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"Exam Efficiency: Lessons Learned Through the Peer Review Program"

True or False Questions — Submit Answers Online

1. The primary focus of an examination should be on traditional financial reporting risks and not solvency threatening issues.
2. The examiner's review of planning related documents should include all years covered by the statutory examination period.
3. Any risks that are identified and documented by the analyst need to be concluded on by the examiner at the end of the examination.
4. The Peer Review Program has commonly identified that examiners have devoted too little resources to the planning portion of the examination and too many resources for purposes of addressing Phase 3 and Phase 5 risk statements.
5. For purposes of addressing Other Than Financial Reporting Risks (OTFRs), the Peer Review Program has frequently found that not always have these risks had enough resources devoted to them.

"Lender Placed Insurance"

True or False Questions — Submit Answers Online

1. The premium paid by a lender or servicer for lender placed insurance is based on standard risk factors and pricing that is underwritten by the insurer.
2. In guidance issued to loan servicers by Fannie Mae and Freddie Mac in November, 2013, servicers and their affiliates were prohibited from receiving any commissions or other compensation from lender placed insurance companies, but were permitted to provide insurance and reinsurance through affiliate insurers like anyone else.
3. As of early 2015, the Mortgage Portfolio Protection Program – which provides flood lender placed insurance through FEMA- had issued only about 800 lender placed policies out of over 5 million total policies in the National Flood Insurance Program nationwide.
4. The market for lender placed insurance is highly competitive because of the historic premium the coverage generated and 6 insurers split an estimated 70%-90% of the overall lender placed insurance market nationally.

CRE READING PROGRAM QUESTIONS

All quizzes MUST be taken online

(continued)

5. To date, limited reliable data exists to evaluate the lender placed insurance industry and the GAO recommends that the NAIC work with state regulators to establish better procedures and policies to collect data for this type of insurance.

"Drones Take Flight"

True or False Questions — Submit Answers Online

1. The fundamental risks facing the use of drones – an emerging technology include cyber attack and privacy concern.
2. Adequate insurance coverage is key to risk management of drone technology. Insurance products and developed policies may cover D&Os, employer liability, etc., but not the exposure terrorism and war.
3. Drone and other emerging technologies present a significant challenge to regulatory system, particularly in the area of licensing and compliance.
4. Professional indemnity insurance for drown technology covers litigation cost and damages caused by privacy breach.
5. Three areas that are likely to influence the availability of insurance solution are Safety, Security and Privacy.

"The Role of Analytics"

True or False Questions — Submit Answers Online

1. Part of advanced analytics is to perform behavioral simulation under multiple scenarios.
2. Advanced analytics are utilized to understand customer behavior which can be utilized to better develop, price and market products.
3. Life insurers have been at the forefront of using advanced analytics to understand customers.
4. The actuarial department is the only department that is responsible for analyzing the data.
5. Advanced analytics can assist insurers to act quickly to re-price products if emerging experiences are identified.

Exam Efficiency: Lessons Learned Through the Peer Review Program

By **Miguel A Romero Jr, CPA**
National Association of Insurance Commissioners

Examiners have been performing risk-focused examinations since 2007. Over time, the examination focus has shifted away from financial reporting issues and onto a broader range of risks that threaten the insurer's solvency. Examiners generally do a good job of prioritizing time and resources to ensure that significant risks identified through the course of planning procedures receive the most substantive amount of testing during Phases 3/5 of the examination.

However, through the NAIC Peer Review program, several opportunities to improve the efficiency of examinations have been identified. As exams become more efficient, examiners will have a greater ability to devote the necessary time and effort in addressing the most significant solvency risks identified during each exam. To assist examiners in realizing effic¬¬iencies and conducting more effective examinations, a number of sound practices, discussed below, have been developed.

To frame this conversation, consider the purpose of an examination, which is reflected in the opening line of the Financial Condition Examiners Handbook (Handbook) Preamble:

> *The primary purpose of a risk-focused examination is to review and evaluate an insurer's business processes and controls (including the quality and reliability of corporate governance) to assist in assessing and monitoring its current financial condition and prospective solvency. As part of this process, the examiner identifies and evaluates risks that could cause the insurer's surplus to be materially misstated both currently and prospectively. In order to complete this task efficiently and effectively, examinations should be planned to identify and focus on the areas of higher risk (2015 Handbook pg. 3).*

Understanding this purpose is crucial in designing an effective and efficient exam. As seen above, the primary focus of an exam should be on issues that threaten solvency and not simply on the traditional financial reporting risks that can use extensive exam resources.

This article will focus on sound practices that have been developed to assist examiners in conducting examinations that achieve the purpose set forth in the Handbook. The sound practices (including those noted as specific efficiency tips) discussed below illustrate how examiners can enhance exam efficiencies by leveraging the work of the department analyst and the insurer's auditors, thereby freeing up resources to tackle areas of greater risk and/or concern.

Leveraging the Work of Analysts

A common peer review finding is that examiners often spend valuable exam resources duplicating the work of the department's analysts. Analysts spend a considerable amount of time reviewing an insurer's results of operations, including reviews of actuarial opinions, IRIS reports, and company filings,

Exam Efficiency: Lessons Learned Through the Peer Review Program

(continued)

among others. Therefore, examiners should be able to reduce the review of these filings and reports during the planning phase of the examination. Any documents the examiner does review should be limited to the most recent year of the examination period, unless there are specific concerns warranting a deeper look. Examiners should also be able to reduce or eliminate their independent review of the historical results of operations (i.e. 5 year trend analytical work on income statement/balance sheet activity) by leveraging the existing work of the department's analysts. Exhibit A – Examination Planning Procedures Checklist was recently revised to clarify these expectations.

To further help in addressing this observation, the Insurer Profile Summary (IPS) has recently been revised to encourage the documentation and communication of risks identified through the course of normal analysis reviews. Revisions to Section 2, Phase 1 of the Handbook as well as Exhibits A and B make clear that the examiner can and should leverage the work of the analysts extensively. For instance, the following language has been added to the narrative guidance:

> *By utilizing information and input provided by the analysts, the examination team can request updates to existing information available to the department rather than duplicating requests for information already provided to the analyst. This process eliminates the need for examiners to redevelop the financial analysis information in the examination workpapers so that examination resources may instead be used to update the information while on-site at the insurer. Similar to the benefits of reviewing and using external or internal auditor workpapers, examiners use of detailed financial analysis workpapers in the examination files should result in examinations being more efficient and streamlined. (Adopted by the FEHTG on 7/23/15 into Section 2, Phase 1 of the Handbook).*

To be clear, the intent of this language and other revisions to the Handbook previously referenced is that the examiner reduce or eliminate independent review of documents typically already reviewed by the analyst and, instead, gather this information through discussion with the analyst and review of the IPS.

