September 18, 2013

Ed DeMarco, Acting Director *Via e-mail and U.S. mail*
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20024

Re: FHFA Action on Force-Placed Insurance

Dear Acting Director DeMarco:

The undersigned housing, civil rights and consumer advocacy organizations urge the Federal Housing Finance Agency (FHFA) to act swiftly to protect homeowners and taxpayers from costly force-placed insurance (FPI) abuses. As the agency's March 2013 request for comments and subsequent hearing have made clear, borrowers, investors, and taxpayers are being gouged by FPI charges due to a market structure that gives servicers the power to command kickbacks and considerations from companies that provide FPI and insurance tracking services. Servicers then pass the costs of those kickbacks on to borrowers, taxpayers and investors through inflated FPI charges.

FHFA is in a unique position to address the dysfunctional FPI market and protect homeowners, investors, and taxpayers. Until recently, state insurance regulators have done nothing to address FPI abuses, and recent actions have been limited to only a few states. Federal agencies that oversee mortgage servicers have also failed to address FPI abuses. The CFPB's mortgage servicing rule focuses on warning borrowers about FPI and requiring servicers to keep certain voluntary policies in place. But the rule does not address kickbacks and inflated FPI charges. The Enterprises' purchasing power puts FHFA in a position to utilize market forces to discipline servicers and FPI providers. Requiring the Enterprises to purchase FPI directly will be much more effective than trying to regulate against a market that servicers have the power to manipulate to their advantage .

So far, in regard to FPI, FHFA has failed to meet its responsibilities as a regulator and conservator. Last February, the agency scuttled Fannie Mae's plan to directly purchase FPI and tracking services – a plan that would have ***immediately*** brought down FPI prices and stopped kickbacks. Last March, FHFA issued draft servicing standards addressing FPI, but the agency has taken no action to finalize or implement them. In the meantime, borrowers, investors, and taxpayers continue to be saddled with unfair and inflated FPI charges. In addition, FPI flood placements have grown and will continue to increase as a result of the Biggert-Waters Act.

FHFA must not only act now to stop FPI abuses, but must also act effectively – by providing substantive relief and not superficial changes that maintain the abusive status quo. In March 2013, FHFA proposed prohibiting certain types of kickbacks between sellers and servicers. While we support this ban, a prohibition alone will not sufficiently address the problem of reverse competition in the FPI marketplace. Without the market discipline a direct purchase plan imposes, FPI vendors will evade the proposed rule by finding new ways to compensate servicers.

In order to restore balance to the FPI market, FHFA must simplify the insurance buying process and allow the Enterprises to buy FPI and insurance tracking directly. As long as servicers can pass inflated FPI charges on to the Enterprises, the servicers will have no incentive to shop for the least expensive insurance or seek out FPI unencumbered by kickbacks. The Enterprises must purchase FPI for their portfolios directly because they are ultimately responsible for paying FPI charges for a significant portion of mortgages. Otherwise, the FPI market will continue to be plagued by kickback schemes and anti-competitive pricing.

We encourage FHFA to take the following steps immediately:

1. Prohibit servicers from having any financial interest in the placement of FPI, other than the coverage provided by the insurance.

FHFA's proposal identified two types of kickbacks – commissions and captive reinsurance agreements. While prohibiting these types of kickbacks is necessary, it is not sufficient. Unless FHFA creates a blanket prohibition against any type of consideration from FPI and tracking providers to servicers, providers will simply change the mechanism for the kickback.

As we wrote in response to the agency's recent request for comment, we strongly support FHFA's proposed ban on reinsurance deals and commissions. Affiliates of mortgage servicers often unnecessarily reinsure FPI policies to share in potential underwriting profits. Since the loss ratios for FPI are extremely low, averaging just 25.3% nationwide over the past nine years, using affiliates for reinsurance is a no-risk way for the servicers to further gouge homeowners by claiming a portion of the exorbitant premiums charged for FPI. JPMorgan Chase, for example, reinsured 75% of the FPI premiums it collected from homeowners through its subsidiary Banc One.[1]

Banning reinsurance deals and commissions is an important step, but mortgage servicers also enjoy free or reduced-cost insurance tracking and other services and have, in the past, purchased FPI from affiliated entities. These practices must also be prohibited to ensure that struggling homeowners and the Enterprises are not overcharged.

