Public Hearing on Private Lender-Placed Insurance

Property and Casualty Insurance (C) Committee and Market Regulation and Consumer Affairs (D) Committee

National Association of Insurance Commissioners

Testimony of

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Biography

My name is Robert P. Hartwig and I am an Economist and serve as President of the Insurance Information Institute, an international property/casualty insurance trade association based in New York City.[1] I hold M.S. and Ph.D. degrees in Economics and am also a Chartered Property Casualty Underwriter (CPCU), I have worked on and testified on a wide variety of insurance issues during my 19 years in the property/casualty insurance and reinsurance industries, including many related to property insurance issues, catastrophe loss exposure, rate of return and cost of capital requirements and overall industry financial performance.. The Institute's members account for nearly 70 percent of all property/casualty insurance premiums written in the United States. Its primary mission is to improve understanding of the insurance industry and the key role it plays in the U.S. and global economies. A copy of my biography is attached as Appendix A.

Executive Summary

My testimony today is intended to provide insights into the economic and financial necessity of lender-placed insurance (LPI) and the broad benefits that LPI brings to the product's many stakeholders—homeowners, lenders, investors in mortgage-backed securities, insurers, regulators and taxpayers—by virtue of the critical role that it plays in protecting all parties against potentially ruinous losses arising from the damage and destruction of mortgaged property from a wide spectrum of risks.

LPI is a coverage whose important role in the economy, within the insurance industry and among lenders and borrowers is as complex as it is critical. Its importance has been growing, both as a result of increased demand for LPI in the wake of the nation's housing crisis and also because of rising vulnerability of property to damage from increased catastrophe activity. LPI also facilitates the smooth functioning of the primary and secondary residential mortgage markets and serves as a means for satisfying the requirements placed on the mortgage market by federal regulators.

In order to effectively address the many key issues in the LPI market, my testimony is divided into two sections. Section I provides a primer into the unique nature of lender-

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placed insurance, the drivers of demand for the product, operational details of the LPI market and the major distinctions between LPI and standard homeowners insurance coverage. Section I also includes discussions and implications of the following key features of LPI:

- High concentration of catastrophic risk in LPI;
- Implications of the lack of individual risk underwriting in LPI, and
- Automatic, continuous and retroactive coverage provisions.

Section II focuses on the role of LPI as a valuable and legitimate risk management tool designed to meet the unique needs of lenders. I will also address the key role played by LPI in reducing uncertainty in primary and secondary mortgage markets and potential market (price and availability) consequences associated with introducing unnecessary or unsound regulatory changes on LPI coverage. Finally, I will discuss LPI as an indispensible means for protecting state and federal taxpayers as well as policyholders from the threat of higher premiums, residual market assessments and taxes, especially in an era of megacatastrophes.

A summary of my major points in Section II follows:

- Lender-placed insurance coverage is a legitimate and important risk management tool for financial institutions;
- LPI provides real and tangible value to homeowners;
- LPI allows lenders to satisfy stringent regulatory requirements set forth by federal regulatory agencies;
- LPI facilitates the secondary market for mortgage-backed securities;
- LPI protects federal taxpayers, and
- LPI protects other policyholders and states taxpayers by keeping substantial numbers of policies out of state-run property insurance residual market plans.
- LPI is itself effectively a highly specialized, privately funded residual market and not a market where the notion of “reverse competition” is applicable.

SECTION I: A Primer on Lender-Placed Insurance

Background: The Economic Rationale and Demand for Lender-Placed Insurance

The section that follows provides and explanation of what lender-placed insurance is, how it works, and why it differs from traditional homeowners insurance in the way it is sold and priced.

When a residential mortgage is originated for the purposes of a home purchase, the lender acquires an ownership stake in the house as collateral for the loan. To protect the value of its collateral, the lender requires the borrower to obtain and maintain insurance that would pay for damage or destruction caused by the hazards/perils (e.g., a fire, a hurricane) to which the house might typically be exposed in an amount that, at a minimum, would pay off the loan. To meet this requirement, the vast majority of borrowers buy homeowners insurance.[2]

Lender-placed insurance generally comes into play when a mortgage borrower *stops* paying homeowners insurance premiums. To continue protecting their financial interest in the home, lenders place property insurance with an insurance company that specializes in this distinctive and critical form of coverage, charging the premiums to the borrower.

Although instances of nonpayment of homeowners insurance premiums are relatively uncommon, they do occur, even in prosperous times. However, in the last few years the incidence of homes-as-collateral without an in-force property insurance policy has increased dramatically, mainly due to two developments:

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[2] In addition, for homes situated in a FEMA-designated flood plain, lenders require the purchase of flood insurance, which is available from FEMA's National Flood Insurance Program. In some coastal areas, purchase of a separate wind insurance policy is also required, typically through state-run pools and plans, though in most locations wind damage is covered by the basic homeowners insurance policy.

1. The 2007-2009 recession, during which the unemployment rate rose sharply, impacted the ability of some homeowners to continue making mortgage, property tax and homeowners insurance premium payments.

2. The bursting of the "housing bubble," in which even people who could continue making mortgage (and homeowners insurance) payments found that the balance on their loan far exceeded the market value of the house—wiping out all of their equity and offering little hope of recovering the equity in any foreseeable future. As a result, some stopped making their mortgage and insurance payments, while others abandoned the home (or sought "short sales") and moved to cheaper rental quarters. This action is sometimes referred to as a "strategic default."

Table 1 indicates how quickly and how severely conditions deteriorated in the U.S. mortgage market in recent years. By year-end 2010, the delinquency rate on residential mortgages had increased more than six-fold to 4.02 percent from 0.64 percent in 2007.

Table 1: Percent of Nonfarm Residential Mortgage Loans Delinquent 90 Days or More or in Nonaccrual Status

Year-end	**Delinquency Rate**
2007	0.64%
2008	1.80%
2009	3.34%
2010	4.02%
2011	3.53%
2012:Q1	3.76%

Source: *FDIC Quarterly Banking Profile*, Table V-A ("Loan Performance, All FDIC-Insured Institutions, Mortgage Lenders")

While down from its 2010 peak, the delinquency rate in early 2012 remained elevated. Many (if not most) mortgages that become delinquent eventually sustain a lapse in homeowners insurance coverage as well. It is at this point that LPI coverage comes into force. These factors dramatically increased the demand for lender-placed insurance. Exhibit 1 shows this pattern of growth, with direct earned premiums for lender-placed insurance more than tripling from $954 million in 2006 to $3.1 billion in 2011.[3] The operation of LPI is discussed in detail in the next section.

How Lender-Placed Insurance Works

Because continuous insurance coverage is so important to the lender's collateral, lenders hire a firm to track the status of insurance coverage on each home on which the lender has an outstanding mortgage loan. Again, this function is necessary because the borrower who initially had insurance sometimes does not keep that coverage in effect.

To ensure that insurance coverage remains in place on a mortgaged property even if the borrower's insurance is no longer in force, mortgage servicers connect the information from the tracking service with an insurer that provides a master group property insurance policy. The group policy initiates coverage on the home, retroactive to the instant when the borrower's policy terminated. This is called lender-placed insurance (LPI). The premium for this insurance is, under the originating mortgage document, the responsibility of the borrower.

Borrowers are notified that the premium they will be charged for lender-placed insurance is likely to be more expensive than what they have been paying for their own homeowners insurance. However, in several notices sent to borrowers from their lender/servicer, the borrower is informed that they can replace the lender-placed coverage with their own homeowners insurance at any time (and likely lower their premium payments) by arranging for the homeowners coverage and notifying the mortgage servicer that they no longer need the lender-placed policy. If it is discovered that the borrower had property insurance in force continually, the lender-placed insurance is cancelled retroactively, and all premiums collected for it are returned.

Some borrowers pay the LPI premium as it comes due. For others, the amount of insurance premiums paid on the borrower's behalf is added to the outstanding balance of the loan and is collected (to the extent possible) when the property is ultimately sold.