Past peer review participants have noted that conversation is also a key aspect of communicating risks between the analyst and examiner functions in that a conversation may help draw out even more information to supplement the IPS given to the examiner. A conversation may also give the examiner an opportunity to follow up on issues to ensure they are properly understood, and therefore properly addressed by the exam procedures. The 2016 Handbook guidance will include this concept and will specifically direct the examiner to meet with the analyst in person as opposed to discussing the analysts' work exclusively via e-mail correspondence:

While general information may have been requested from the company during examination pre-planning through use of Exhibits B and C, the examination team should determine what other information is already available to the department before making additional information requests. To do so, the examination team should meet (in-person or via conference call) with the assigned financial analyst (and/or analyst supervisor) prior to requesting additional information for use in examination planning. An email exchange, in and of itself, is not deemed sufficient to achieve the expectation of a planning meeting with the assigned analyst. (Adopted by the FEHTG on 7/23/15 into Section 2, Phase 1 of the Handbook)

***Efficiency Tip # 1:* When engaging with your department analyst, frame the conversation in terms of what you can do for them.**

- What would be helpful for you (the analyst) to know about?
- If you were designing the exam, where would you focus your attention?
- What are the key issues/concerns you track, specific to this insurer when you do your quarterly/annual analysis of this company?

Key to making the examiner-analyst relationship work is what the examiner does with the information provided by the analyst. If the analyst provides several risks that they have been monitoring over the past few years, the examiner should be prepared to comment on each and every one of the risks at the end of the exam. To assist in facilitating the communication of information back to the analyst, the Supervisory Review Memorandum (SRM) has been revised in conjunction with the revisions to the IPS. The extent of information shared with the analyst at the conclusion of the exam will vary based on the examination findings and may or may not require ongoing monitoring by the analyst. Regardless of the status of the risk at the end of the exam, the examiner is required to conclude on each risk identified by the analyst.

If all else fails, we've also been told that fresh coffee and donuts do a great job of facilitating informative conversation.

Other Planning and General Efficiencies

Another common peer review finding relates to the overall efficiency of the procedures performed during examination planning. Insurers can be complex entities and have risk exposures that are often hard to identify, difficult to understand and challenging to test. However, it is important that examiners complete the planning portion of an exam in a timely manner and leave adequate resources to address the identified risks in the later portions of the exam. Through the peer review program, examiners have demonstrated a great

understanding of the risks facing insurers; but, with a broad range of information available when gaining an understanding of the company and its risks, it can be difficult to know where to scale back. Additionally, many examiners have expressed that often procedures are performed because they believe there is a Handbook requirement in place, rather than as a result of concerns or perceived high risk areas. In this section we'll discuss some of the sound practices developed to help improve efficiencies in examination planning.

1. **Process Memos** – Understanding an insurer's response to risks is important and often results in examiners feeling compelled to draft detailed process memos to capture this understanding. However, risks that are identified through process memos tend to focus on lower risk financial reporting issues (e.g. whether all transactions are posted to the GL and whether cutoff of transactions is appropriately considered, etc.). As we'll note later in this article, these sorts of risks can generally be eliminated based on a review of the work of the insurer's external auditor.

***Efficiency Tip #2:* Use company or auditor provided process memos instead of creating your own process documentation.**

***Efficiency Tip #3:* Perform walkthroughs once you identify risk mitigation strategies and controls instead of using walkthroughs to drive the risk identification process.**

Note that process memos are not a Handbook requirement. The examiner is required to gain an understanding of the controls and risk mitigation strategies in place for identified risks. Therefore if any process memo is created, it should be brief and specific to the risks identified to avoid using valuable exam resources.

2. **Inherent Risk Assessment** – The peer review program has consistently demonstrated that examiners do a good job of identifying relevant risks for the insurer and then assessing those risks appropriately. Still, one way to create efficiencies in this area is to limit the extent of documentation devoted to rationalizing why or why not certain risks were identified for consideration by the examination and, for those identified, how the inherent risk level was determined.

    a. Assessing risks is certainly important, but examiners should trust their own judgment and devote more of the exam resources to responding to risks instead of spending an extended amount of time debating a risk's exact inherent risk level (e.g. moderate versus high).

b. The risk repositories are not intended to be a checklist that causes examiners to spend time documenting the risks omitted from each key activity matrix. Instead, the repositories are a tool and any risk within the repositories that is not addressed, does not need to be explained.

***Efficiency Tip #4:* Trust your instinct when assessing inherent risk and save exam resources for Phase 3/5 of the exam.**

3. **Interviews** – Discussions with management can be extremely helpful as the company executives are often in the best position to provide insight regarding the insurer's risks. However, examiners are encouraged to delegate the interview process to a limited set of experienced regulators.

***Efficiency Tip #5:* Coordinate interview questions and topics to ensure each regulators concerns are addressed; Encourage regulators to review interview notes in lieu of attending each individual interview.**

***Efficiency Tip #6:* Consider limiting interview count to key company representatives by determining which interviews will provide unique insights.**

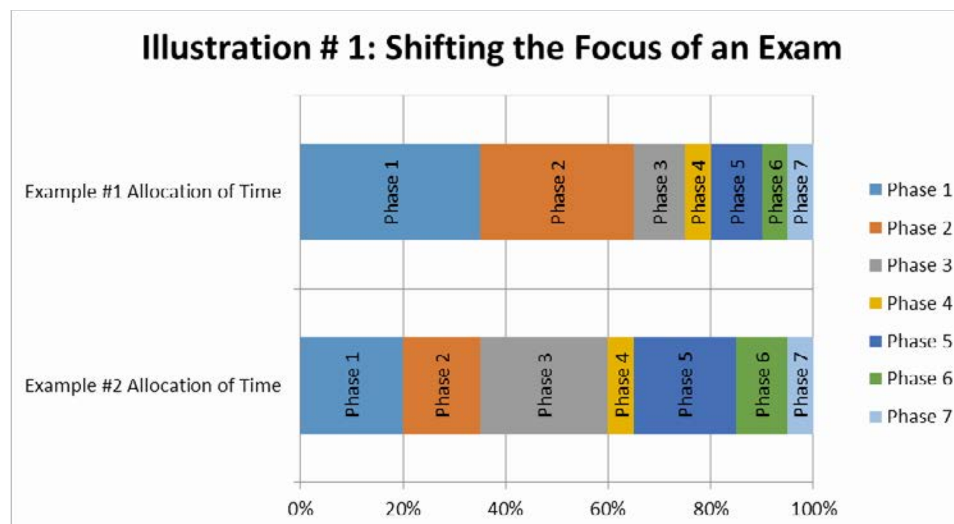
A Sound Practice document has also been developed to outline examination requirements so that examiners can quickly determine if a specific procedure is required or not required. This document can be located on the Sound Practice page of the Financial Examination Tools and Resources page on the NAIC website.

As examiners apply the concepts discussed in this section, they may find that they are better able to address the identified risks in Phase 3/5 of the examination. For instance, in Illustration #1, Example #1, the examiner has used over 60% of the exam budget in identifying and assessing risks the insurer faces. Examiners typically have some flexibility to extend the budget when needed, but a common peer review finding is that examiners devote excess resources to the planning portion of the examination and then are unable to thoroughly investigate the risks in Phase 3/5 due to budget and/or scheduling constraints. In the alternate allocation of time demonstrated by Illustration #1, Example #2, the examiner has applied several of the planning efficiency concepts previously discussed and then is able to perform thorough investigation of the key risks facing the insurer.

Exam Efficiency: Lessons Learned Through the Peer Review Program

(continued)

Note: Illustration #1 is an example allocation of time that may vary based on exam circumstances.



