

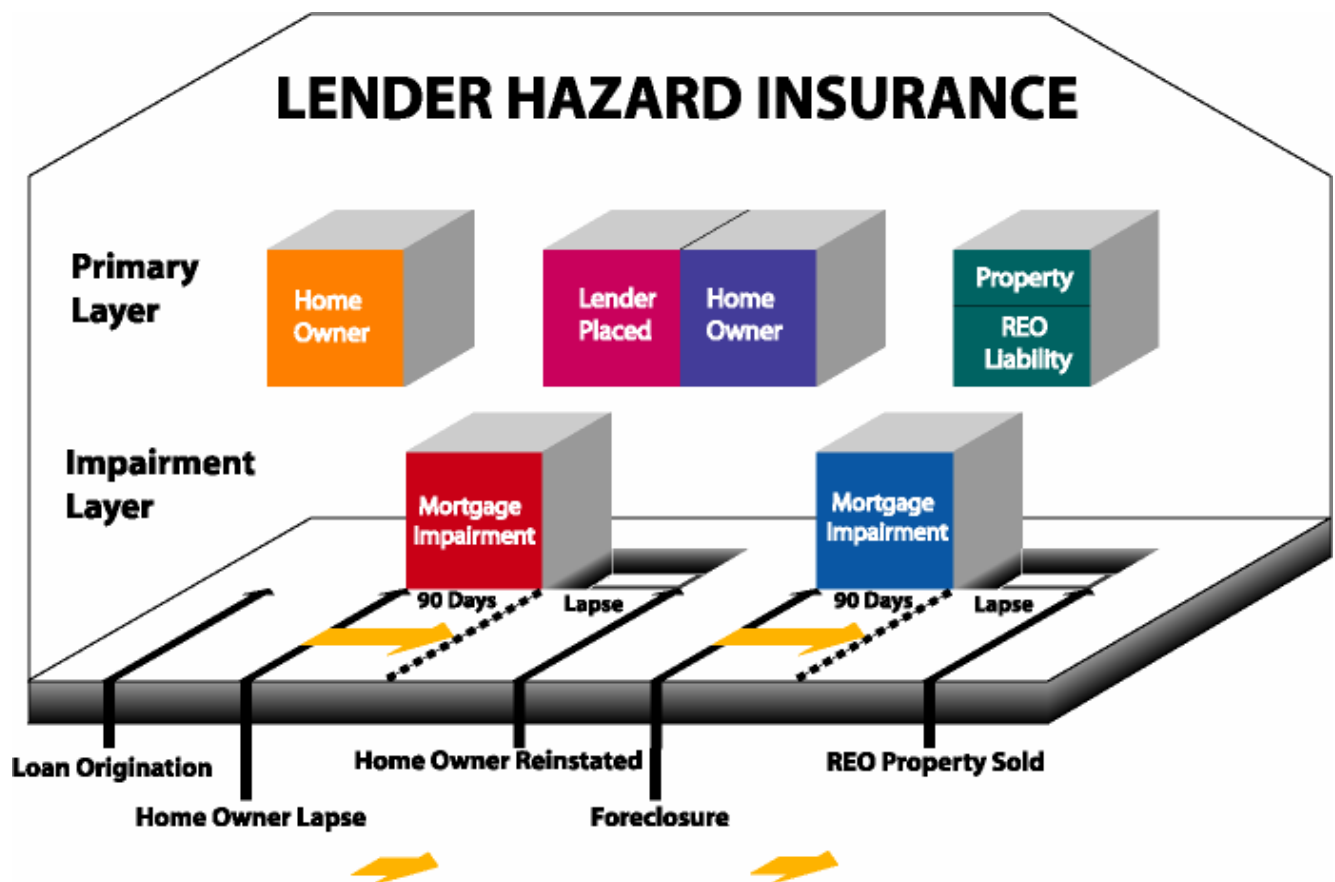
Lender Hazard Insurance Overview

Introduction

Mortgage operations involve various risks such as credit, interest rate, collateral, and operational risk. Lending organizations may transfer the interest rate and credit risk to a very efficient secondary mortgage market to meet specific risk management objectives. Collateral and Operational risks can be catastrophic risks which are unpredictable. These include collateral being destroyed by a fire or flood, as well as a class action lawsuit which finds the lender at fault for a compliance error. Due to the possibility of large losses, collateral and operational risks should be

insurance, the lender's interest in the property is best protected using the two-tier coverage approach shown below.