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[3] Testimony of Sheri L. Scott, FCAS, MAAA, *NAIC Hearing on Private Lender-Placed Insurance,* Appendix B, August 9, 2012.

The Federal National Mortgage Association (Fannie Mae) recently revised its rules for use of lender-placed insurance on mortgages it buys.[4] These affect the amount of insurance carried, the timing and content of notices to be sent to the borrower, the qualifications of insurers that may be used, and the determination of rates to be charged.[5] Since Fannie Mae buys a majority of the mortgages issued, these rules have the effect of determining practices for the lender-placed insurance market.

The insurer providing lender-placed insurance covers every home with a lender's mortgage that doesn't have homeowners or similar property insurance, and the premium rate charged is generally the same for all homes. Unlike standard homeowners insurance, the LPI insurer cannot reject a risk or charge a higher premium for what an underwriter or actuary would normally consider a higher-than-average risk. Indeed, many homes on which LPI coverage has been activated are highly vulnerable to catastrophes, such as hurricanes in Florida. Some have had multiple prior claims. Many homes are at higher risk simply because they are vacant or abandoned and vulnerable to the elements and vandalism. Others are occupied by people who likely do not have the financial resources (and possibly the motivation or incentive) to keep the home safe, secure or properly maintained. The LPI insurer also must provide flood and wind coverage even if a standard homeowners insurance policy would exclude (or charge additional premium for) covering those perils. In addition, it cannot recover money spent to initiate coverage that is later found to have been not needed.

[4] https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2012/svc1204.pdf. The revision took effect March 14, 2012.

[5] For mortgage loans that are delinquent for fewer than 120 days, the insurance should be the borrower's last-known amount; for loans delinquent for 120 days or more, the amount should be the lesser of (i) the outstanding principal balance or (ii) the insurable value of the improvements. For other rules, see the Guides cited above.

Differences Between Lender-Placed Insurance and Homeowners Insurance

There are several important differences between homeowners insurance, on the one hand, and lender-placed insurance, on the other.

Coverage Distinctions

LPI coverage is designed to protect the lender's financial stake in a mortgaged property on which the homeowner has allowed a residential property coverage policy to lapse. Consequently, LPI coverage is restricted to damage done to the structure of the mortgaged property. LPI does not cover contents (i.e., the personal possessions of the homeowner) or provide liability protection (which provides coverage in the event that the property owner is found legally liable to a third party).[6] LPI insurance also does not cover additional living expenses (ALE).[7] In this sense, LPI is narrower than under a standard homeowners insurance policy.

Underwriting Distinctions

However, from an underwriting perspective, LPI coverage is offered under substantially more liberal terms and conditions. Indeed, there is effectively no underwriting of the individual homes insured under LPI programs. Properties are admitted into the program on a "bulk acceptance" basis. In contrast, in the standard homeowners insurance market insurers underwrite extensively and individually in order to assess risk and establish a price that accurately reflects the risk of a single, specific property. Standard market home insurers take many criteria into consideration, including the physical characteristics of the home (e.g., construction features, age, etc.), its location (both in relation to the home's physical environment—including vulnerability to catastrophic perils such as hurricane, tornadoes, hail, wildfire, snow/ice/freezing—and the home's access to services like fire and police departments), the amount of insurance in relation to the cost of rebuilding the home and prior claim activity. Also, home insurers often use credit-based insurance scores in their underwriting decisions because lower insurance scores are highly correlated with high relative losses. No consideration is given to any of these factors for

[6] Examples of common liability claims under a standard homeowners insurance policy would include slip-and-fall claims or dog bite liability.

[7] Additional living expense coverage under a standard homeowners insurance policy pays for expenses incurred above and beyond normal living expenses on residences rendered uninhabitable following damage by a covered cause of loss.

any individual property as a precondition for acceptance under the bulk master LPI program.

Geographic Concentration and Exposure to Catastrophic Risk

The freedom of selection that homeowners insurers possess enables them to spread their risk geographically, avoiding insuring homes that are too close to each other—and therefore potentially subject to the same cause of damage at the same time. Geographic distribution of risk (i.e., avoiding excessive geographic concentration) is critical to the success of property insurance markets. The expected value of losses arising from insuring 100 geographically-dispersed homes (e.g., across a state) valued at $100,000 each is substantially less than insuring the same number of homes of equal value in a geographically concentrated area (e.g., same city or county) because the chance of all 100 geographically-dispersed homes sustaining damage at the same time from the same cause is many orders of magnitude smaller than for those homes located in the same geographic area.

In contrast, insurers offering lender-placed policies do not underwrite individual properties. LPI insurers agree to provide coverage on any and all homes whose property insurance has lapsed, regardless of the proximity of the newly insured home to others already insured, and regardless of the location, condition, prior claim activity or other factors that homeowners insurers use to select and price.

Yet another key difference is the freedom of homeowners insurers to decide which perils to cover, and on what terms. For example, for many decades, standard homeowners insurance policies have excluded coverage for damage caused by flood, including homes located within FEMA-designated flood plains. To protect their financial interest in the mortgaged property, lenders require borrowers to obtain flood insurance from the federal National Flood Insurance Program, at rates that are generally subsidized by taxpayers. In contrast, LPI includes flood coverage, but at unsubsidized actuarially-sound rates.

The Table 2 below summarizes the key distinctions between coverage provided under a standard homeowners insurance coverage and LPI programs.

Table 2.
Key Coverage and Underwriting Distinctions Between Lender-Placed Insurance and Standard Homeowners Insurance Coverage

	Homeowners Insurance	**Lender-Placed Insurance (LPI)**
Property/Expenses Insured	Home and outbuildings, Contents, Additional living expense	Home and outbuildings
Liability Insurance	Yes	No
Premium/Underwriting Considerations	Many, including location and construction of the home, claim history, other insurance with the same carrier, etc.	None
Flood-Caused Damage	Requires separate NFIP policy	Covered under LPI
Wind-Caused Damage	Might require separate policy	Covered under LPI
Geographical Concentration of Risks	Insurers are generally free to select so as to avoid excessive risk concentration	Insurers must take all risks, even if doing so results in a high risk concentration

Implications for LPI Pricing

The preceding discussion established that while LPI coverage is narrower in some respects, the coverage it affords is broader in others. Both factors influence pricing but in opposite directions. Beyond the issue of breadth of coverage are considerations related to the unambiguous risk amplifying effects associated with LPI coverage. These factors, discussed initially in the previous section, exert upward pressure on pricing and include the following:[8]

- **Concentration of Catastrophic Risk:** The bulk acceptance of properties under LPI programs, compounded by the fact that a number of states with the highest mortgage foreclosure rates are highly catastrophe prone, suggests that LPI insurers will have vulnerability to catastrophe losses that often exceeds that of

[8] Some material in this section is drawn from the testimony of John Rollins, FCAS, MAAA, at the National Association of Insurance Commissioners hearing on Lender-Placed Insurance, August 9, 2012.

standard market home insurers. The resulting expectation of higher catastrophe losses and greater variability in annual results over time must be reflected in the cost of LPI coverage, irrespective of the structure of LPI insurer's reinsurance program.

- **Lack of Individual Risk Underwriting:** The lack of individual risk underwriting unambiguously increases uncertainty for any given portfolio of properties accepted on a bulk basis under an LPI program relative to the same properties underwritten in the standard homeowners insurance market. The increase in uncertainty (and commensurate increase in volatility) must be reflected in the price of LPI coverage.
- **Automatic, Continuous and Retroactive Coverage:** LPI coverage is activated *automatically* at the moment the property owner's standard policy lapses (again, without the benefit of any individual risk underwriting). The coverage is *continuous* is the sense that even if the lapse is not discovered until days or weeks later, the coverage is *retroactive* to the instant of lapse. In other words, an LPI insurer could effectively wind up insuring a home that had burned down or been blown down weeks earlier. Stated simply, the old adage that you can't insure a house that's already on fire doesn't apply to LPI insurers. Again, this unique and risky feature of LPI, which is unheard of in the standard homeowners insurance market (or even in high risk state-run residual markets), must be reflected in the cost.
- **Financial Responsibility:** The lapse of a voluntary market homeowners insurance policy is usually triggered by a major credit event such as a significant delinquency or default on a mortgage. As discussed previously, credit standing, as measured by credit-based insurance scores, has been demonstrated in many studies to be predictive of insured loss. Consequently, insurers in many states use insurance scores in the underwriting process. The combination of a major credit event suggests enhanced riskiness while the loss of the ability to use credit information going forward (due to the inability to underwrite risks on an individual basis) adds to uncertainty which again must be reflected in base rates for LPI coverage.