FHFA should make clear that mortgage servicers and affiliates servicing loans purchased or guaranteed by the Enterprises may not receive any fee, commission, kickback, reinsurance contract, insurance tracking or administration, or other thing of value in exchange for purchasing FPI.

2. FHFA should commit to ensuring that the Common Securitization Platform includes options for the Enterprises and investors to directly purchase force-placed insurance (as well as title insurance and mortgage insurance).

Direct purchase is the best way to eliminate kickbacks. Banning kickbacks can be accomplished two ways: 1) through a direct purchase program in which competition for the Enterprises' business will wring out the kickbacks; or 2) by maintaining the current reimbursement system but limiting reimbursements to the actual costs of providing FPI.

[1] See testimony of Banc One and Select Portfolio Servicing at 5/17/12 NYS Department of Financial Services hearing on force placed insurance, available at http://www.dfs.ny.gov/insurance/hearing/fp_052012_trans_err.htm

The direct purchase approach is superior for many reasons. With direct purchase, borrowers, investors and taxpayers will see immediate reductions in FPI costs without comprehensive audits of FPI providers or actions by state insurance regulators. In contrast, allowing reimbursements while trying to exclude certain costs will be much more complex and provides no guaranty that FPI charges will decrease. If FHFA continues to allow the Enterprises to reimburse servicers, reducing FPI charges will require action by state insurance regulators and determining which expenses to exclude from reimbursement will require complex and expensive audits.

Basic economics also indicates that aligning market forces with the interests of borrowers, investors, and taxpayers through a direct purchase approach is the most effective way to address inflated FPI charges. If FHFA does not mandate direct purchase, however, the Agency should provide the technology infrastructure within the CSP to allow for direct purchase of products or services required by third parties, but paid for by borrowers, including, but not limited to FPI, title insurance and mortgage insurance. Each of these insurance products has been plagued by inflated prices arising from kickbacks from insurers to those entities in a position to refer business to the insurers.

3. If FHFA opts initially to continue the reimbursement approach, FHFA should set the reimbursements on the basis of the reasonable cost of providing FPI rather than seeking to identify specific unreasonable expenses.

There are two approaches to limiting expense reimbursement. The first is to identify unacceptable expenses and exclude those amounts from the reimbursements. The second is to identify the reasonable cost of providing FPI and limit reimbursements to that amount. While both approaches will theoretically produce the same result, the second approach is far easier to implement and monitor for compliance.

Under the first approach of excluding certain expenses from reimbursement, FHFA will have to:

1. Identify the activities for which reimbursement will not be provided;
2. Identify the expenses associated with those activities; and
3. Routinely audit FPI providers to ensure those expenses are not added back in.

A significant difficulty with this approach is identifying the activities for which reimbursement will not be provided and then identifying the expenses for these activities. This may be difficult because FPI providers will seek to mask those expenses. To illustrate, we attach some correspondence between the Florida Office of Insurance Regulation (OIR) and American Security Insurance Company (ASIC) in which OIR seeks information on insurance tracking expenses and whether those expenses are included in proposed FPI rates. ASIC refuses to provide the requested expense information – twice – and claims that:

> While a number of levels of achievement of a reduction in the number of potential lender placed policies is shown in the Tracking Waterfall, these represent artificial markers or signposts describing conditions alongside a continuous process, not separate functions or processes in themselves. To give an example: much of the activity along the waterfall chart is accomplished via mail or phone calls. The mail processing and phone calls are not performed by discrete units portioned in the manner of the chart. They are instead performed by comprehensive mail units, or phone call units, consistent with the

> continuous process described above. Costs for phone calls and mail are recorded in the aggregate. However a finer distinction does not exist, as all the costs relate to a single continuous process. **The measurement of expense is only available to us at the process level, and not at a sub-process level of distinction. Thus, while the chart is useful to illustrate the effectiveness of this process, we cannot provide expense information specifically attributable to each step in the process.** (Emphasis added.)

