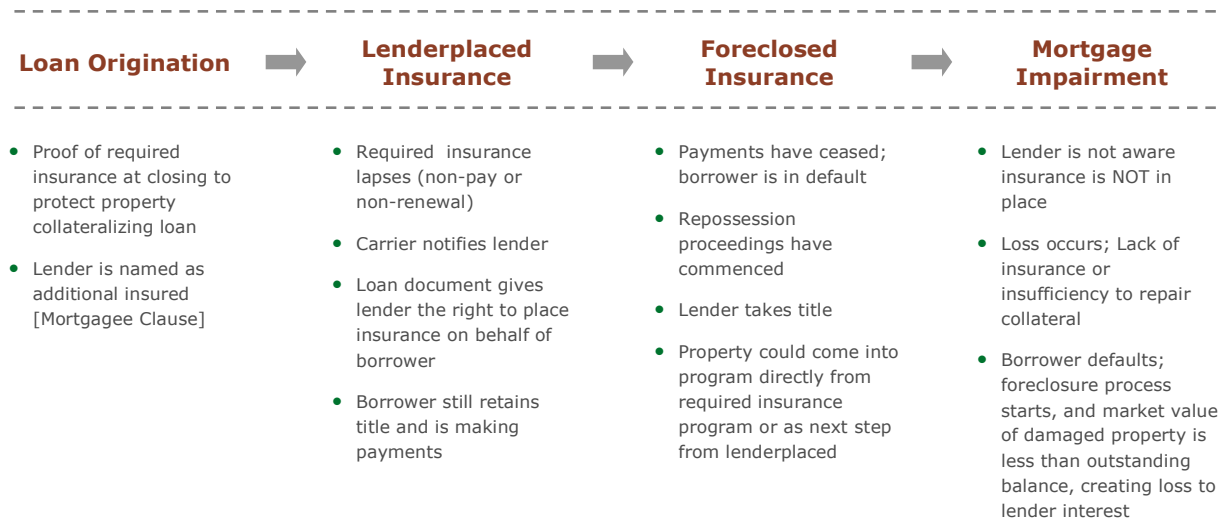
Understanding the Collateral Protection Sequence

To best understand collateral protection products, it is important first to appreciate the phases that exist between origination and, ultimately, mortgage impairment. This is because with each "phase" comes a broadening sphere of risk that can be addressed by various insurance strategies. Figure 1 graphically illustrates this "timeline," and highlights those products that are associated with the progression of loan default.

¹ CNNMoney.com: "20% of homeowners 'underwater': study finds that more than 20% of U.S. homeowners--about 20 million residences--owe more than their homes are worth., May 6, 2009, accessed 5/26/09

² According to Realty Trac's U.S. Foreclosure Market Report, in April 2009, one out of every 374 homes in the U.S. had received a foreclosure filing.

Figure 1



As illustrated above, following loan origination and proof of insurance at closing, there are three fundamental products for collateral protection, as described below.

Lender Placed Insurance

Typically, real estate loan contracts grant lenders the authority to purchase insurance when a borrower fails to do so. If insurance has lapsed, the lender may place coverage to protect the property, i.e., its investment. For an institution with a large portfolio of real estate loans, ad hoc placement for lapsed insurance is an administrative burden. Associated delays, both in discovery of the lapse, as well as the placement itself, can lead to coverage gaps. It can also jeopardize the lender's financial position on loans collateralized by real property. Furthermore, adding properties on a piecemeal basis may result in inefficient pricing, narrow coverage terms and insufficient policy limits.

A solution to these issues exists in a streamlined process referred to as "Lender [or Forced] Placed" insurance. Consolidating the process through a master program can prove efficient and cost-effective. These programs are typically written on an annual basis, but properties are only charged premium for the time that they are at "risk." Ease of handling is provided by bordereaux reporting on a monthly or quarterly basis. Some salient features of this product include:

- Named peril or broad form Causes of Loss
 - > Lender may choose the perils to be insured from fire, theft and collapse to windstorm, flood or earthquake

- Replacement cost or Actual Cash Value
 - > Lender has the option of replacing the property or simply settling for the actual cash value and walking away
- Commercial and residential property coverage
 - > Lender placed programs aren't restricted to single family homes; in today's economic environment, businesses of all sizes may allow insurance to lapse for non-payment

Foreclosed/Real Estate Owned Insurance

Sometimes referred to as "REO" coverage, this product is intended for the instance when foreclosure is in process and title has passed to the lender. This situation would normally be created because the borrower has ceased making payments and the loan is in default. The fundamental difference between REO and Lender Placed insurance is the actual ownership or possession of title to a particular property.

In the Lender Placed scenario, the borrower is still the legal owner of the property and is making payments. Therefore, while the lender may have contractual rights to place insurance to protect the loan's collateral, its interest is limited to the outstanding loan balance on the property. In an REO situation, however, the lender has become the owner. Therefore, its insurable interest includes not only the physical property, but also potential liabilities to third parties entering the premises, such as real estate agents or property managers.