Leveraging the Work of Auditors

Another way that examiners may find efficiency in the exam process is by leveraging the work performed by the insurer's auditors. Auditors have considerable expertise in addressing financial reporting risks, and the Handbook includes guidance that gives examiners extensive flexibility in leveraging such work to reduce the financial reporting risks on each key activity matrix. Handbook guidance states that:

> *To the extent that the audit function is determined to be effective, the examination team may place greater reliance on the work of auditors by identifying fewer financial reporting risks for review during the examination (2015 Handbook pg. 199).*

Importantly, if this concept is applied, examiners do not have to map the work performed by the auditors to risks that are being kept off of the matrix. To make the determination to rely on audit work to reduce financial reporting risks, the examiner is only asked to perform a review that is:

> *The high-level general review of the workpapers is to assess the competency and approach of the external auditor and determine what work is available and conducted in a manner that will allow reliance by the examiner. (Exhibit E, Question #8).*

Examiners have also been able to use this concept to limit the number of key activities identified. Examples of common key activities that are typically addressed by the auditor and therefore do not require the attention of the

Exam Efficiency: Lessons Learned Through the Peer Review Program

(continued)

examiner under this concept are premiums, expenses, taxes, and financial reporting. As examiners are able to narrow the focus of their exam, they generally find that they are able to increase the depth of Phase 3/5 procedures. In Illustration # 2, consider how comprehensive an examination response you would be able to develop for a particular risk if you had fewer risks to address. The risks that were removed in the illustration below are generally expected to be lower risk financial reporting issues that the examiner can expect the company's auditors to thoroughly address.

Note: Illustration # 2 is an example based on a typical insurance company and is not intended to reflect the risks faced by insurers on any specific exam.

Illustration # 2: Potential Impact of Leveraging The Work of Auditors

Matrix that does not leverage the work of the insurer's auditor

Identified Risk Number	Identified Risks
A	Future market fluctuations will lead to an adverse impact on the insurer's investments.
B	The insurer may not manage its assets and liabilities in order to ensure payment of future obligations.
C	The insurer does not review its liquidity position to determine if it needs to adjust its short-term investment level.
1	The insurer's extensive real estate holdings may be valued incorrectly.
2	The securities reported on the balance sheet may not exist or may not be free of encumbrances.
3	The insurer's bonds, stocks and short term investments are incorrectly valued.
4	Investment income accruals, amortization of premiums and interest purchased and sold are not accurately calculated and recorded.
5	The insurer's investments in contract (policy) loans are incorrectly valued.

Matrix that leverages the work of the insurer's auditor

Identified Risk Number	Identified Risks
A	The insuer's investment portfolio and strategy (e.g. quality, maturity, diversification) are not appropriately structured to match the insurer's business strategy.
B	The insurer's investment committee and management do not effectively update/implement/enforce the investment strategy.
C	The insurer may not effectively manage its asset duration to match its future liabilities.
1	The insurer's extensive real estate holdings may be valued incorrectly.

Exploring the Benefits of Increasing Efficiency

One of the most significant and frequent findings through the peer review program is that while examiners often do a good job of addressing the traditional areas of focus (e.g. Did the company book the right reserves, are these complex investments valued appropriately, etc.), they do not always devote enough resources to address the Other Than Financial Reporting Risks (OTFR) facing the insurers. The hope behind this discussion on efficiency is that at least some of the efficiency gains can be used to increase the examination response on OTFR's, including those that are prospective in nature. These risks can be complex and difficult to test. Therefore, if the

examiner is able to find efficiencies in other areas of the examination, the examiner may have an adequate amount of time to properly test these significant risks.

The focus on OTFR's is driven by past experience shared across all states. Insurer's operate in complex business environments and therefore face significant strategic challenges that require robust regulatory oversight. Examiners have consistently demonstrated that they are up to the task of solvency monitoring, but as examinations continue to evolve to better address solvency concerns, there continue to be opportunities to improve the efficiency and therefore the effectiveness of our examination process.

About the Author

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Miguel A Romero Jr. is a Financial Examination Advisor for the Financial Regulatory Services Division of the National Association of Insurance Commissioners (NAIC). Mr. Romero joined the NAIC in August 2014.

His primary duties have been to provide staff support for various NAIC groups charged with supporting regulators in monitoring the solvency of domestic insurers including the Financial Examiners Handbook Technical Group and the IT Examination Working Group. Mr. Romero has also assisted in the preparation of updates for the Financial Condition Examiners Handbook, organization of Peer Review sessions, and preparation of training material to enhance the state insurance department's understanding of the guidance provided in the Examiners Handbook.

Mr. Romero's involvement in the Peer Review program provides a unique perspective allowing him to help in identifying new Sound Practices for distribution to examiners via the Financial Examination webpages. Mr. Romero also has a primary role in the development of content for the "Monitor"; a newsletter distributed by the financial examination unit after each NAIC National Meeting. This newsletter provides financial examiners across the US with updates related to applicable Working Group activities and guidance for newly adopted Handbook content and emerging sound practices related to financial examinations.

Prior to his current position with the NAIC, Mr. Romero worked approximately six years in public accounting, specializing in providing audit services to clients in various sectors, including financial services.

Mr. Romero graduated from Baylor University with Bachelor's and Master's degrees in accounting. He is a Certified Public Accountant and a member the American Institute of Certified Public Accountants (AICPA).

United States Government Accountability Office

Report to the Ranking Member, Subcommittee on Financial Institutions and Consumer Protection, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

September 2015

LENDER-PLACED INSURANCE

More Robust Data Could Improve Oversight

GAO-15-631

GAO Highlights

Highlights of GAO-15-631, a report to the Ranking Member, Subcommittee on Financial Institutions and Consumer Protection, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

September 2015

LENDER-PLACED INSURANCE

More Robust Data Could Improve Oversight

Why GAO Did This Study

Mortgage servicers use LPI to protect the collateral on mortgages when borrower-purchased homeowners or flood insurance coverage lapses. The 2007-2009 financial crisis resulted in an increased prevalence of LPI. Because LPI premiums are generally higher than those for borrower-purchased coverage, state insurance regulators and consumer groups have raised concerns about costs to consumers.

This report addresses (1) the extent to which LPI is used; (2) stakeholder views on the cost of LPI; and (3) state and federal oversight of LPI. GAO examined documentation, studies, and laws and regulations related to LPI, and interviewed stakeholders including state insurance and federal financial regulators, consumer advocates, insurers, servicers, and industry associations. GAO selected interviewees based on their involvement in the LPI market and other factors to obtain a diverse range of perspectives. GAO selected the seven state insurance regulators to interview based on a number of factors including LPI premium volume and involvement in the LPI market.

What GAO Recommends

GAO recommends that NAIC work with state insurance regulators to collect sufficient, reliable data to oversee the LPI market. This includes working with state insurance regulators to develop and implement more robust policies and procedures for LPI data collected annually from insurers and to complete efforts to obtain more detailed national data from insurers. NAIC said it would consider the recommendations as part of its ongoing work in the area.

View GAO-15-631. For more information, contact Alicia Puente Cackley at (202) 512-8678 or cackleya@gao.gov.

What GAO Found

Mortgage servicers purchase lender-placed insurance (LPI) for mortgages whose borrower-purchased insurance coverage lapses, most often because of nonpayment by the borrower or cancellation or nonrenewal by the original insurer. The limited information available indicates that LPI generally affects 1 percent to 2 percent of all mortgaged properties annually and has become less prevalent since the 2007-2009 financial crisis as foreclosures have declined. Although used more often when borrowers without escrow accounts (about 25 percent to 40 percent of borrowers) stop paying their insurance premiums, servicers also use LPI when an insurer declines to renew a policy. LPI insurers often provide services such as tracking properties to help servicers identify those without insurance and confirming coverage. LPI insurers said they must refund premiums if a borrower provides evidence of coverage, which occurs on about 10 percent of policies. The Federal Emergency Management Agency offers flood LPI, but industry officials said most servicers prefer private coverage because of more comprehensive coverage and lower rates, among other things.

