SERVICING MANAGEMENT®

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Adjust Accordingly To The Risk Profiles Of Collateral And Portfolios

When assessing lender-placed insurance options, servicers should consider a number of variables.

BY BERNIE DIMONT

Lender-placed hazard insurance protects an investor's or servicer's interest in mortgaged properties when the borrower has not maintained the mortgage agreement's required hazard insurance.

The policy premium is charged to the borrower's loan balance. Therefore, it is in both the servicer's and insurer's interest for the servicer to be notified each time a borrower's policy is out of force. A lapse can occur for various reasons, such as the borrower's nonrenewal.

By the standard terms of the policy's mortgagee-related provisions, the servicer is required to notify the carrier when there is a significant change in risk, such as a foreclosure or vacancy, via a change-of-risk letter.

Real estate owned (REO) coverage provides hazard coverage on a named-peril or broad-form cause-of-loss basis for properties that have been acquired by the mortgagee through foreclosure. The servicer pays the premium on REO policies.

Because lender-placed policies are single-interest - the interest of the servicer is in the mortgaged property only - the borrower is not a named insured under that policy. Single-interest policies provide coverage for limits up to the unpaid principal balance (UPB).

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In the last decade, blanket hazard insurance has become available to the industry. With this type of policy, a servicer insures loss in the same way as with traditional lender-placed policies due to uninsured physical damage - but on an entire portfolio rather than on an individual-loan basis.

Under these policies, a servicer is not required to notify the carrier each time a borrower's policy lapses. Blanket policy premiums are paid by the lender rather than the borrower and are calculated on the total value of loans in a portfolio.

A wide range of policy limits exist to fit the risk profile of the servicer, and it is important to know details about the portfolio being serviced.

First, subprime and Federal Housing Administration (FHA) portfolios typically have more damage than prime portfolios. FHA properties, however, are generally repaired to a standard (convey condition) required by the U.S. Department of Housing and Urban Development (HUD) to convey the property.

Subprime servicers, on the other hand, most frequently do not repair the property. Thus, it is critical to know the makeup of any portfolio to adequately negotiate the policy and premium.

Policy rates are underwritten for each servicer. The master policy rate is determined by portfolio characteristics, collateral types insured, previous loss history, the deductible option chosen and the location of the risk. The premium charged to the borrower is this rate multiplied by the current UPB at the time of placement.

Investors typically require tracking and reporting on these lender-placed policies, and most insurers provide tracking products where they ensure coverage is in force. Once coverage lapses, the policy is immediately placed on the risk spectrum. The cost of these tracking products is bundled and factored into the premium.

Deductibles are flexible and can range from $500 to $25,000. These deductibles are a crucial element in successful claims management - affecting the premium.

A deductible set too low for the specific portfolio, for instance, could mean unnecessary premium expense. But if the deductible is too high, the policy may be functionally useless unless the aim is simply catastrophe coverage for large storms or fires.

For example, if the deductible is $5,000 and the claim amount is $5,000 with $1,000 of depreciation, the claim would not be paid - as the insurable damage is less than the deductible.

Lowering the deductible to $1,000 could result in millions of dollars in recovered claims. The difference between a $5,000 deductible and a $1,000 deductible on an REO portfolio with a flow of 1,000 properties per month could be over $5 million per year in recovered claims.

New options

Hazard insurance policies are divided by the two major ways the ben-

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efit is paid: replacement cost value (RCV) or actual cash value (ACV). The more comprehensive of the two, RCV policies pay for the total cost to replace the loss without offsets for life expectancy or depreciation.

For example, an ACV policy would only pay half of the cost to repair a 10-year-old roof damaged by fire - as the life expectancy of a roof is 20 years. The RCV policy, in constrast, would pay the entire cost to repair the roof, less the deductible.

Also of note is that servicers can recoup the recoverable depreciation initially withheld on an ACV policy if repairs are made within 180 days.

Mortgage impairment policies (MIPs) are relatively new innovations in the market. A MIP allows the bank to thoroughly protect its financial interest in properties, given that events that trigger coverage are different from those covered by traditional lender-placed insurance and blanket hazard policies.

Instead of being protected from direct physical damage, as with lender-placed or blanket hazard policies, the bank is protected from loss due to the borrower's default in paying the mortgage following uninsured physical damage to the mortgaged property.

What sets MIPs apart from traditional lender-placed policies is that the mortgage must be in default before coverage is initiated. Flexibility in the way the lender verifies a borrower has coverage in place is the benefit of having a MIP.

The servicer may select to only verify borrower insurance at the mortgage closing and has two possible ways to handle lapses in the borrower's policy: The servicer would still need to respond to cancellation notices and take appropriate action, but it could also expand coverage to a full-blanket MIP.

With a full-blanket MIP, the servicer would not have to track lender-placed insurance on the portfolio, even in the event of a lapsed policy.

There is a drawback to blanket coverage, however. While both blanket hazard insurance and full-blanket mortgage impairment remove the need to track insurance on each loan and proof of insurance coverage is only required at loan closing, most investors require tracking and lender-placed insurance on all loans serviced.

Consequently, the mortgage servicer would not be in compliance if it uses a blanket program when investors are involved. Neither Fannie Mae nor Freddie Mac allows such blanket policies or MIPs.

Because blanket coverage policies are paid for by the servicer, not accepted by most investors and not compliant with Fannie Mae or Freddie Mac, traditional lender-placed policies offer the best choice for most servicers.

In summary, when assessing insurance options, servicers should consider the deductible, whether coverage is written at RCV or ACV, if claims are paid when the property is repaired or left as is, if periodic reports of value are required, how quickly claims are settled and levels of customer service.

Furthermore, mortgage servicers should endeavor to write policies with a reputable carrier and ask for references from the industry. Other mortgage servicers can share their experiences with force-placed carriers.

Hazard claims management outsourcers can also be important partners in selecting the right insurance program for the portfolio by providing statistics on how insurers and their specific programs perform. SM

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