

SERVICING MANAGEMENT®

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Understanding The Effect Of Loss Ratios On Premiums

The area of lender-placed insurance presents many opportunities to either save money or incur unnecessary costs. Are you making the right decisions?

One of the conditions imposed upon borrowers under their deed of trust or mortgage is to obtain and maintain homeowners insurance for their property. The mortgage servicing industry refers to homeowners insurance as hazard insurance. While borrowers are required to maintain insurance coverage, servicers know from experience that delinquent borrowers often let their policy lapse early on in the default process. The responsibility falls on the servicer to track every loan to ensure the required hazard insurance is in effect.

When a borrower fails to pay their premium and maintain their hazard insurance, the servicer will obtain coverage on the borrower's behalf and charge the cost of the premium to their loan balance. This is known as force- or lender-placed coverage.

The premium for this coverage can be three to five times more expensive than the amount paid by the borrower for their retail policy. Additionally, the policy only covers the building structure and does not include the personal property, additional living expenses and liability coverages that would typically be included in the borrower's retail coverage.

Insurance carriers calculate premiums by using a combination of different factors. The most heavily weighted factor used by both lender-placed and retail carriers is the insured's loss ratio.

The loss ratio is simply the loss costs expressed as a percentage of premium dollars paid. Loss ratio is defined by Black's Law Dictionary as

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"the ratio between premiums paid and losses incurred during a given period." Simply put, if you pay \$1 million in premiums to insure your assets and you receive \$900,000 back in claims recoveries, you have a loss ratio of 90%. Theoretically, as loss costs increase, so will your premiums. As loss costs decrease, so should your premiums.

Hazard insurance carriers make money by paying out less in expenses and claims dollars than they collect in premium dollars. They also earn income by investing their premium dollars collected and surplus earned. Surplus is essentially retained earnings.

Premium dollars are applied to several basic categories. Typically, about 70% goes toward the payment of claims (loss costs), about 25% goes toward overhead and expenses, and the balance is earned as profit. Loss costs are calculated as a percentage of each premium dollar the carrier expects to pay out in claims.

Claims investigations

Some insurance carriers, particularly lender-placed insurers, also include the expense of the claim investigation as part of the calculation. That loss ratio calculation would then be the pure claims dollars paid plus the cost of the investigation (which is initially borne by the carrier, even if the loss is not covered).

So, if the insurance carrier had claim expenses of \$50,000, then its

calculation would drive up the loss ratio to 95%. This is a very important distinction and one that can drive up your premiums if you do not use discretion in deciding when to file a claim. It is critical to know if your insurance carrier includes the costs associated with the investigation of claims as part of its loss ratio/loss costs or if it classifies those expenses in the general overhead and expense category.

There are several things a mortgage servicer can do to effectively manage its loss ratio and prevent escalating premiums.

Prior to filing a claim, be sure to effectively assess each damaged property to distinguish between insured damage and uninsured damage. It is imperative to have a full understanding of the policy coverages. If you do not know what is covered and excluded in the policy, then you may be filing claims that are excluded.

Once a claim is filed, the insurance carrier must perform a thorough investigation. The costs and expenses of each investigation will be included in the calculation of your loss ratio, even if there is no coverage and the claim is ultimately denied. There is no benefit to the servicer to file claims that are not covered.

Intentionally filing claims that are specifically excluded may also be deemed to be fraudulent activity. Entities that are licensed as public insurance adjusters are expressly forbidden by virtue of their licensing from filing claims on losses that are excluded. Even more troubling would

be to have an unlicensed entity filing insurance claims for damages that are excluded under the policy.

It is a good idea to set a threshold for the minimum amount of damage needed to file a claim. The minimum should be no less than two times the amount of the deductible if you have an actual cash value policy. The insured mortgagee is entitled to be paid the actual cash value until repairs have been completed. To arrive at the actual cash value, the insurance carrier will deduct depreciation from the replacement cost value. Unless the mortgagee repairs or replaces the damaged property, he or she will only be paid the amount of the actual cash value.

Simply filing a claim on every damaged property is often viewed as a shortcut - an easy way to process claims - but it serves no purpose other than to unnecessarily increase your claim expenses (which, as noted previously, is part of the calculation of your loss ratio).

There is no consequence for filing an abundance of claims. However, there can be a significant consequence to the servicer and investor if it results in an increased loss ratio and, thus, increased premiums. The servicer should review the percentage of claims paid to claims filed to determine if cost-effective decisions are being made. A fair benchmark

would be if at least 70% of claims filed result in recovery.

Verify that the carrier is including all premium dollars paid. Is the carrier including the premiums paid on all assets, including current, delinquent and real estate owned (REO) loans? It is not uncommon to see a very high loss ratio on REO assets.

By looking at all insurance placements, your combined ratio will be much lower. Sometimes hazard insurance carriers will offer voluntary policies. A voluntary policy is one in which the borrower is offered coverage by the lender-placed carrier, but the policy contains broader coverages, similar to what a retail carrier would offer.

In some geographic locations where premiums have significantly increased, the number of voluntary placements has increased. The premiums for these policies are much more competitive and in line with other retail carriers. Does your combined ratio include voluntary placements?

It is important for the servicer to understand what effect claims filed by borrowers have on the loss ratio and premium. If the number of claims filed by and paid to borrowers increases, will your loss ratio and premium increase? Is the servicer affected by the increase or decrease in claims paid to borrowers? These are some of the questions

servicers should ask their carrier to explain to them.

Thinking about canceling?

Sometimes a lender-placed policy is issued and then cancelled at a later date. If the borrower eventually provides proof or evidence of insurance indicating that he or she had other coverage all along, then the lender-placed carrier will cancel the policy back to its inception.

This is known as a flat cancellation. In other cases, a policy is issued, the borrower obtains coverage through a retail carrier and the policy cancels back to a specific inception date. The premium for those policies should be refunded on a pro-rata basis. Mortgage servicers should have a complete understanding of what effect their cancellations have on their loss ratios.

Servicers and investors across the board are seeing an increase in losses from defaulted loans and damaged properties. Servicers can do their part to more effectively manage their loss ratio and prevent premium increases while actively pursuing legitimate claims on insured damages. **SM**

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