LPI premium rates are higher than rates for borrower-purchased insurance, and stakeholders disagreed about whether the difference is justified. Insurers pointed out that they provide coverage for any property in a servicer's portfolio without a rigorous underwriting process, and the limited information requires higher rates. They added that LPI properties tended to have higher risk characteristics, such as higher-risk locations (along the coast) and higher vacancy rates because of foreclosures. But some consumer advocates and state regulators said that the factors that insurers cite for higher rates, as well as the insurers' limited loss histories, do not justify the magnitude of the premium differences. They also said borrowers have little influence over the price of LPI and that some insurers competed for the servicers' business by providing commissions to the servicer that passed the costs on to the borrower through higher premium rates. Insurers, however, said that LPI premium rates were filed with and approved by state regulators and that commissions were a standard industry practice, but their use had decreased.

State insurance regulators have primary responsibility for overseeing LPI insurers, but federal financial regulators generally oversee the servicers that purchase LPI coverage for their portfolios. However, a lack of comprehensive data at the state and national levels limits effective oversight of the LPI industry. For example, regulators lack reliable data that would allow them to evaluate the cost of LPI or the appropriateness of its use. The National Association of Insurance Commissioners (NAIC), which helps coordinate state insurance regulation, requires insurers to annually submit state-level LPI data, but the data were incomplete and unreliable. NAIC provides guidance for the reporting of these data and shares responsibility with state regulators for reviewing and analyzing the data, but neither has developed policies and procedures sufficient for ensuring their reliability. State and federal regulators have coordinated to collect more detailed national data to better understand the LPI industry, but insurers failed to provide them all of the requested information, and whether and when they will is unknown. Without more comprehensive and reliable data, state and federal regulators lack an important tool to fully evaluate LPI premium rates and industry practices and ensure that consumers are adequately protected.

United States Government Accountability Office

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Abbreviations

Biggert-Waters Act	Biggert-Waters Flood Insurance Reform Act
CFPB	Consumer Financial Protection Bureau
CIEE	Credit Insurance Experience Exhibit
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
FCA	Farm Credit Administration
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Board of Governors of the Federal Reserve System
FEMA	Federal Emergency Management Agency
FHFA	Federal Housing Finance Agency
FIO	Federal Insurance Office
LPI	lender-placed insurance
MPPP	Mortgage Portfolio Protection Program
NAIC	National Association of Insurance Commissioners
NCUA	National Credit Union Administration
NFIP	National Flood Insurance Program
NYDFS	New York State Department of Financial Services
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
RESPA	Real Estate Settlement Procedures Act

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U.S. GOVERNMENT ACCOUNTABILITY OFFICE

441 G St. N.W.
Washington, DC 20548

September 8, 2015

The Honorable Jeff Merkley
Ranking Member
Subcommittee on Financial Institutions and Consumer Protection
Committee on Banking, Housing, and Urban Affairs
United States Senate

Dear Senator Merkley:

Homeowners insurance and flood insurance help protect both borrowers and lenders from the financial losses that can arise when homes are damaged. If a borrower allows coverage to lapse or otherwise become inadequate or loses coverage and does not respond to the servicer's requests to provide proof of sufficient coverage, the mortgage loan documents allow the servicer to protect the mortgage holder's interest in the property by purchasing insurance to cover the collateral on the mortgage loan and charge the borrower for the premium.[1] Servicers' use of this type of insurance, known as lender-placed insurance (LPI), peaked during the 2007-2009 financial crisis as an increasing percentage of borrowers fell behind on their mortgage and insurance payments. According to officials from the National Association of Insurance Commissioners (NAIC), LPI accounted for about $3 billion in premiums in 2014. Although this amount represents only about 0.1 percent of the overall U.S. insurance industry, LPI can have a significant impact on affected consumers because it is often more expensive than the borrower-purchased coverage it replaces.[2]

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[1]A mortgage servicer is a company that serves as an agent for the mortgage holder, and handles the management of the mortgage loan. Typically, a mortgage servicer processes loan payments and manages defaults, foreclosure proceedings, and notification of borrowers and investors.

[2]We use the term "borrower-purchased" to refer to the standard homeowners or flood insurance coverage that has lapsed or become insufficient and therefore triggered LPI placement. Others have used "voluntary insurance" to distinguish this coverage from LPI. In special flood hazard areas located in communities participating in the National Flood Insurance Program (NFIP), property owners who obtain mortgages from federally regulated lenders are required to purchase flood insurance.

Questions have grown about LPI's financial effect on consumers during and since the 2007-2009 financial crisis. In particular, state insurance regulators and consumer groups have raised questions about the high cost of LPI, citing investigations and studies saying that the amount of claims that LPI insurers pay does not justify the premium rates.[3] These groups also expressed concerns that borrowers had little influence over the price of LPI because the lender selects the insurer. Further, they said that some insurers might compete for the servicers' business by providing commissions to the servicer and passing the costs on to the borrower through higher premium rates. Additionally, industry officials noted that LPI is more common for mortgages that are delinquent or in foreclosure. As a result, borrowers may pay higher premiums when they are already in financial distress. Insurers, however, have said that LPI policies have a number of risk characteristics that justify their higher premium rates and that they have rigorous processes to notify borrowers of the need to buy less expensive replacement coverage.

Because state law governs the business of insurance, state regulators have had the responsibility for overseeing homeowners LPI.[4] In recent years, three states have reviewed LPI premium rates and related activities and reached agreements with insurers on LPI practices aimed at ensuring premium rates are appropriate. Further, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), among other things, amended the Real Estate Settlement Procedures Act (RESPA) to establish requirements for mortgage servicers on borrower notification before charging for homeowners LPI, termination of homeowners LPI, and refunding premiums paid by the borrower for homeowners LPI while the borrower maintained borrower-purchased coverage, among other things.[5] In 2013, the Consumer Financial Protection Bureau (CFPB) amended Regulation X to implement RESPA's

[3]Birny Birnbaum, *Overview of Lender-Placed Insurance Products, Markets, and Issues* (June 13, 2013), and J. Robert Hunter, testimony before the New York Department of Financial Services on Force-Placed Insurance, May 17, 2012.

[4]We use the term "homeowners LPI" to refer to the non-flood LPI that is subject to the Real Estate Settlement Procedures Act and the mortgage servicing rules enacted under it, known as Regulation X. Others have used "hazard" to distinguish non-flood LPI from flood LPI because homeowners insurance typically covers other risks such as theft and liability, but we chose "homeowners" to avoid implying that flooding is not a type of hazard.

[5]Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1463(a), 124 Stat. 1376, 2182 (2010) (codified at 12 U.S.C. § 2605(k)-(m)).