As pointed out in the Center for Economic Justice's comments on the ASIC submission, ASIC's assertions are not credible. But ASIC's response illustrates how difficult it will be to identify and exclude prohibited expenses from FPI reimbursements. Although an audit of actual FPI provider expense is certainly possible, it requires an auditor with knowledge of insurance operations as well as mortgage servicing operations and cooperation from both FPI providers and servicers.

The second approach – a cost-plus approach – starts with the FPI insurer's expected loss costs, which are the estimates of ultimate expected claims per unit of FPI exposure, and then adds reasonable provisions for fixed expenses (such as general administrative and overhead expenses) and variable expenses (such as profit and premium taxes). The reasonable amounts for such expenses associated with a master policy can be more easily estimated – even in the absence of data or cooperation from LPI providers or servicers – than expenses for prohibited activities.

4. Limit retroactive charges.

Mortgage servicers are responsible for tracking insurance coverage on the loans they service. When there is a lapse in a homeowner's insurance coverage, the servicer, typically through an insurance tracking vendor, notifies the force-placed insurer. It is the servicer's responsibility to identify lapses in insurance and notify homeowners of these lapses in a timely fashion.

Regulatory requirements and industry practice make clear that that insurance tracking is a responsibility of the mortgage servicer. Among other things:

a. Federal law requires federally regulated or insured lenders / servicers to monitor loans for the continuous presence of required flood insurance on properties located in a Special Flood Hazard Area[2] and federal regulation requires mortgage servicers to provide notices in specified time frames before charging for hazard FPI, and prohibits placing FPI if a borrower has an escrow account on her loan and payment of premium will keep the voluntary policy in force.[3]

b. Notices to borrowers regarding required hazard or flood insurance are sent on mortgage servicers' letterhead; and

c. Fannie Mae has determined that insurance tracking is a servicer responsibility whose costs should not be included in FPI charges to borrowers.

[2] 42 U.S.C. § 4012a (e)
[3] Regulation X (12 C.F.R.) §§ 1024.34, 1024.37.

Mortgage servicers purchase FPI coverage from insurers through a master policy covering all properties serving as collateral for serviced loans. The master policy provides automatic coverage if and when the borrower's voluntary hazard or flood insurance coverage lapses and that coverage comes into force the instant the voluntary insurance coverage lapses.

Once a lapse in voluntary coverage is discovered by the servicer and FPI coverage is issued under a FPI master policy, the FPI insurer charges a premium to the servicer. The servicer, after sending required notices to the affected borrower and failing to receive evidence of voluntary insurance, charges the borrower for FPI. Servicers bill borrowers for FPI at some point after the lapse in coverage, but charge for coverage beginning at the date of the lapse. Consequently, servicers retroactively charge borrowers for the coverage that was automatically in-force the instant the borrower's voluntary hazard or flood insurance coverage lapsed.

It is not unreasonable that the servicer (or insurance tracking vendor) may not instantly discover a lapse in coverage, resulting in retroactive charges for a short period of time--perhaps up to 60 days from the lapse. ***But it is unreasonable, however, for a servicer to fail to discover a lapse in coverage for an extended period of time, fail to notify the borrower in a timely fashion, and to then retroactively charge for lengthy periods of time.*** A 60-day period gives the servicer or vendor sufficient time to discover a lapse in coverage and notify the before imposing any FPI charges. If the servicer fails to identify the lapse in coverage within this reasonable period of time, the servicer – not the borrower – should bear the responsibility for the cost of the FPI.