SECTION II: Risk Management, Regulation and LPI Market Implications

The Risk Management Role of Lender-Placed Insurance

Insurance is a financial risk management tool that allows individuals and businesses to reduce or avoid risk through the transfer, pooling or sharing of risk with a third party, usually an insurance company. In return for a payment (i.e., the premium), the insurer assumes the risks—that is, obligates itself to pay the losses—of all policyholders.

Lender-placed insurance is no different and fits squarely within this definition. It is first and foremost a risk management tool for financial institutions that helps them to manage risk on more than 48 million residential mortgages written on properties all across the United States. The underlying value of the property associated with these mortgages as of Q1 2012 was a staggering $12.2 *trillion* with an aggregate outstanding mortgage debt of $8.6 *trillion*, implying a loan-to-value ratio of 70.5 percent.[9] Put differently, the $8.6 trillion in outstanding mortgage debt of borrowers is presently 2.4 times larger than borrowers' home equity of $3.6 *trillion*.

LPI has never been more important to helping maintain stability in the primary and secondary mortgage markets. Default rates on mortgages have soared in recent years. Because borrowers who cease mortgage payments are also likely to stop paying residential property insurance premiums, the potential uninsured exposure to lenders is likewise large and growing. The aggregate value of the more than 800,000 completed foreclosure transactions in United States in the 12-month period ending in May 2012 was approximately $150 billion.[10] Exhibit 2 shows the number of completed foreclosures by state during this same period. Leading the list are catastrophe-prone states that are also among the largest LPI states, most notably California and Florida. Exhibit 3 shows the inventory of foreclosed homes (i.e., the proportion of all mortgaged home currently in the foreclosure process). Again, Florida leads the way.

Even today, three years after the official end of the "Great Recession" in June 2009, 11.4 million mortgages—24 percent of all mortgages—are in a negative equity position (i.e.,

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[9] As of the Q1 2012; CoreLogic Press Release, July 12, 2012.

[10] Based on CoreLogic foreclosure data (June 29, 2012 press release) and RealtyTrac data on average sale value of foreclosed property in May 2012.

the outstanding value of the mortgage exceeds the value of the home). Another 2.4 million mortgages (nearly 5 percent of all mortgages) are in a “near” negative equity position.[11] Again, these conditions have given rise to a large and ongoing surge in the number of residential mortgages with lapsed homeowners insurance coverage and unprecedented demand for LPI coverage. LPI allows lenders to reduce or eliminate the risk that the value of mortgaged properties will be reduced (potentially to zero) by damage or destruction from a wide range of perils as discussed in Section I. At the same time, LPI helps preserve the value of a tangible asset (a home) and therefore provides significant benefits to homeowners as well. Again, a homeowner whose property is currently insured through an LPI program can at any time reinstate their policy by paying a premium to a home insurer operating in the standard homeowners insurance market.

Lender-Placed Insurance Provides Real and Tangible Value to Homeowners

In recent years, LPI carriers have paid billions in dollars in claims arising from the damage and destruction of homes on which homeowners had allowed their insurance coverage to lapse. In the absence of LPI, these homeowners would be not only still be responsible to the lender for the outstanding value of any mortgage balance, but would have little or no collateral and no means for repairing or rebuilding a home that had been damaged or destroyed. This problem would be exacerbated for homeowners who were/are in negative equity positions or who also had outstanding home equity loans/lines of credit.

LPI Is Necessary in Order for Lenders to Meet Federal Regulatory Requirements

All mortgage lenders require residential property coverage to be in force at all times. Fannie Mae and Freddie Mac, government sponsored enterprises (GSEs) that together currently support approximately 60 percent of all mortgage originations in the United States, likewise require continuous coverage on all properties that serve as collateral. Consequently, LPI is necessary in cases where the homeowner ceases to keep coverage in force as required under the mortgage agreement. Were it not for LPI, many if not most of the properties on which policies had lapsed would have to be placed into state-run residual market programs, potentially drawing subsidies from the broader

[11] Defined as properties in negative equity or within 5 percent of being in a negative equity position.

property/casualty insurance market or even the state's taxpayers. Interesting, even state-run markets of last resort may reject many of these properties (details are discussed in more detail below). The adverse public policy consequences of such a situation are discussed later in Section II.

Lender-Placed Insurance Facilitates the Secondary Market for Mortgage-Backed Securities

As of the second quarter of 2012, the total value of mortgage-backed securities (MBS) outstanding exceeded $8.3 trillion. Over the past few years, with foreclosure rates rising, LPI has played an increasingly important role in maintaining stability and viability in the MBS markets. LPI reduces investor uncertainty associated with the value of underlying assets that back MBS, therefore enhancing liquidity, lowering transactions costs and keeping mortgage interest rates lower than they would otherwise be.

Lender-Placed Insurance Protects Federal Taxpayers

According to the Federal Housing Finance Authority, government sponsored enterprises such as Fannie Mae and Freddie Mac held or securitized $5.3 trillion in outstanding residential mortgage debt in 2010—46.7 percent of the total $11.4 trillion in mortgage debt outstanding. Because a large and increasing number of mortgages have become delinquent in recent years, GSEs have suffered tremendous losses requiring a massive federal bailout costing taxpayers some $190 billion to date. Indeed, Fannie and Freddie were effectively nationalized in late 2008. As the number of mortgage delinquencies soared in recent years, so did the nonpayment of homeowners insurance premiums, increasing the exposure of taxpayers. LPI coverage has prevented hundreds of millions—if not billions—of dollars of addition losses to taxpayers by preserving the value of mortgaged assets that have been damaged or destroyed by covered causes of loss.

Lender-Placed Coverage Reduces the Burden on State-Run Residual Market Programs, Protects P/C Lines Policyholders and State Taxpayers

LPI reduces the size of already financially strained state-run property residual market programs. Figure 4 shows the rapid growth in state-run property residual market in terms of policies in force programs since 1990. Most of that growth occurred over the past decade, with policy counts nearly tripling from 1.2 million in 2001 to 3.3 million in 2011. The associated residual market exposure to loss, displayed in Exhibit 5, more than tripled, from $244.2 billion to $884.7 billion over the same period.

If there were no LPI market, or if the size of that market were reduced though unsound regulation or the adoption of rates or rate making methodologies that are unsupported by actuarial science, state-run residual markets could end of insuring many of these properties, increasing policy counts and exposure to loss—potentially substantially in some states like Florida. Many of these plans are deeply troubled financially, charge premiums that are not actuarially sound and have run deficits that must ultimately be financed through subsidies (in the form of assessments and surcharges) from policyholders who maintain their policies in good standing. Even non-property lines, such as auto insurance, can be assessed. In the event of particularly severe events, the state's taxpayers could be impacted because states often guaranty the borrowing capability of the state-run insurer.

It is important to note that if regulatory changes are adopted that lead to a reduction in capacity in the LPI market, state-run residual markets are not automatically *obliged* to accept these policies. Some (perhaps many) properties insured under LPI programs will not meet the underwriting criteria of these plans, leaving lenders and homeowners with no private or public sector alternatives. Indeed, a review of underwriting guidelines for Florida's Citizens Property Insurance Corporation, Florida's large residual market, reveals that there are many types of properties that are routinely insured through LPI that would be ineligible for coverage by Citizens (see Appendix B). For example, Citizens "Rules of Practice" states that properties with the following characteristics (to name just a few) are uninsurable and should not be submitted:[12]

- Condemned Properties
- Properties in Disrepair

[12] Citizens Property Insurance Corporation, *Rules of Practice*, Rule 7, Document Nos. HO.ROP-10 through HO.ROP-14, June 2012 through October 2012 editions.