LPI provisions added by the Dodd-Frank Act. CFPB's amendments to Regulation X became effective in 2014.[6]

You requested that we review the LPI industry and the role of federal and state regulators in monitoring LPI practices. This report (1) describes the extent to which LPI is used, (2) discusses stakeholder views on the cost of LPI, and (3) describes state and federal oversight of LPI. To address these objectives, we reviewed LPI laws and regulations, agency guidance, settlements involving LPI, hearings, and studies, as well as past GAO reports on homeowners, flood, and title insurance. We interviewed officials from 10 relevant federal agencies, including financial institution regulators, as well as a selection of state regulators, LPI insurers, bank and nonbank servicers, industry associations, and consumer advocates. We selected interviewees based on their involvement in the LPI market and other factors to obtain a diverse and wide range of perspectives. To understand states' oversight of LPI, we interviewed insurance regulators from California, Florida, Illinois, New Jersey, New York, Ohio, and Texas and reviewed their states' laws and regulations. We selected these states based on the volume of LPI premiums, rate filing processes, and LPI regulatory activity. This selection of states is not generalizable to all states. We also reviewed aggregated financial data that LPI insurers report annually to state regulators to compare premiums and claims data for LPI to that of borrower-purchased insurance, but we determined that the data were unreliable for our purposes. Finally, we obtained and reviewed policy- and servicer-level LPI data collected through an interagency data call to understand characteristics of the LPI market and assess LPI premium rates, but we limited our analysis to geographical data because the data were incomplete. We discuss data issues more fully later in this report.

We conducted this performance audit from March 2014 to September 2015 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[6] 78 Fed. Reg. 10,696, 10,880 (Feb. 14, 2013) (codified at 12 C.F.R. § 1024.37).

Background

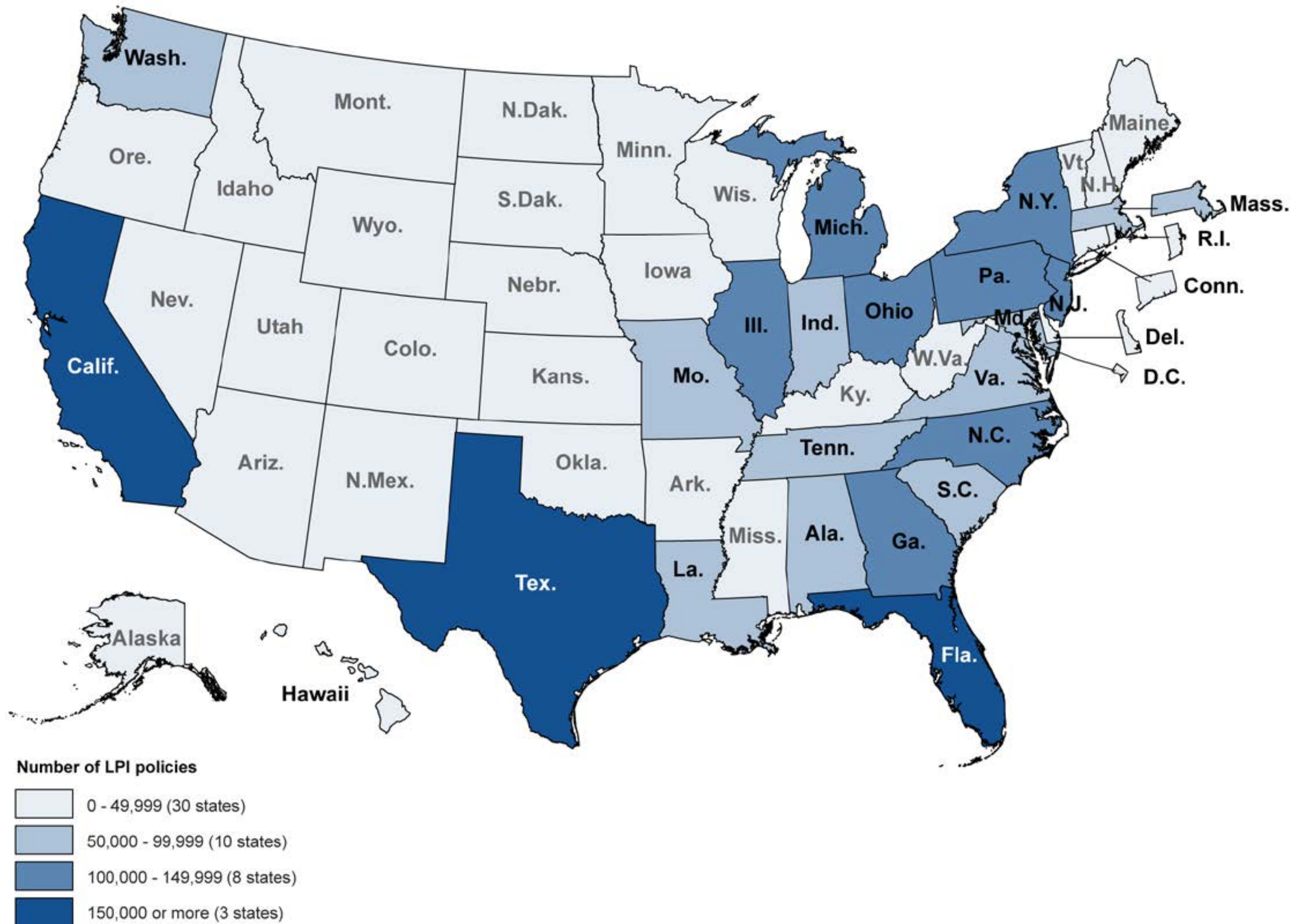
LPI, also known as “force-placed” or “creditor-placed” insurance, is an insurance policy purchased by a mortgage servicer on a home to ensure continuous coverage when the borrower’s homeowners or flood insurance lapses or otherwise becomes inadequate. Most investors, such as Fannie Mae and Freddie Mac, require continuous homeowners insurance coverage on properties that serve as collateral for loans, and mortgage contracts usually require that borrowers maintain continuous coverage to protect the investor’s financial interest in the property.[7] Regulated lending institutions are also required to ensure that borrowers obtain and maintain flood insurance for properties in special flood hazard areas.[8] If a borrower does not maintain continuous coverage as required by the mortgage contract, the servicer is required to purchase LPI and may charge the borrower for the associated premiums and costs.[9] As a result, LPI allows servicers to meet these requirements and protect the mortgage holder’s financial interest in the property. A distribution of LPI policies in 2013 can be seen in figure 1.

[7]Fannie Mae and Freddie Mac are secondary market institutions that purchase conventional loans and issue securities backed by those loans. Both were established to provide liquidity, stability, and affordability in the secondary market for both single- and multifamily mortgages.

[8]Specifically, the mandatory purchase requirement for flood insurance applies to homeowners with mortgages held by federally regulated lenders on properties in participating communities identified by the Federal Emergency Management Agency (FEMA) to be in special flood hazard areas. 42 U.S.C. § 4012a. Special flood hazard areas are the land in the flood plain within a community subject to a 1 percent or greater chance of flooding in any given year according to flood maps developed by FEMA. 44 C.F.R. § 59.1.

[9]Under the Flood Disaster Protection Act, the servicer is required to purchase flood LPI in the event borrower-purchased coverage lapses or becomes inadequate after taking required steps such as providing notice to the borrower. *See* 42 U.S.C. § 4012a(e)(1)-(2).