The Leghorn Case: An example of retroactive FPI billing abuse

On January 30, 2012, Mr. and Mrs. Leghorn[4] were notified by their servicer that temporary FPI flood coverage had been placed for a 90-day period beginning on December 12, 2009. This notice arrived *more than two years* after the alleged lapse in coverage. On March 6, 2012, the servicer charged the Leghorns for FPI flood coverage for the full year from December 12, 2009 to December 12, 2010 – almost 27 months after the lapse in coverage and almost 15 months after the coverage had expired, but only 36 days after the notice of problems with evidence of required insurance.

The servicer then sent a notice the next day, March 7, 2012, to the Leghorns stating that it required evidence of flood insurance for the period from December 12, 2010 through December 12, 2011. Thirty days later, on April 6, 2012, the servicer charged the Leghorns for FPI flood for the period December 12, 2010 through December 12, 2011 – almost 16 months after the lapse in coverage and almost four months after the coverage had expired. Both of these charges were unreasonable because the charges were made long after 60 days from the date of lapse of the voluntary flood policies and long after the Leghorns could make use of the information in the required notices.

Retroactive charges for extended periods of coverage are unfair to borrowers for at least two reasons. First, the lengthy retroactive charges render the notice requirements for FPI meaningless. The purpose of the notice requirements is to empower the borrower to take action to avoid FPI charges. When a borrower receives the FPI notices long after she can take any

[4] See complaint in *Leghorn, et al v. Wells Fargo Bank, N.A.*, Case No. 4:13-CV-00708-JCS (N.D. Cal.).

action to avoid the FPI charge, the notice is meaningless. Second, a lengthy retroactive charge means that the servicer has failed to do a reasonable job of tracking voluntary insurance coverage. Since tracking is the servicer's responsibility, it is unfair for the servicer to charge the borrower for the servicer's failure. ***FHFA should refuse to reimburse a servicer for any <u>retroactive</u> FPI charges for more than 60 days of coverage and for any period of time after 60 days from the lapse in coverage***

5. Require servicers to advance payment for existing insurance policies that are at risk of cancellation for non-payment – instead of buying force-placed insurance.

The FHFA should require that, if homeowners fall behind on their insurance payments, servicers must advance their own funds to pay past due premiums and reinstate the homeowners' insurance coverage. If homeowners do not have existing escrow accounts, servicers should establish escrow accounts to pay future premiums. Servicers are already notified by insurers when a policy is at risk of cancellation. And servicers already advance their own funds to pay for FPI. In addition, the Enterprises uniform mortgage documents already authorize servicers to establish escrow accounts. Therefore, this requirement would impose almost no additional burden on servicers and would save borrowers and the Enterprises the additional cost of FPI. The FHFA should make clear that servicers must exhaust all options to keep homeowners' existing insurance policies in place before resorting to FPI.

Adopting this policy would substantially reduce the need for FPI and would help prevent foreclosures. Voluntary premiums are far less expensive than FPI, and requiring servicers to advance these premiums rather than impose FPI would reduce the Enterprises' potential losses in two ways. First, excessive FPI charges can themselves cause foreclosures – either when homeowners fall behind on their mortgages due to the additional expense of FPI, or when homeowners in default cannot secure an affordable loan modification due to inflated arrears or excessive escrow charges resulting from high-cost FPI. Second, the escrow shortages incurred would be smaller than those incurred when FPI is imposed, effectively reducing the size of reimbursements servicers would require from the Enterprises after foreclosure sales.

In closing, we urge FHFA to take decisive action to stop force-placed insurance abuses and reduce FPI costs to borrowers, investors and taxpayers.

Sincerely,

Americans for Financial Reform
Center for American Progress
Center for Economic Justice
Consumer Federation of America
National Association of Consumer Advocates
National Consumer Law Center, on behalf of our low-income clients
National Fair Housing Alliance
New Economy Project (formerly NEDAP)

cc: Sandra Thompson, Meg Burns, Maria Fernandez, Jim Gray, Mike Price