

**TESTIMONY OF JOHN FROBOSE, AMERICAN SECURITY INSURANCE
COMPANY**

NAIC PUBLIC HEARING ON PRIVATE LENDER-PLACED INSURANCE

I. Lender-Placed Insurance Fulfills an Important Need

Homeownership in America is possible because of mortgage lending. A necessary foundation for residential mortgage lending is maintaining insurance on the underlying collateral for the loan: the home. Mortgage lenders have always required homeowners to carry insurance on the mortgaged property. Under the terms of virtually all mortgage loan agreements, homeowners are required to carry such insurance coverage.

All originators and purchasers of home mortgages, including Fannie Mae and Freddie Mac, require mortgage servicers to ensure that insurance coverage “is in place at all times.” To meet this requirement, mortgage servicers engage insurance companies, such as American Security Insurance Company (“ASIC”), to provide insurance coverage on properties when no other coverage is in place because no standard insurer will provide coverage or the homeowner has failed to maintain coverage. The most critical feature of this type of insurance is that it ensures continuous coverage as of the date a standard policy lapses or is canceled, enabling servicers to meet the requirements of Fannie Mae and Freddie Mac and private investors who buy loans in the secondary market. This insurance is referred to as Lender-Placed Insurance (“LPI”). Without the safety net of LPI, mortgage loan interest rates would rise and mortgage lenders would make fewer loans.

ASIC LPI covers homeowners and lenders. To protect both, LPI policy limits historically have been set at the coverage amount of the previous policy, which is the best estimate of the replacement cost of the home. As a result, homeowners have the means to repair

or rebuild in the event of a covered loss (for example, damage from fire, wind or hail). LPI policies are automatically effective from the date the prior standard coverage lapses or is canceled, providing homeowners with continuous coverage. So, for example, if the home is damaged or destroyed by a covered peril immediately after the standard policy lapses or is canceled, the LPI insurance carrier pays the loss. This coverage also assures the lender that damage or destruction of the property from a covered peril will not wipe out the security for the loan.

Historically, LPI has helped many homeowners who did not have standard insurance coverage to rebuild their homes in the face of catastrophe. For instance, ASIC incurred \$94 million in losses covering more than 9,400 homeowners for catastrophes occurring in 2011. Approximately \$38 million of this amount, including \$20 million in flood claims, arose from Hurricane Irene, which soaked the Eastern Seaboard and devastated communities in 34 New York counties.

Many claims are paid on properties in areas in which standard insurers have reduced their coastal and other high risk exposure. Following the destructive hurricane seasons of 2004 and 2005, standard insurers continued a trend of withdrawing from certain high-risk areas, leaving homeowners with fewer options in the standard insurance market. In contrast with these standard carriers, ASIC is required to provide coverage in all states and in all areas, regardless of the risks.

II. LPI – The Insurance of Last Resort, Rarely Placed

Lender-Placed Insurance is not “forced” on anyone. ASIC has developed thorough processes to ensure that homeowners have ample opportunity to avoid LPI whenever other coverage is available to them and they choose to buy it. LPI is a safety net, and ASIC dedicates substantial resources to *avoid* placing coverage where standard coverage may be

obtained or is already in force. And for good reason: ASIC has every financial incentive to avoid placing LPI that is not needed. When ASIC issues a policy on a home that is covered by standard insurance, it incurs all of the costs of placing and removing the policy but retains none of the premium. Upon receipt of proper documentation, every single policy placed on a home already covered by standard insurance is canceled, and the premium is refunded, at ASIC's expense.

Under its agreements with mortgage servicers, ASIC serves as the contact for all matters related to the homeowner's insurance coverage. Servicers instruct insurance carriers and agents to route all correspondence regarding insurance coverage, such as renewals, expirations, and cancellations, directly to ASIC. Each year, ASIC receives more than 83 million insurance notices and other documents from homeowners' insurers and their agents. ASIC also fields six million phone calls annually from homeowners, their insurers and agents from all over the country regarding homeowners' insurance coverage.

A. Avoiding LPI Placement

ASIC uses sophisticated technology to process the communications it receives regarding the status of insurance on the properties securing loans in its servicer clients' portfolios. These communications are processed through a proprietary system that extracts data and uses it to update the servicers' systems, apprising the servicers on a daily basis of the insurance coverage on millions of homes and businesses nationwide.