Figure 1: Numbers of LPI Policies Issued by State, 2013



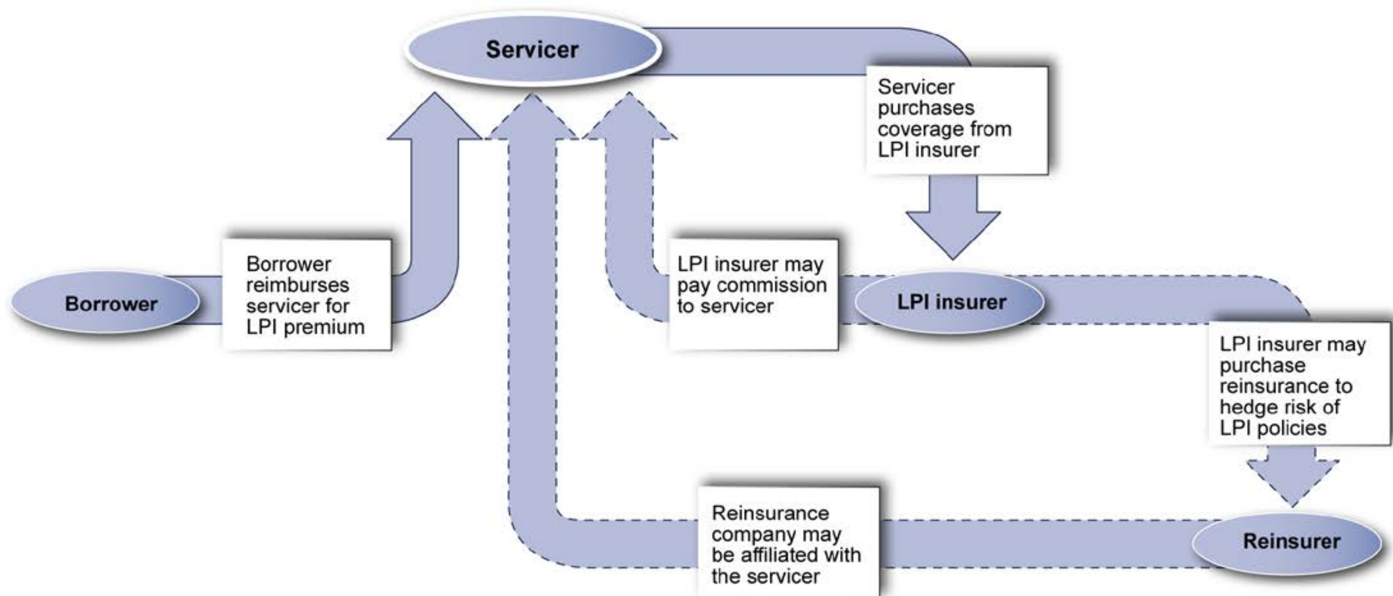
The LPI Process

Servicers generally contract with LPI providers to cover all the mortgages in their portfolios from the date any borrower-purchased coverage lapses, regardless of when the coverage lapse is discovered. According to industry officials, most servicers outsource tracking and notification services—that is, monitoring of the mortgages' insurance policies for possible lapses in coverage and communicating to borrowers that LPI will be placed unless the borrower provides proof of insurance—to LPI

insurers or managing general agents.[10] Because LPI insurers are responsible for losses that occur during coverage lapses, some of the larger insurers perform these services themselves. Industry officials said that some smaller LPI insurers use a managing general agent to perform some or all of the tracking services, usually because setting up these services requires a large upfront investment, but generally continue to perform the notification services directly. Insurers typically factor the expenses associated with such activity into the LPI premium rates, which are based on the value of the underlying properties. When the servicer places an LPI policy, it pays the premium to the LPI insurer and reimburses itself with funds from the borrower's escrow account or by adding the premium amount to the mortgage's principal balance. In some cases, the insurer may pay a commission to the servicer or servicer's agent for the business and can also use a portion of its premium revenue to purchase reinsurance to hedge its risk of loss (see fig. 2). Also in some cases, the company providing reinsurance to the LPI insurer could be affiliated with the servicer who placed the LPI policy.

[10]We use industry officials to refer generally to officials from insurance industry associations, insurance companies, and bank and nonbank mortgage servicing companies with whom we spoke. A managing general agent is an insurance agent or broker that, unlike traditional agents or brokers, is vested with underwriting authority from an insurer.

Figure 2: Potential Flow of Funds and Parties Involved in an LPI Transaction



Source: GAO analysis. | GAO-15-631

Differences between LPI and Borrower-Purchased Insurance

LPI differs from borrower-purchased homeowners insurance in several ways. First, with borrower-purchased insurance, insurers evaluate the risks for individual properties and decide whether to cover a property and how much to charge. Because LPI covers all mortgages in a servicer's portfolio, insurers do not underwrite properties individually. Instead, they provide coverage without assessing the condition of individual properties and provide coverage for a broader range of risks, including defaults and vacancies. Second, industry officials said that the servicer rather than the borrower is typically the named insured on the LPI policy, although in some cases, borrowers can be additional insureds who have the right to file a claim in the event of a loss, and their interest is included in any settlement. Third, servicers rather than insurers are responsible for determining the amount of coverage. Most servicers purchase the same amount of coverage that was available under the lapsed borrower-purchased policy. This amount approximates the replacement value of the home and protects the borrower's financial interest and the servicer should the property be damaged. However, in some situations the servicer may not know the amount of coverage under the previous policy and may instead use the mortgage's unpaid principal balance. Finally, LPI

coverage may differ from the coverage provided by borrower-purchased insurance. Industry officials said that LPI policies typically insure the dwelling and other related structures on a property but often do not include the borrower's belongings or liability risks, as borrower-purchased policies do. However, one industry official said that LPI policies typically provide broader structural coverage, insure against vandalism, and continue coverage in the event of vacancy.

Role of State Insurance Regulators

Like borrower-purchased insurance, LPI is subject to state insurance regulation, including rate and form reviews and approvals where applicable. The McCarran-Ferguson Act provides that state law governs the business of insurance and is not superseded by federal law unless a federal law specifically relates to the business of insurance.[11] State regulators license agents; review insurance products and premium rates, including LPI products and rates where applicable; and routinely examine insurers' financial solvency. State regulators also generally perform market examinations in response to specific consumer complaints or regulatory concerns and monitor the resolution of consumer complaints against insurers.[12]

NAIC is a voluntary association of the heads of insurance departments from the 50 states, the District of Columbia, and five U.S. territories. While NAIC does not regulate insurers, it provides services to make certain interactions between insurers and state regulators more efficient. These services include providing detailed insurance data to help regulators understand insurance sales and practices; maintaining a range of databases useful to regulators; and coordinating state regulatory efforts by providing guidance, model laws and regulation, and information-sharing tools. NAIC has coordinated state regulatory efforts on LPI by developing a model law for LPI and holding public hearings on LPI.[13] In

[11]McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011-1015).

[12]Market examinations are examinations of insurance companies to ensure that the companies doing business within their states comply with state laws and regulations with respect to rating, underwriting, and claim practices.

[13]NAIC was created, among other things, to coordinate regulation of multistate insurers and publishes model laws, regulations, and guidelines that state regulators can use as resources for developing their laws and regulations.

1996, NAIC developed the Creditor-Placed Insurance Model Act, which serves as a guide for state legislation on LPI for personal property, such as automobiles.[14] Additionally, in August 2012, NAIC held a public hearing to discuss the use of LPI for mortgages and the effect of the practice on consumers.