REO insurance coverage is thus a broader program, contemplating both property insurance (as described previously for Forced Placements) and General Liability insurance. As with Lender Placed programs, this contract is typically written on an annual basis with pro-rated premiums and bordereaux reporting. Some highlights of REO coverage include:

- Covers vacant properties and vacant land
 - > With foreclosure, the borrower no longer resides on premises; many fire insurance policies exclude coverage for unoccupied dwellings as an increased hazard. General liability underwriters exclude vacant land because of the "attractive nuisance" it may provide. It is therefore critical to have these extensions of coverage in an REO program.
- Provides loss of rental income
 - > In the event the lender is able to rent the repossessed property [which may be more desirable than simply holding the asset], they will want to protect the revenue stream of rental income. This coverage can be included in an REO program.

Mortgage Impairment / Mortgage Liability Insurance

All financial institutions that originate, sell, securitize, or service mortgages should have mortgage impairment coverage. This product is designed for the “triple play,” where a property has suffered property damage, insurance is unknown or insufficient, and the borrower has defaulted on his loan obligation—collectively resulting in a financial loss of mortgage interest to the lender. Mortgage Impairment/ Mortgage Liability insurance is designed to provide both first party property coverage and third party errors and omissions coverage. It is also intended as a catch-all or safety net to protect collateral in situations where a property slips through the metaphorical cracks because somewhere in the “collateral protection sequence,” the tracking process failed. As a result, the property is uninsured or underinsured. The main components of this coverage are:

- Direct physical loss or damage from “required perils”
 - > This coverage focuses on loss due to perils that are required by the lender and for which insurance is uncollectible or non-existent. An optional extension may be purchased for the “balance of perils,” i.e., those that are not required by the lender. However, it is important to note that only owned mortgages are covered under a balance of perils extension. Earthquake is the peril most often sought under the balance of perils, especially by lenders with significant loan portfolios in California.
- Liability of Insured in Maintaining Borrowers’ Insurance Policies
 - > Lenders have responsibility to administer and dispense insurance premiums from escrow account or in various government guarantee programs such as VHA or GNMA.
- Real Estate Tax Liability
 - > Many lenders pay real estate taxes on behalf of borrowers from escrow accounts. This product is intended to provide coverage for the failure to administer property tax payments for borrowers.
- Wrongful Flood Zone Determination
 - > At loan origination, the lender performs a flood zone determination and advises the borrower if flood insurance is required. This provides for any errors or omissions arising out of that process.

“Watch the Gap”

As our “collateral protection sequence” shows, these insurance products are aligned in tandem to assure that the lender’s interest is protected through a variety of scenarios. The key to avoiding an unexpected loss is to have each protection in place, and assure that the

perils, limits and coverages fit your risk profile. Consider, for example, the financial loss associated with these common and real-life scenarios:

- A lender learns of a fire at a mortgaged property sixty days after the event. When the lender attempts to report the fire to the borrower's insurer, the lender learns that the policy was cancelled four months ago by a borrower who could no longer afford the insurance premium.
- After borrower default, a lender forecloses on residential property. Shortly thereafter, while showing a prospective buyer the property, a real estate agent is injured by tripping on a loose step. The real estate agent sues.
- A lender's system for tracking escrowed real estate taxes experiences a critical error, resulting in fifty-percent of the real estate taxes not being paid on time. The borrowers join forces against the lender. Defense costs and settlements need to be paid.

Consider Your Options Carefully

As more and more Americans surrender their homes or default on mortgages, non-performing loan portfolios are growing in leaps and bounds. As a consequence, lenders increasingly find themselves holding and managing huge real estate portfolios. The volume of large commercial exposures and potential geographic concentrations of catastrophic exposures challenge the "status quo," and call for a new approach to the underwriting community. Revisiting traditional Lender Placed, REO and Mortgage Impairment programs in your ongoing risk management strategy will help ensure that they are adapting to ongoing changes in your lending portfolio.

Anne Anderson is a Managing Principal and Executive Broker for clients in our New York and San Francisco offices. She has an extensive background servicing Financial Institution clients and has spoken publicly on how to best address the challenges impacting mortgage lending.

Ryan Barber is a Managing Principal and Property Leader for Integro's New York office. He has an extensive background in the placement and servicing of large Real Estate and Financial Institution clients, including Forced Placed, Foreclosed/REO and Mortgage Impairment programs.

About Integro

Integro is an insurance brokerage and risk management firm dedicated to serving the insurance and risk management needs of large or complex institutional risks. Integro has offices across North America, as well as in Bermuda and London. Its headquarter office is located at 1 State Street Plaza, 9th Floor, New York, NY 10004. Call 1-877-688-8701 and visit www.integrogroup.com

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