In the first tier, called the *primary layer*, coverage is supplied by the borrower in the form of homeowners insurance. The lender is named as lien holder. Since lapses in the borrower's coverage may occur due to cancellation or non-renewal of the homeowner policy, the lender must have a second tier of insurance, called the *impairment layer*, to protect its interest in the property if a loss occurs when homeowners insurance is not in effect.



transferred through the use of commercial insurance policies.

Collateral Risk – The lender's mortgage is secured by a dwelling and/or real property. The promissory note requires the borrower to maintain homeowners insurance to protect the property. If the lender's collateral risk is to be transferred to commercial

There are dozens of approaches available in the marketplace to deliver this *impairment layer*, which can lead to confusion by the lender. The most popular *impairment layer* coverage comes from the traditional lenders mortgage impairment policy. This policy includes risk transfer features for both collateral and operational risks. The purpose of the collateral coverage is to provide the lender with property protection for a short period of time (90 days) while

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the borrower re-establishes the *primary layer* of insurance. This period begins when the lender receives a notice of cancellation from the homeowners' insurance company. If the borrower does not re-establish a primary layer policy within 90 day period, the impairment layer coverage stops and the lender's collateral risk is exposed.

In order for the lender to prevent impairment layer exposure, the lender should establish two procedures. The first is designed to determine when the borrower's homeowner insurance cancels. The second procedure enables the lender to re-establish primary layer coverage to protect interest in the property if the borrower is unable or unwilling to reinstate the required homeowners insurance within the 90 day period. The Minitier-Mortgage Website is specifically designed to enable the lender to cost effectively manage these two procedures in an automated workflow environment.

Operational Risk – The lender has established procedures for servicing their loan portfolio. An error in executing these procedures that causes loss to a third party would be considered operational risk. These third party (liability) losses often result in lawsuits. These losses and the cost of their legal defense can be transferred to the operational risk section of the lenders mortgage impairment policy. See Mortgage Impairment Insurance for more details.

Primary Layer

This is the first layer of protection for both the lender and the borrower. The most important feature of the primary layer is that losses to mortgaged property will be paid without the need for the lender to foreclose on the property. This enables the borrower to stay in the home and continue to fulfill his mortgage obligations in the event of a loss to the property. There are five types of insurance that are used in the primary layer.

Borrower Homeowner Insurance with lender named as lien holder - The vast majority of homeowners in a mortgage portfolio will maintain homeowners insurance with the lender named as lien

holder. The minimum coverage required is defined by the lender in the promissory note. This coverage has dwelling and real property coverage as well as liability coverage. The lender is most interested in the property coverage, since title to the property is in the borrower's name and any liability claims would be brought against the title holder.

Lender Placed Mortgage Hazard Insurance - The lender's promissory note requires the borrower to maintain proper insurance which protects the lender's interest. If the borrower fails to do this, the lender has the right to place insurance that will protect their interest. The policy premium is billed to the borrower and is designed to protect the lender for physical damage losses up to the outstanding loan balance. Liability coverage is not included because the lender has minimal liability risk as the borrower still maintains title to the property. The advantage to this type of policy is that the borrower is required to pay the premiums which reduces the lenders operational expense, the drawback to this type of coverage is that the lender must track all borrowers insurance policies to know when a lapse in coverage is about to occur.