ASIC monitors policy status for possible lapses in coverage, such as when a homeowner's standard policy has been canceled or is about to expire. If ASIC then confirms that it has not received proof of continuing coverage, it undertakes an extensive "open items" process. It is at this point that ASIC attempts to obtain renewal information or other evidence of valid insurance coverage. Starting about 15 days prior to the expected coverage lapse, ASIC

initiates multiple calls and other communications with homeowners' insurers, their agents, and borrowers themselves to find proof of insurance coverage. Through this "open items" process, ASIC avoids unnecessarily placing homeowners into the next phase of the process, called the "letter cycle." ASIC does not take into account loan characteristics such as delinquency to identify potential lapses in coverage, and delinquency status does not affect the rates that ASIC charges on individual policies under its products currently used.

If – and only if – proof of insurance coverage has not been received after the "open items" process is completed, ASIC begins the "letter cycle" process, which typically includes the following actions on behalf of the servicer:

- Around the date of expiration of the existing standard policy: ASIC sends a letter to the homeowner, informing him or her that the servicer does not yet have proof of coverage, as required, and reminding the homeowner to provide the proof of coverage. This letter also explains several ways for the homeowner to provide such proof to ASIC.
- 30 days later, if no response to the above letter: ASIC sends a second letter informing the homeowner that the mortgage lender still has not received proof of coverage and that a policy will be purchased if ASIC does not receive a response within a stated period, typically 24 to 30 days. This letter states that LPI coverage *will be more expensive* than the homeowner's prior standard coverage and will not cover liability or contents, as a standard policy generally does, and it encloses a binder that sets forth the annual premium to be charged in the event that an LPI policy is issued. This letter again explains several ways for the homeowner to provide proof of coverage to ASIC.
- 30 days later, if no response to either of the above letters: The servicer places the ASIC LPI policy and sends the homeowner a complete policy package.¹ This package includes a letter that again encourages the homeowner to obtain standard coverage and explains that if the homeowner does so, the LPI policy *will be canceled and the homeowner will be charged only for the period when no other coverage was in place.*

¹ Although premiums may not be charged until the end of the letter cycle, the policy is effective from the date of expiration of the prior policy, providing the homeowner with continuous coverage. So, if a homeowner suffers a covered loss during this period, ASIC pays the appropriate amount to satisfy the claim so that the home can be repaired or rebuilt or the loan can be repaid.

The system works. Historically, of more than 28 million home loans nationwide for which ASIC tracks insurance coverage, it identifies about 13% annually as being at risk of a potential lapse in coverage, triggering the “open items” process. After the open items process, about 9% of loans enter the “letter cycle.” For about 3% of loans tracked, borrowers receive the second letter enclosing the binder, and LPI is placed for about 2% of such loans. Thus, as a result of ASIC’s processes, standard coverage is maintained on the vast majority of properties with policies at risk of lapse or cancellation, and LPI is placed only on a small fraction.

Even when a homeowner stops making mortgage payments, LPI is not always placed. For home loans for which the borrower has established an escrow account to cover insurance and taxes, as is most common, the servicer will advance the necessary funds to pay the premium to the standard insurer, so as long as the policy remains valid and an invoice for renewal can be obtained. If such a homeowner does not intentionally cancel the standard policy and the standard carrier does not cancel or non-renew it, it should remain in effect throughout the delinquency period. It is impossible for the servicer to secure a new standard policy for the homeowner, because that would require knowledge of the underwriting data to rate the policy, homeowner involvement, and a signed application.

B. Removal of LPI

In its communications with homeowners, ASIC clearly explains that, once an LPI policy is placed, the homeowner can cancel it at any time by providing proof of other coverage or simply the name and telephone number of the current agent or carrier, whom ASIC then contacts directly to verify coverage. If there is a gap in coverage, the homeowner is charged LPI premium just for the period when the LPI was the only policy in effect. If ASIC receives proof that there was no gap in coverage, it cancels the LPI policy and refunds all LPI premiums paid.

LPI is placed *only* when ASIC's efforts to confirm existing coverage are unsuccessful, *and* after the borrower fails to provide proof of such coverage despite multiple requests that he or she do so. Some have implied that placement of LPI when other coverage exists is "false" or "erroneous" in some way. There is nothing "false" or "erroneous" about placing coverage in such circumstances, even if other coverage in fact exists, and upon proof that it does all LPI premium is refunded for the period in which other coverage exists. This is the way the system is supposed to work to ensure continuous coverage. In support of servicers and the homeowners, ASIC consistently met or exceeded customer care standards throughout the tracking process.