- Properties with Existing Damage
- Properties Over 50 Years Old (unless wiring has been updated)
- Properties with Heating, Electrical and Plumbing Systems Not in Good Working Order
- Roofs that Are Damaged, Have Visible Leaks, Have Fewer than 3 Years of Remaining Useful Life or Are Beyond a Certain Age (e.g., 25 years for a shingle roof)
- Vacant or Unoccupied Property
- Seasonal Homes
- Prior Sinkhole Claim

Many properties insured today under LPI programs would be ineligible for coverage even in Florida's market of last resort because they would trigger one or more of these ineligibility factors. Moreover, even if a property is eligible to be underwritten by Citizens, the homeowner will be surcharged and be required to wait a month before coverage is activated (hence coverage is not automatic, retroactive or continuous as is the case with LPI):[13]

"Both the surcharge for no prior insurance and a 30-day wait period will apply for applicants ***who had force-placed coverage*** or no prior insurance within the 45 days prior to applying for Citizens coverage. All risks submitted to Citizens must show proof that the applicant qualifies under either the no-offer-of-coverage rule or the 15-percent rule."

While it should go without saying, nonpayment of premium will result in cancellation of a residual market policy just as it would with any standard homeowners insurer. With LPI, the coverage remains in force even if the homeowner never pays a premium.

In effect, because of the bulk acceptance of properties under LPI programs, LPI functions like a privately funded residual market—but one in which rates are actuarially sound. Unlike most residual market plans, LPI is entirely self-funding. No taxpayer or property/casualty insurance policyholders subsidize LPI insurance or insurers. In many

[13] Citizens Property Insurance Corporation, Agent Technical Bulletin #010-12, April 20, 2012.

respects the coverage available through LPI programs is underwritten in a far more liberal manner.

Lender-Placed Coverage Is Becoming Increasingly Valuable as the Frequency and Severity of Catastrophe Losses Continues to Rise

There is no question that the frequency and severity of catastrophe losses in the United States tracking upwards. Consequently, the broad protection provided by LPI is becoming increasingly necessary and valuable to lenders and homeowners alike. Evidence of the increasing value of insurance protection against catastrophe risks is clearly evident in Exhibit 6 and Exhibit 7, which show the number and insured losses associated with natural catastrophes in the United States since 1980. Both are generally increasing, with much of the increase being driven by catastrophes in states with large LPI markets. This trend is corroborated in Exhibit 8, which depicts a clear upward trend in the number of Federal Disaster Declarations, with records set in both 2010 and 2011. Exhibit 9 shows that many of these declarations are in states with a large LPI market presence. Further evidence of the vulnerability of LPI insurers to catastrophic loss is displayed in Exhibit 10, which shows that the majority of the fourteen largest catastrophes in the United States (ranked by insured loss), were in larger LPI markets. Exhibit 11 shows that years with high insured catastrophe loss totals are increasingly common. Indeed, insured losses were close to or exceed $30 billion in five of the eleven years from 2001 to 2011.

Summary

Lender-placed insurance is an increasingly important and highly specialized coverage that produces significant benefits to the product's many stakeholders—homeowners, lenders, investors in mortgage-backed securities, insurers and taxpayers alike. By virtue of the critical role that LPI plays in protecting all parties against potentially ruinous losses arising from the damage and destruction of mortgaged properties from a wide spectrum of risks, uncertainty and volatility are reduced for all parties.

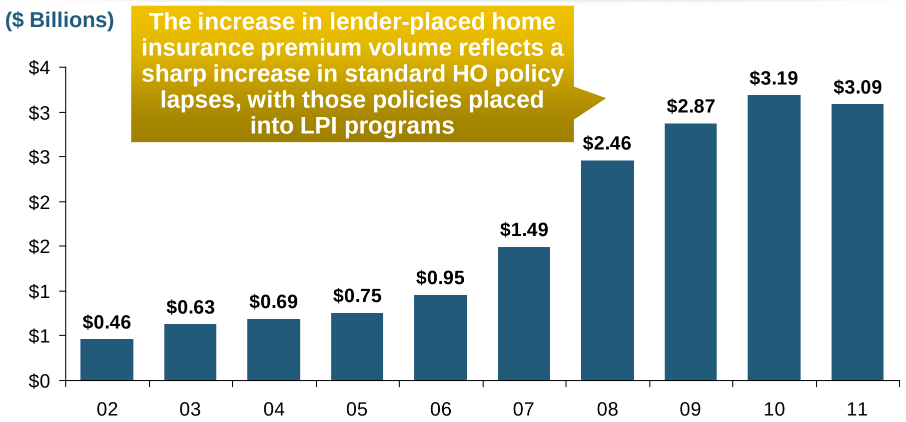
LPI's unusual bulk acceptance feature, lack of individual risk underwriting and automatic, continuous and retroactive coverage provisions make the product unique in the insurance world. Coupled with the inability to spread risk geographically and high exposures to catastrophe loss—LPI is also uniquely risky. Yet, despite these challenges, LPI remains an important risk management tool for lenders as well mortgage investors. Importantly, LPI also serves to reduce potential taxpayer and policyholder exposure to loss via already overburdened residual market mechanisms. LPI, though it functions much like a quasi-residual market, receives no subsidies and imposes no burden on taxpayers.

As is the case with any insurance market, regulations or changes to rates or ratemaking methodologies that are not based on sound actuarial principles could potentially reduce capacity in the highly specialized LPI market, jeopardizing the ability to protect the property of homeowners, the lender's mortgage interest in the property as well as the stability of the primary and secondary mortgage markets.

Thank you for you for the opportunity to testify before the Committee today. I would be happy to respond to any questions you may have.

Exhibit 1

Lender-Placed Homeowners Insurance, Earned Premiums, 2002-2011

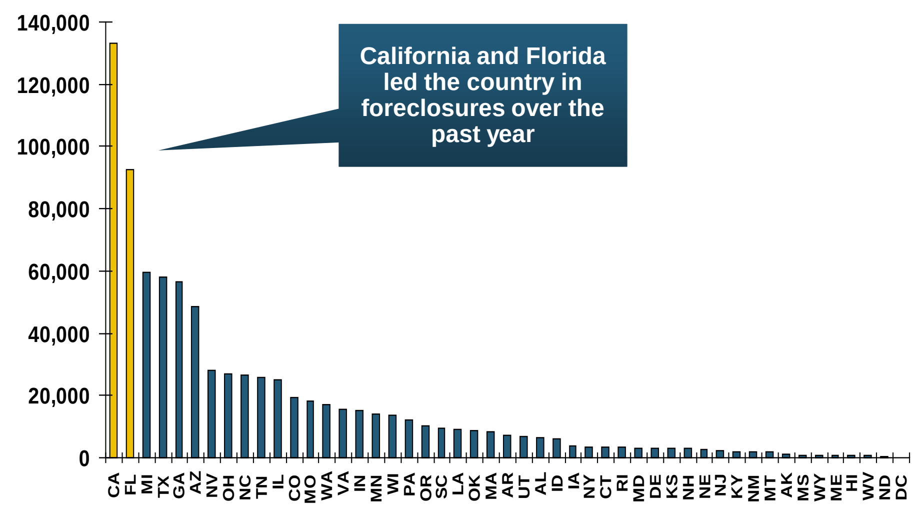


Rising Delinquency Rates on Residential Mortgages Sharply Increased the Demand for Lender-Placed Coverage Beginning in 2007

Source: Data are drawn from Milliman Inc., Testimony of Sheri L. Scott, FCAS, MAAA, at NAIC Public Hearing on Lender-Placed Insurance, August 9, 2012.

Exhibit 2

Completed Residential Foreclosures by State, 12 Months Ending in May 2012



Note: The number of completed foreclosures for South Dakota and Vermont were not available. Completed foreclosures, 12 months, ending May 2012.
Sources: CoreLogic May 2012; Insurance Information Institute.