Blanket Mortgage Hazard Insurance - This policy protects the lender's entire mortgage portfolio for property damage and would be a substitute for Lender Placed Mortgage Hazard Insurance. When a loss occurs to a mortgaged property that is not covered by the borrower's homeowner policy, the lender is protected up to the outstanding loan balance. The advantage to this type of policy is that the lender is not required to track the borrowers' insurance policies and there is no chance for an insurance tracking error that may leave a property exposed. The disadvantage of the blanket mortgage hazard policy is that the lender must pay for this coverage and the premium is based on the size of the portfolio being insured. This coverage is typically used by community banks with a history of no lender placed primary layer losses. When this occurs the expense of the blanket premium paid for by the lender will approach the expense reduction of eliminating the tracking function.

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Blanket 2nd & HELOC Mortgage Hazard Insurance – This policy protects the lender’s entire portfolio of 2nd mortgage, equity and HELOC loans and lines. When a loss occurs to a mortgaged property that is not covered by the borrower’s homeowner policy and exceeds the limit of liability of any primary layer insurance provided by the first mortgage lender, the lender is protected up to the outstanding loan balance. The advantage to this type of policy is that the lender is not required to track the borrowers’ insurance policies and there is no chance for an insurance tracking error that may leave a property exposed. The lender pays for this coverage annually and the premium is based on the size of the portfolio being insured. Since the mortgage in first position maintains primary layer insurance as well, this coverage is less expensive.

REO Hazard and Liability Insurance – This policy protects the lender after property is foreclosed and the lender has title to the property. This coverage has dwelling and real property coverage as well as liability coverage available by endorsement since the title is now in the lender’s name. This coverage is typically placed by the lender at foreclosure. The lender keeps this coverage in place until the property is sold. Coverage can be extended to REO properties from both the lender placed hazard insurance or the blanket hazard insurance policies.

Impairment Layer

This is the layer of insurance that responds if the lender is financially impaired. By definition, lender impairment can only be calculated after property is foreclosed and sold, or when legal liability is proven against the lender. Mortgage impairment policies are designed to protect the lender from physical damage losses as well as losses due to errors & omissions in servicing a mortgage.

Homeowner Tracking Techniques – Tracking techniques, which are defined by the insurance tracking requirements of the impairment layer, include both checking and ex-checking tracking. The checking technique requires the borrower to verify all borrowers’ homeowner insurance annually as well as

respond to cancellation or non-renewal notices within the 90 day window. This type of tracking is usually required when servicing secondary market loans. Ex-checking tracking eliminates the requirement of annual homeowner verification, but still enables the lender to respond to cancellation and non-renewal notices.

90 Day Direct Physical Loss Coverage – Traditional Mortgage Impairment Policies provide 90 days of physical loss coverage. The purpose of this coverage was to allow the lender to re-establish primary layer coverage by having the borrower re-obtain homeowner’s coverage or to enable the lender to place mortgage hazard insurance to protect the lender’s interest. This policy requires the lender to know when the borrower’s insurance has lapsed and to respond before the end of the 90 day time period. Mortgage Impairment policies allow different tracking techniques including checking and Ex-checking described above. If the lender does not remedy the coverage within 90 days of becoming aware of the insurance lapse, and a physical damage claim occurs, there will be no coverage under the Mortgage Impairment Policy.

Blanket Direct Physical Loss Coverage – There are Mortgage Impairment Policies now available that will eliminate both the 90 day coverage rule and the need to track homeowners insurance. These types of policies are cost effective to lenders with low risk portfolios who have a limited physical damage loss history. These types of policies should be compared with traditional Mortgage Impairment Policies to determine the most cost effective approach.

Summary

Lender hazard insurance has traditionally been a very specialized form of insurance requiring insurance and mortgage experts to design policies with dozens of customized endorsements to meet the needs of individual lenders. Many of the new products on the market today will broaden coverage and eliminate the “expertise” required to implement fail safe programs. We can help you understand your options in layman’s terms so that you can make an informed decision on your lender hazard insurance.