III. The Cost of LPI

ASIC provides coverage without regard to risk because that is the purpose of LPI: to ensure continuous insurance coverage on *all* mortgaged properties. Unlike standard insurers, which evaluate the risks associated with insuring individual properties, ASIC is required to provide coverage for all exposed properties in the servicer's portfolio. ASIC provides this coverage without inspection or underwriting of the risks associated with any insured home. As a result, ASIC insures a broader range of risks than do standard insurers, including homes in the most catastrophe-prone areas and those that are vacant, unoccupied, or have other negative underwriting factors. Thus, ASIC and other LPI insurers face greater risks than standard insurers and price for that volatility. For this reason, LPI is necessarily more expensive than standard hazard insurance.

A. Loss Ratios

ASIC publicly reports its premiums and losses, from which the loss ratio is derived, in its statutory annual statement and the associated supplemental exhibits. Each state in

which ASIC operates receives a copy of this filing annually. ASIC's annual statutory filings show premiums and losses by statutory line of business and by state.

Actual loss ratios may vary from expected loss ratios for several reasons. In property insurance, a principal reason for the variance is catastrophe experience. ASIC may experience loss ratios lower than expected in non-catastrophe years, offset by loss ratios higher than expected in catastrophe years. The expected loss ratio reflects a long-term average view of the expected results for a product line.

B. The mortgage crisis has caused a temporary increase in premium volume for LPI

As economic conditions affecting the housing sector have changed, the LPI market has also changed. An important factor underlying this change has been an unanticipated and significant increase in the volume of LPI on properties for which homeowners have stopped making mortgage payments. Homeowners who do not make payments for principal, interest, and taxes may also fail to maintain insurance coverage on their properties, triggering the placement of LPI. As a result, the number of LPI policies placed during the last few years has increased along with premium volume. In most cases, our policies have gone into effect after the homeowner defaulted on his or her loan. We do not believe that LPI placement has caused loans to become delinquent, but rather that LPI placement rates have increased due to the recent surge in delinquent loans.

As the foreclosure process has lengthened in recent years, so, too, has the period of time during which LPI policies have remained in force. Historically, serious loan delinquencies were resolved by foreclosure within a relatively predictable period of time after the first payment default. At foreclosure completion, the standard homeowner's policy or LPI

policy typically is canceled. However, delays and moratoriums in the foreclosure process – which have allowed some borrowers to remain in their homes when they are no longer making mortgage payments – have lengthened the period in which LPI remains in force, increasing the premiums ASIC has collected.

ASIC anticipates that premium volume will revert to more normal historical levels as the housing market stabilizes and the number of delinquent loans decreases. Nevertheless, great uncertainty remains. The risk profile of homes insured by ASIC continues to increase as a greater portion are in geographical locations with greater risk of loss than the standard market is exiting, or are on properties in which their owners are seriously delinquent in their mortgage loan payments.

It is worth noting that not only is the standard market actively working to limit its exposure to risks that fall into the LPI market, the number of insurers participating in the LPI market also has declined substantially in the last 20 years. Prior to Hurricane Andrew in 1992, there were as many as 10 insurers actively participating in the LPI market. After Hurricane Andrew, many of the major companies discontinued writing LPI, including Progressive, Transamerica, and CIGNA. After the 2004 and 2005 hurricanes, other insurers such as ACE, Safeco, and Zurich also chose to exit the LPI market. These exits, along with continued consolidation, have brought us to the current point, where the market is served by two major insurers. It has been suggested by some commentators that LPI offers “excessive profits”, yet insurers have chosen to exit the market rather than enter the market. Market behavior instead supports the idea that LPI risk is significantly higher and more volatile than risk in the standard market.

Conclusion

LPI exists because it meets important needs of homeowners, lenders, and investors. It provides a safety net when standard insurance is simply not available. It is a critical component of the national residential mortgage system. LPI is more expensive than standard insurance, but the difference in price reflects the greater risk that LPI carriers assume. We appreciate the opportunity to participate in this hearing. As the leader of the LPI industry, we look forward to a constructive dialogue with the members of the NAIC to explore and address any concerns that may exist.