Role of Federal Regulators

Although the business of insurance is regulated by the states, federal regulators generally have authority over regulated lenders' and their servicers' activities related to flood insurance, including flood LPI. The Board of Governors of the Federal Reserve System (Federal Reserve), Farm Credit Administration (FCA), Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and National Credit Union Administration (NCUA) are the regulators responsible for overseeing the mandatory flood insurance purchase requirement for their institutions (see table 1). Since the passage of the Flood Disaster Protection Act of 1973, flood insurance has been mandatory for certain properties in special flood hazard areas within communities participating in the National Flood Insurance Program (NFIP), and federal regulators have been responsible for enforcing compliance with this mandatory purchase requirement.[15] In 1994, the enactment of the National Flood Insurance Reform Act required a regulated lending institution or a servicer acting on its behalf to notify borrowers of lapsed coverage, and if the borrower did not purchase coverage within 45 days of the notice, to purchase flood LPI.[16] The act clarified that servicers could charge the borrower for the cost of premiums and fees for flood LPI. It also required regulators to issue civil money penalties against regulated lending institutions for a pattern or practice of mandatory flood insurance purchase requirement violations, including LPI requirements. In 2012, the Biggert-Waters Flood Insurance Reform Act (Biggert-Waters Act) clarified

[14]Generally, a model law or act is meant as a guide for subsequent legislation by states. State legislatures may adopt model laws in whole or in part, they may modify them to fit their needs, or they may opt not to adopt them.

[15]NFIP is administered by FEMA and is a part of the federal government's efforts to limit the damage and financial impact of floods. NFIP makes federally backed flood insurance available to property owners in participating communities. Flood Disaster Protection Act of 1973, Pub. L. No. 93-234, § 102, 87 Stat. 975, 978 (1973) (codified as amended at 42 U.S.C. § 4012a).

[16]National Flood Insurance Reform Act of 1994, Pub. L. No. 103-325, Tit. V, § 524, 108 Stat. 2255, 2259 (1994) (codified as amended at 42 U.S.C. § 4012a(e)).

that servicers could charge for flood LPI from the date of a coverage lapse or from the beginning date of insufficient coverage and also required them to issue refunds to borrowers who provided proof of insurance for any period of duplicate coverage.[17] Each of the federal regulators has issued regulations to implement flood LPI rules for their respective institutions.[18]

Table 1: Federal Agencies and the Entities They Oversee for Flood and Homeowners Lender-Placed Insurance (LPI) Activities

Federal agency	Regulated entities
Board of Governors of the Federal Reserve System (Federal Reserve)	State-chartered banks that opt to be members of the Federal Reserve System, bank and thrift holding companies, the nondepository institution subsidiaries of those institutions, and nonbanks designated as systemically important by the Financial Stability Oversight Council
Consumer Financial Protection Bureau (CFPB)	Insured depository institutions and insured credit unions with more than $10 billion in assets; certain nonbank entities including mortgage originators, brokers, and servicers; and larger participants of other markets for consumer financial products or services
Farm Credit Administration (FCA)	Farm credit system institutions
Federal Deposit Insurance Corporation (FDIC)	State-chartered banks that are not members of the Federal Reserve System and federally insured state savings banks and thrifts
Federal Housing Finance Agency	Fannie Mae, Freddie Mac, and the 11 Federal Home Loan Banks
National Credit Union Administration (NCUA)	Federally-chartered credit unions, and for certain requirements, federally insured state-chartered credit unions
Office of the Comptroller of the Currency (OCC)	National banks, federal savings associations, and federal branches or agencies of foreign banks

Source: GAO. | GAO-15-631

Note: FDIC, Federal Reserve, OCC, and NCUA oversee compliance with the Real Estate Settlement Procedures Act (RESPA), including related to homeowners LPI, for banks and credit unions with less than $10 billion in assets, and compliance with flood insurance requirements for regulated institutions of all sizes. FCA oversees compliance with RESPA, including LPI, and flood insurance activities of Farm Credit System Institutions. CFPB oversees compliance with RESPA in connection with the homeowners LPI and certain hazard insurance activities of banks or servicers with assets over $10 billion. However, the CFPB’s Regulation X specifically excludes certain hazard insurance, including that required by the Flood Disaster Protection Act of 1973, from its definition of “force-placed insurance.” 12 C.F.R. § 1024.37(a)(2)(i).

[17]Biggert-Waters Flood Insurance Reform Act of 2012, Pub. L. No. 112-141, § 100244, 126 Stat. 916, 966 (2012) (codified at 42 U.S.C. § 4012a(e)).

[18]*See* 12 C.F.R. pts. 22, 172 (Office of the Comptroller of the Currency); 12 C.F.R. § 208.25 (Federal Reserve System); 12 C.F.R. pt. 339 (Federal Deposit Insurance Corporation); 12 C.F.R. pt. 614 (Farm Credit Administration); 12 C.F.R. pt. 760 (National Credit Union Administration).

Federal regulators also have supervision and enforcement authority for their regulated entities' activities related to homeowners LPI. In 2010, the Dodd-Frank Act amended RESPA with specific provisions for homeowners LPI and granted CFPB rulemaking authority under RESPA. In 2013, CFPB adopted amendments to Regulation X to implement Dodd-Frank Act amendments to RESPA.[19] CFPB's amendments to Regulation X became effective in January 2014. The rules:

- prohibit servicers from charging borrowers for homeowners LPI unless they have a reasonable basis for believing that the borrower has not maintained homeowners insurance as required by the loan contract;
- require all charges to be bona fide and reasonable (does not cover charges subject to state regulation as the "business of insurance" and those authorized by the Flood Disaster Protection Act);
- require servicers to send two notices to borrowers before placing LPI;
- specify the content of the notices with model forms;
- generally prohibit servicers from obtaining homeowners LPI for borrowers with escrow accounts for the payment of hazard insurance whose mortgage payments are more than 30 days overdue unless the servicer is unable to disburse funds from the borrower's escrow account to ensure that the borrower's hazard insurance premiums are paid on time. The servicer is not considered unable to disburse funds because the borrower's escrow account contains insufficient funds or if the loan payment is overdue. A servicer is considered unable to disburse funds from a borrower's escrow account only if the servicer has a reasonable basis to believe either that the borrower's insurance has been canceled (or not renewed) for reasons other than nonpayment of premium charges or that the property is vacant. The

[19] LPI rules in Regulation X do not apply to servicers' activities related to hazard insurance required by the Flood Disaster Protection Act or hazard insurance obtained by the borrower but renewed by the borrower's servicer under certain circumstances. 12 C.F.R. § 1024.37(a)(2). Additionally, Regulation X applies to servicers' mortgages that are federally related. Regulation X defines a federally related mortgage loan as any loan that, among other things, is secured by a first or subordinate lien on residential real property and is made by a federally regulated lender, creditor, or dealer; made or insured by an agency of the federal government; made in connection with a housing or urban development program administered by a federal agency; loans made and intending to be sold by the originating lender or creditor to Fannie Mae, Freddie Mac, or Ginnie Mae; is made by certain creditors that make or invest in residential real estate loans aggregating more than $1 million per year; or is the subject of a home equity conversion mortgage or reverse mortgage issued by a lender or creditor subject to the regulation. 12 C.F.R. § 1024.2.