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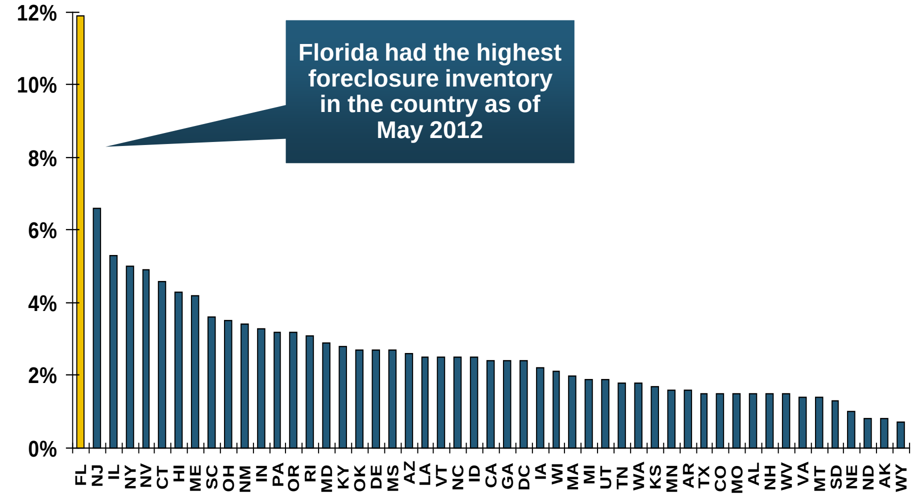
Exhibit 3

Residential Foreclosure Inventories by State as of May 2012*

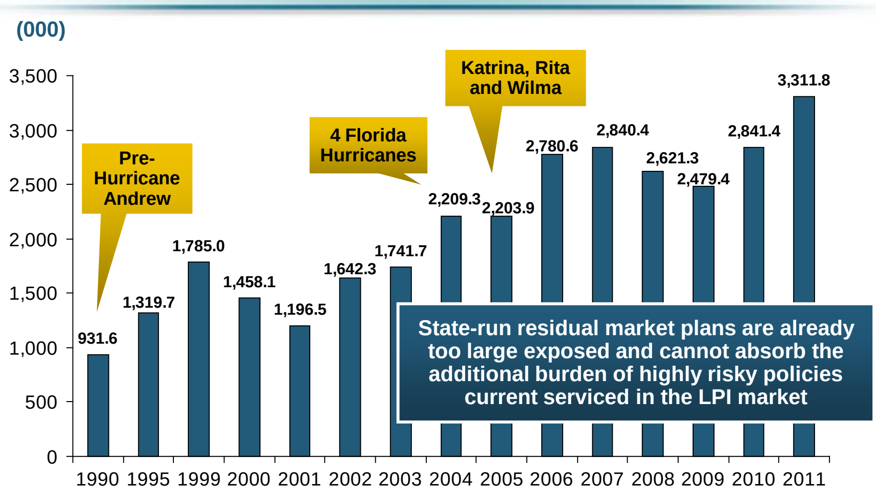


*The foreclosure inventory represents the number and share of mortgaged homes that have been placed into the process of foreclosure by the mortgage servicer.

Sources: CoreLogic May 2012; Insurance Information Institute.

Exhibit 4

U.S. Residual Market: Total Policies In-Force (1990-2011) (000)



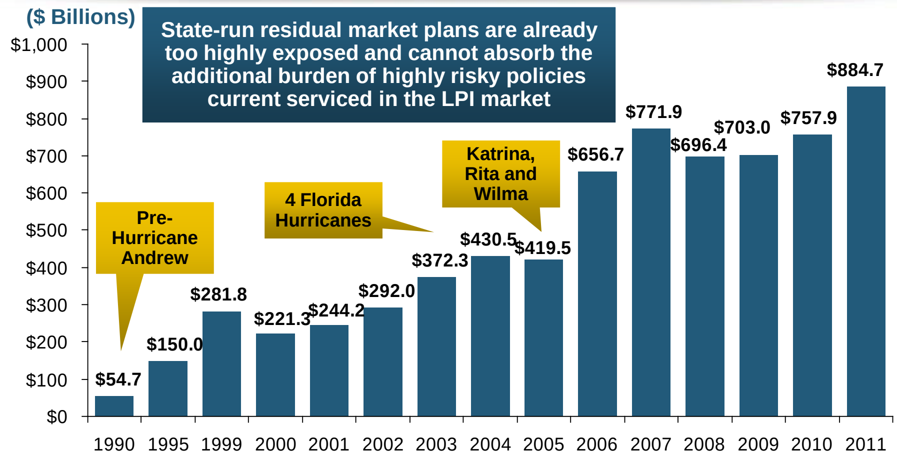
In the 22-year period between 1990 and 2011, the total number of policies in-force in the residual market (FAIR & Beach/Windstorm) Plans has more than tripled, exposing policyholders and taxpayers to significant losses.

Source: PIPSO; Insurance Information Institute

Exhibit 5

U.S. Residual Market Exposure to Loss ($ Billions)

INSURANCE INFORMATION INSTITUTE



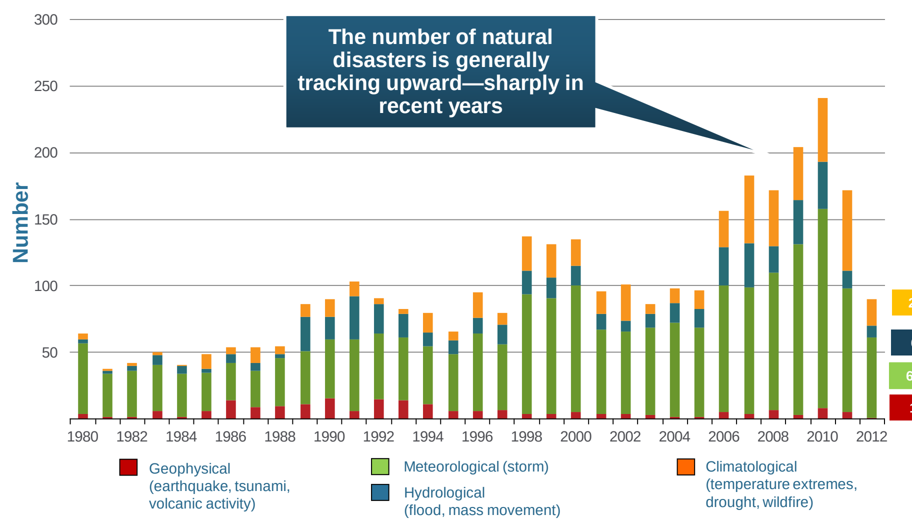
In the 22-year period between 1990 and 2011, total exposure to loss in the residual market (FAIR & Beach/Windstorm) Plans has surged by more than 1,500% from $54.7 billion in 1990 to a record high of $884.7 billion in 2011.

Source: PIPSO; Insurance Information Institute (I.I.I.).

Exhibit 6

Natural Disasters in the United States, 1980 – 2012:H1

INSURANCE INFORMATION INSTITUTE

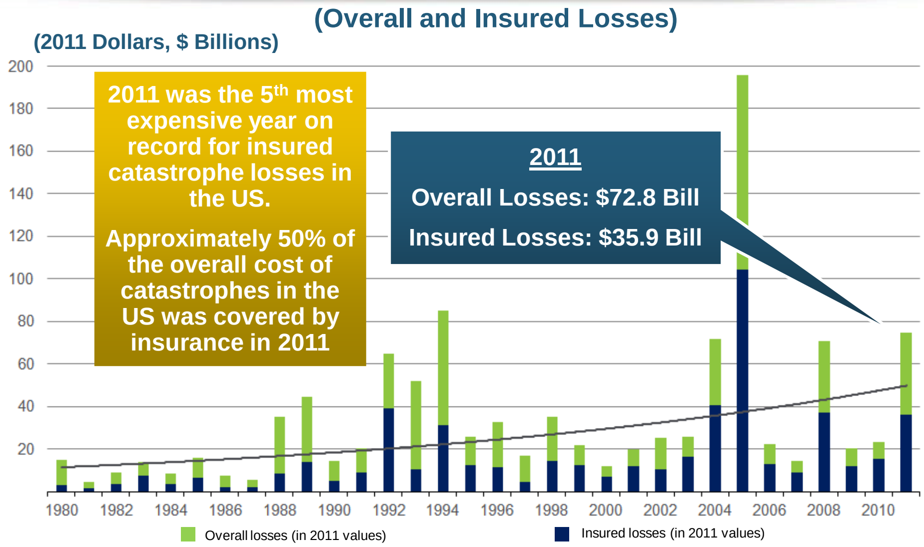


Source: MR NatCat*SERVICE*

Exhibit 7

Losses Due to Natural Disasters in the US, 1980–2011 (Overall & Insured Losses)

INSURANCE INFORMATION INSTITUTE



Source: MR NatCat*SERVICE*

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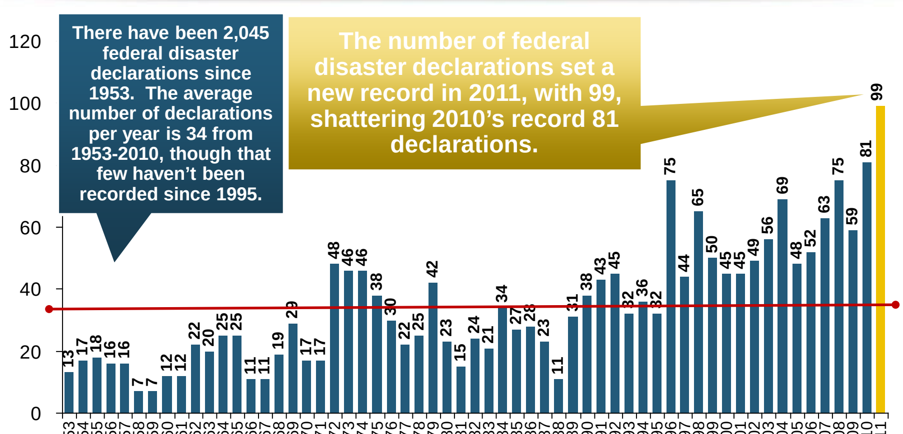
Exhibit 8

Number of Federal Disaster Declarations, 1953-2011

INSURANCE INFORMATION INSTITUTE



The Number of Federal Disaster Declarations Is Rising and Set New Records in 2010 *and* 2011

Source: Federal Emergency Management Administration; http://www.fema.gov/disasters; Insurance Information Institute.

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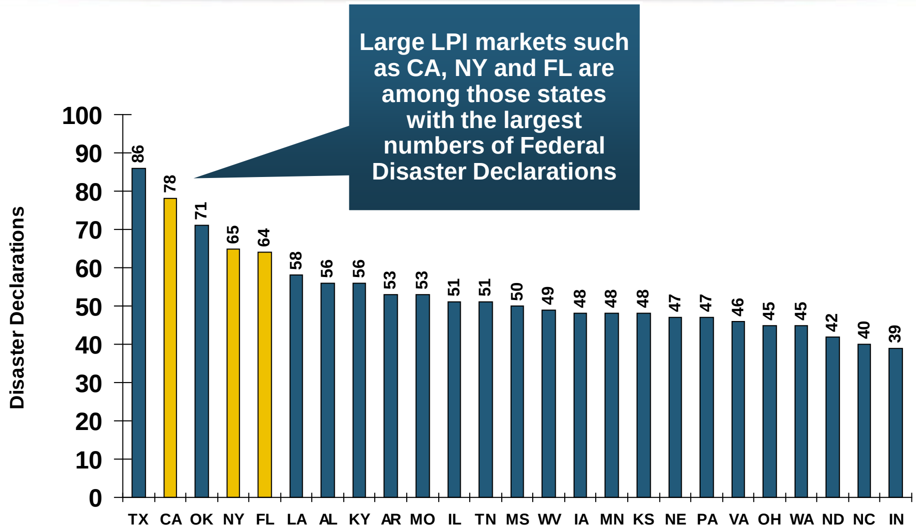
Exhibit 9

Federal Disasters Declarations by State, 1953 – 2012: Top 25 States*



*Through July 27, 2012. Includes Puerto Rico and the District of Columbia.
Source: FEMA: http://www.fema.gov/news/disaster_totals_annual.fema; Insurance Information Institute.

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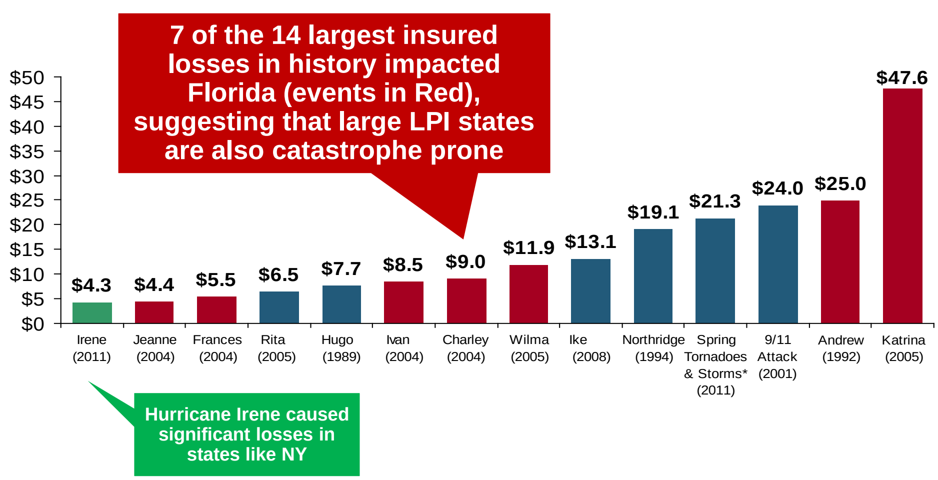
Exhibit 10

Top 14 Most Costly Disasters in U.S. History

(Insured Losses, 2011 Dollars, $ Billions)



*Losses are actually broken down into several "events" as determined by PCS. Includes losses for the period April 1 – June 30, 2011.
Sources: PCS; Insurance Information Institute inflation adjustments.

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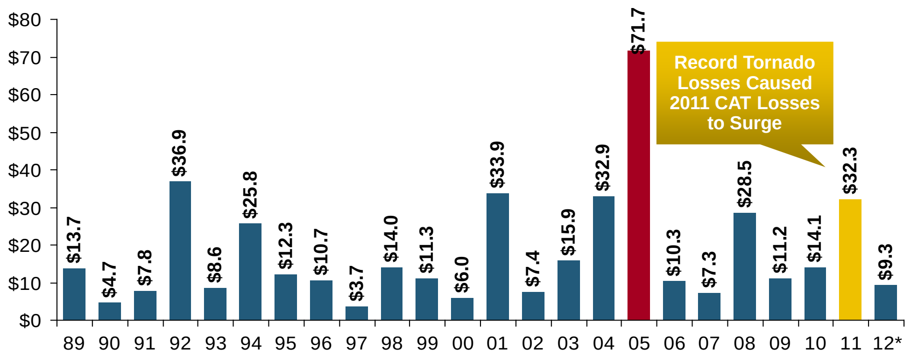
Exhibit 11

US Insured Catastrophe Losses

($ Billions, 2011 Dollars)



US CAT Losses in 2011 Were the 5th Highest in US History on An Inflation-Adjusted Basis

*Munich Re figure for H1 2012.

Note: 2001 figure includes $20.3B for 9/11 losses reported through 12/31/01 ($25.9B 2011 dollars). Includes only business and personal property claims, business interruption and auto claims. Non-prop/BI losses = $12.2B ($15.6B in 2011 dollars.)

Sources: Property Claims Service/ISO; Insurance Information Institute.

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APPENDIX A, Page 1 of 2

ROBERT P. HARTWIG, Ph.D., CPCU is President of the Insurance Information Institute. Since joining the I.I.I. in 1998 as an economist and becoming Chief Economist in 1999, Dr. Hartwig has focused his work on improving the understanding of key insurance issues across all industry stakeholders including media, consumers, insurers, producers, regulators, legislators and investors.

Presently, the I.I.I. provides assistance on thousands of stories annually and covers all aspects of print, television, radio and news media while also responding to thousands of requests from I.I.I. member companies and other constituencies. The Institute is generally recognized to be the most credible and frequently used single source of information and referral for the widely diverse insurance industry. Its Board represents companies from all areas of the industry including life insurers. In addition, some 20 other insurance organizations contract with I.I.I. for media services.

The I.I.I. is involved in products and services as varied as original research and publications with the National Bureau of Economic Research and The Wharton School, from widely used consumer publications and Fact Books, to maintaining the National Insurance Consumer Helpline on behalf of the entire U.S. property/casualty industry. Each year the institute's staff makes more than 100 presentations worldwide on behalf of member organizations. The Institute also develops software and apps designed to improve policyholder preparedness in the event of a routine claim or major natural catastrophe.

Dr. Hartwig previously served as director of economic research and senior economist with the National Council on Compensation Insurance (NCCI) in Boca Raton, Florida, where he performed rate of return and cost of capital modeling and testified at workers' compensation rate hearings in many states. He has also worked as senior economist for the Swiss Reinsurance Group in New York and as senior statistician for the United States Consumer Product Safety Commission in Washington, D.C. He is a member of the American Economic Association, the American Risk and Insurance Association, the National Association of Business Economics and the CPCU Society. In 2005 and 2006, Dr. Hartwig served on the state of Florida's Task Force Long-Term Homeowners Insurance Solutions. From May 2005 to May 2008, he served on the board of directors of the Independent Insurance Agents and Brokers Association of New York. Currently, Dr. Hartwig serves on the board of directors of the American Risk and Insurance Association and the Griffith Foundation for Insurance Education.

Dr. Hartwig received his Ph.D. and Master of Science degrees in economics from the University of Illinois at Urbana-Champaign. He also received a Bachelor of Arts degree in economics Cum Laude from the University of Massachusetts at Amherst. He has served as an instructor at the University of Illinois and at Florida Atlantic University. Dr. Hartwig also holds the Chartered Property and Casualty Underwriter (CPCU) credential.

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Dr. Hartwig has authored and co-authored papers that have appeared in numerous publications including the Journal of Health Economics, the Proceedings of the Casualty Actuarial Society, the Journal of Workers' Compensation, the Journal of Insurance Operations, Risk and Insurance and many others. Additionally, he is a regular contributor to *National Underwriter* and many other trade publications.

In 2011, Dr. Hartwig was awarded the National Association of Mutual Insurance Companies (NAMIC) Chairman's Award. In 2010, he was a recipient of a research award from the U.S. Chamber of Commerce Institute for Legal Reform in the area of torts and tort reform.

Dr. Hartwig makes frequent presentations to industry associations, company management, industry executives, analysts and clients and speaks internationally on a wide range of insurance issues. He has testified before numerous state and federal regulatory and legislative bodies, including the U.S. Senate Judiciary Committee, the Senate Banking, Housing and Urban Affairs Committee, the House Financial Services Subcommittee on Capital Markets and many others.

Dr. Hartwig serves as a media spokesperson for the property/casualty insurance industry, and is quoted frequently in leading publications such as *The Wall Street Journal*, *The New York Times*, *USA Today*, *Washington Post*, *Los Angeles Times*, *Financial Times*, *BusinessWeek*, *Newsweek*, *U.S. News & World Report*, *CFO*, *Fortune*, *Forbes*, *The Economist* and many others throughout the world. Dr. Hartwig also appears regularly on television, including programs on ABC, CBS, NBC, CNN, CNBC, Fox, PBS and the BBC.

(Source: www.iii.org)

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Rule 7. UNINSURABLE PROPERTIES (New and Renewal, unless otherwise noted)

The following risks may not be insured in Citizens Personal Lines (All Perils). **DO NOT SUBMIT:**

A. Commercial Property

Commercial property including properties that are eligible for coverage in Citizens' Commercial or Commercial-Residential Program

B. Coverage Limits – Minimum/Maximum

Properties for which Coverage "A" or Coverage "C" is either below or above the required limits

C. Replacement Cost/Market Value Ratio

Properties with Replacement Cost exceeding 1 ½ times the market value, excluding land values.

D. Prior Policy Term

Properties for which the most recent prior coverage was issued for less than a full annual term. These risks remain uninsurable for a period of 6 months from the prior coverage expiration date.

E. Condemned Property

Properties that are condemned or scheduled to be condemned

F. Property In Disrepair

Properties in a state of disrepair

G. Properties with Existing Damage

Properties with existing damage for which acceptable documentation reflecting when the repairs will be completed has not been submitted for review (Refer to Properties to Be Submitted to Citizens for Review Prior to Binding).

H. Property Over 50 Years Old

Properties over fifty (50) years old (N/A to CIT HO-4 or CIT HO-6) unless electrical wiring and heating are both in sound condition and have been updated in the last 35 years. Acceptable documentation from a verifiable qualified inspector must accompany the application or be provided prior to renewal.

I. Farms & Ranches

Dwellings located on a farm, ranch, orchard or grove; or where farming activities or ranching operations take place.

Exception: Dwellings used for residential purposes when farming or ranching is incidental, may be eligible for a Dwelling Policy excluding Liability (see Dwelling Manual).

J. **Business Exposure**

Properties where a business is conducted. Two salient elements to help identify a "business" include: (1) a profit motive and (2) continuity of the activity (e.g., all manufacturing, retail sales when customer traffic is common, bed & breakfast operations, nursing homes, adult care living facilities, produce stands, "u-pick-it" produce operations, kennels, repair work including auto or appliance repair, hair salons, and certain residential Home Day Care operations not Registered or Licensed – see the "Residential Family Day Care Homes" rule for further information on Home Day Care risks)

Exception: Except incidental offices, schools or studios meaning offices for business or professional purposes and private schools or studios for music, dance, photography and other instructional purposes.

K. **Heating, Electrical and Plumbing**

1. Properties with heating systems that are not in good working order; or properties with a portable heater or open flame as a primary source of heat (e.g. electric, oil or kerosene portable space heater; gas heater; or any device utilizing an open flame)

   Exception: Permanent and factory or professionally installed central-gas-fireplaces or wood-burning-stove heat systems

2. Properties with any potentially hazardous electrical conditions, knob & tube or aluminum branch circuit wiring.

   Exception: If aluminum branch circuit wiring has been remediated using a method acceptable to Citizens:

   - The home has been rewired completely with copper wiring; or
   - All aluminum-to-copper connections (e.g., light fixtures, fan fixtures, outlets and switches) have been repaired via the COPALUM crimp method; or
   - All aluminum-to-copper connections (e.g., light fixtures, fan fixtures, outlets and switches) have been repaired via the AlumiConn connector method

   Citizens requires all aluminum branch circuit wire connections to the service panel be inspected and repaired as necessary to ensure no corrosion/oxidation is present and all connections are tight. Refer to the agent portal on the Citizens website for acceptable remediation.

3. Properties with electrical service less than 60 amps (renewal business only; see Additional Underwriting Requirements for new business)

   Exception: If approved by a Florida licensed electrician, licensed journeyman electrician, or municipal building inspector within the last five (5) years.

4. Properties showing signs of leaks or unrepaired water damage; properties where plumbing is not in good working order

L. **Roof Conditions**

- Roofs that are damaged; or
- Roofs that have visible signs of leaks; or
- Roofs that have less than three years of remaining useful life. The "remaining useful life" is the remaining life expectancy of the roof covering to function as intended based upon an inspection of the wear and tear, decay, deterioration, decline, or defect, present from natural, climatic, construction, or other local conditions.

M. **Roof Covering Age**

Shingle, built up tar and gravel, or other roof coverings that are over 25 years old and tile, slate, clay, concrete or metal roof coverings that are over 50 years old must be replaced / updated to be eligible for coverage (see exception below)*. Documentation of full roof replacement must be submitted with the application or prior to the policy renewal in which the roof covering exceeds the maximum age requirements outlined in the following table (not applicable to HO-4 and HO-6 risks).

Roof Eligibility	
Roof Covering	Age
Asphalt, Fiberglass, Composition, or Wood Shake Shingles; Built-up Tar and Gravel; or Other Roof Covering types Not Included Below	Over 25 Years Not Insurable*
Tile, Slate, Clay, Concrete or Metal	Over 50 Years Not Insurable*

***Exception:** Risks that do not meet the roof replacement eligibility requirements above may be eligible for coverage by submitting acceptable documentation verifying the roof has at least 3 years remaining useful life (Refer to Properties to Be Submitted to Citizens for Review Prior to Binding). Risks that establish roof eligibility under this exception are not required to provide documentation of full roof replacement until the policy renewal period in which the remaining useful life of the roof covering falls below the 3-year eligibility threshold.

Acceptable documentation includes a copy of a completed roofing contract; a statement from a licensed roofing contractor showing estimated age; condition and remaining useful life; a completed Citizens Roof Condition Certification form; or other acceptable proof of remaining useful life.

N. Homemade/Rebuilt Property

Dwellings or structures that are homemade or rebuilt, or any dwelling constructed with extensive remodeling.

Exception: If approved by local government building or zoning department or a certificate of occupancy has been issued.

O. Non-Habitational Property

Dwellings used, designed or constructed for non-habitational purposes.

P. Fraternity Or Sorority Houses

Fraternity, Sorority or any similar housing arrangement.

Q. Vacant Or Unoccupied Property

Vacant or "unoccupied" dwellings. "Unoccupied" includes dwellings with personal property contained therein if the dwelling is no longer a place of usual return.

Exception: A new purchase expected to be **owner-occupied** within 30 days (from policy inception) may be bound. (Indicate expected move-in date in "Remarks" section of application.) If beyond 30 days, the application must be submitted unbound for prior approval including an explanation for the delay and any loss control measures taken.

R. Seasonal Homes

A seasonal home (home with continuous unoccupancy of 3 or more consecutive months during any 1 year period) unless the home is located in a "secured area" (limited access with locked gates or guards) or the home has a functioning central station fire **and** burglar alarm and documentation acceptable to Citizens is provided.

S. Special Flood Hazard Areas

Properties located in NFIP designated Special Flood Hazard Areas, (A and V zones), where a Flood Insurance Policy has not been purchased or has not been continued in effect with coverage limits, not less than 80 percent of the building limits, subject to the maximum limits available from the NFIP.

Exception: (See Additional Underwriting Requirements Rule.)

T. Material Misrepresentation, Insurance Fraud or Arson

Applicants canceled or non-renewed for material misrepresentation in the past seven (7) years or insurance fraud in the past fifteen (15) years or convicted of arson in the past twenty-five (25) years.

U. Property Constructed Over Water

Any insured location with a structure constructed partially or entirely over water. (e.g. boat houses, etc.)

Note: Ineligible structures do not include piers and docks.

V. Property Built On Landfills – Refuse

Properties built on landfills previously used for refuse.

W. Inaccessible Property

Properties not readily accessible year round to fire department equipment (e.g. isolated property including barrier islands not connected to the mainland by a road).

Exception: Barrier Islands with a responding fire station located on the island.

X. Excessive, Unusual or Extra-Hazardous Exposure

1. Properties with excessive, unusual or extra-hazardous liability exposure, (e.g. empty in-ground pools, skateboard or bicycle ramps, trampolines, vicious or exotic animals kept on premises).

   Note: The property may be eligible for a Dwelling Fire Policy excluding Liability coverage. The application must be submitted unbound for underwriting consideration.

2. Properties with excessive, unusual or extra-hazardous property exposure, (e.g. excessive cracking in the foundation, walls or roof, slab cracks, out of level foundations, flooring, walls and/or roof, unexplained depressions, active sinkholes or depressions on the premises, or unrepaired sinkhole damage).

   Note: The property may be eligible for a CIT HO-3 policy that does not include coverage for sinkhole. The application must be submitted unbound for underwriting consideration.

Y. Residential Family Day Care Homes

1. **Eligible – Including Personal Liability**

   a. **Registered or Licensed**
   Family Day Care Homes registered in Florida or licensed in Counties requiring licensure are eligible for a Homeowners Policy including Personal Liability coverage.

   b. **Registration or License Not Required**
   Family Day Care Homes not required by law to be registered and/or licensed are eligible for a Homeowners Policy or a Dwelling Fire Policy including Personal Liability coverage.

2. **Eligible – Not Including Personal Liability**
   A separate unattached dwelling or mobile home used for residential purposes which is located on the residence premises where a day care business is located, may be insured under the Dwelling Fire Program excluding Personal Liability. All other non-residential buildings or structures located at the "described location" used in the day care business are ineligible for coverage.

3. **Ineligible**

   a. **Operating In Violation of Law**

   Home Day Care operations not registered where required by Florida law or not licensed in counties that require licensure, are ineligible for any coverage.

   b. **Commercial Operation**

   Any child care operation not included within the provisions of this rule.

4. **Definition – Family Day Care Home**

   "Family Day Care Home" means an occupied residence in which child care is regularly provided for children for more than one unrelated family and which receives a payment, fee, or grant for any of the children receiving care, whether or not operated for profit.

APPENDIX B, Page 5 of 5

A Family Day Care Home will be allowed to provide care for only one of the four following groups of children, which includes those children under 13 years of age who are related to the caregiver:

(1) A maximum of 4 children from birth to 1 year old.

(2) A maximum of 3 children from birth to 1 year old, and other children, for a maximum total of 6 children.

(3) A maximum of 6 preschool children if all are older than 1 year old.

(4) A maximum of 10 children if no more than five are preschool age and of those five, no more than 2 are under 1 year old.

Note 1: "No Coverage For Home Day Care Business" mandatory exclusion endorsement, **HO 04 96** applies.

Note 2: If Personal Liability Coverage is provided under Paragraph "A", a copy of a Certificate of Insurance to Citizens from the insurer providing Commercial Liability on the Family Day Care Home at limits equal to or greater than Citizens Personal Liability limits of liability is required.

Note 3: A copy of the Florida Department of Children & Families "Family Child Care Home Certificate of License" if required to be licensed by the State of Florida, or a copy of the Child Care License issued by the County, if required to be licensed by the County. (Only a copy of the Florida License or County License is required.)

The following counties currently require licensure: Dade, Broward, Palm Beach, Hillsborough, Pinellas, Sarasota and Marion. This listing is for informational purposes only and is subject to change without notice. To confirm registration and/or licensing requirements, contact the Florida Department of Children & Families for a current listing.

Z. Sinkhole

1. Any risk in which the insured location, including the residence premises, other structures, and grounds to be insured has ever experienced a Sinkhole loss or Catastrophic Ground Cover Collapse loss, and the loss payment or payments made by Citizens and/or any other insurer equals the policy limits for property damage provided under Coverage A; or

2. Any risk in which the insured location, including the residence premises, other structures, and grounds to be insured has ever experienced a partial Sinkhole loss or Catastrophic Ground Cover Collapse loss, and fails to meet the requirements of Rule 5. "Sinkhole Exposure."

AA. Multiple Mortgages

Properties with four or more mortgages when the additional mortgagees are not government backed loan programs such as FHA, VA, Fannie Mae, Freddie Mac, etc.

BB. Opening Protection

Properties (**CIT HO-3**) with an insured value of $750,000 or more and located in the wind-borne debris region without opening protection as required by the Florida Building Code for that area.

A mitigation affidavit/form must be completed and signed by a qualified inspector in order to provide evidence of eligibility.

CC. Dwellings in the Course of Construction

Properties under construction

Exception: Dwellings under renovation will be permitted if the dwelling will be occupied throughout the entire renovation period