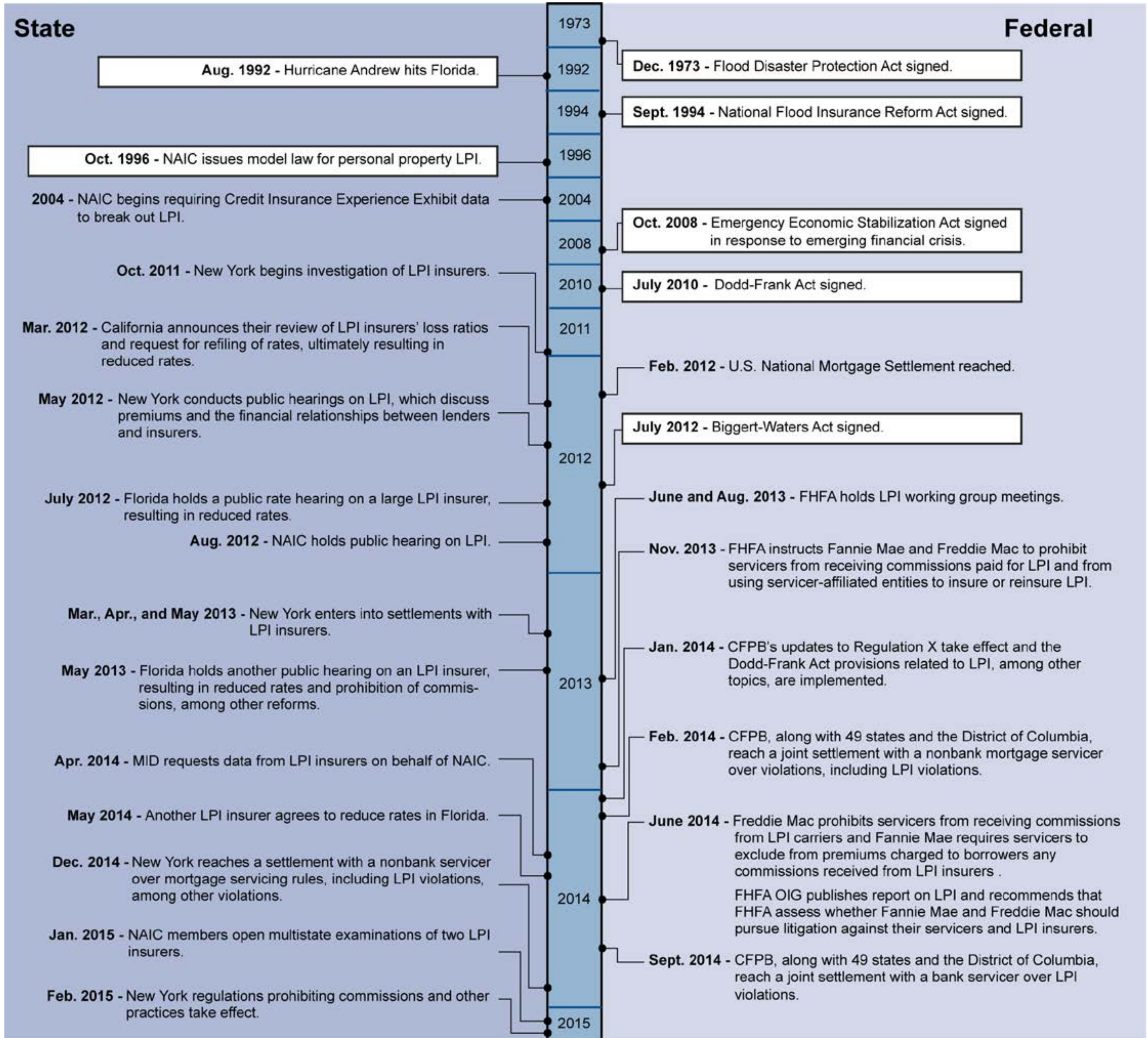
servicer generally must advance funds through escrow to maintain the borrower's coverage; and

- specify procedures for terminating LPI and issuing refunds for duplicative premiums.

In addition to homeowners LPI provisions, amendments to Regulation X included new provisions related to escrow payments; error resolution and information requests; general servicing policies, procedures, and requirements; loss mitigation activities; and mortgage servicing transfers. Mortgage servicers that service loans for investors in mortgage-backed securities must also comply with LPI rules required by their investors, particularly from Fannie Mae and Freddie Mac. In November 2013, the Federal Housing Finance Agency (FHFA), which oversees these entities, directed Fannie Mae and Freddie Mac to issue guidance to their servicers on LPI. In December 2013, the entities issued corresponding guidance, prohibiting their servicers and affiliated entities from receiving commissions or similar incentive-based compensation from LPI insurers and servicers' affiliated companies from providing LPI insurance, including any reinsurance arrangements.[20] See figure 3 for a summary of these and other key events related to LPI oversight.

[20]Specifically, Freddie Mac prohibits servicers from receiving commissions from LPI carriers, and Fannie Mae requires servicers to exclude from premiums charged to borrowers any commissions received from LPI carriers.

Figure 3: Significant Events Related to LPI Oversight, 1973-2015



Legend

Biggert-Waters Act – Biggert-Waters Flood Insurance Reform Act
CFPB – Consumer Financial Protection Bureau
Dodd-Frank Act – Dodd-Frank Wall Street Reform and Consumer Protection Act
FHFA – Federal Housing Finance Agency
LPI – lender-placed insurance
MID – Mississippi Insurance Department
NAIC – National Association of Insurance Commissioners
OIG – Office of Inspector General

Source: GAO. | GAO-15-631

Few Mortgages Receive LPI, and Those That Do Usually Receive It Due to Premium Nonpayment by the Borrower or Coverage Cancelation by the Original Insurer

Mortgage servicers and LPI insurers use tracking and notification processes to determine when required coverage lapses and LPI is necessary. They ultimately place LPI on about 1 percent to 2 percent of mortgages in their portfolios, usually resulting from borrowers not paying their insurance premiums or the original insurers canceling or not renewing coverage. Servicers and insurers said that they use the tracking and notification systems to ensure that LPI placement is as accurate as possible, but that they must refund premiums when the borrower provides proof of coverage, which occurs on about 10 percent of policies. Finally, the Federal Emergency Management Agency (FEMA) offers flood LPI through its Mortgage Portfolio Protection Program (MPPP), but servicers generally said that they prefer private flood LPI coverage for a number of reasons, including more comprehensive coverage and lower premium rates.

Tracking and Notification Processes Identify a Small Percentage of Mortgages Requiring LPI

Mortgage servicers place LPI on a small percentage of mortgages when required coverage lapses, usually as a result of nonpayment by the borrower or cancelation or nonrenewal by the insurer. According to industry officials, mortgage servicers ultimately place homeowners LPI coverage on 1 percent to 2 percent of the mortgages in their portfolio.[21] They said that placement rates were often under 2 percent prior to the 2007-2009 financial crisis but peaked at about 3 percent at the height of the crisis due to increased delinquencies.[22] Industry officials said that placement rates increased as borrowers stopped paying their homeowners or flood insurance premiums along with their mortgage payments. One consumer advocate said that LPI placement rates were much higher for subprime lenders and may have peaked at 15 percent to 20 percent for some of them. Industry officials also said that placement rates were much higher for mortgages that were delinquent or in foreclosure. For example, one official said that its company's placement rate was 0.6 percent for current loans, compared with 17 percent for noncurrent loans. Industry officials said that even as the housing market has improved, properties can remain in foreclosure for an extended

[21]In general, this section on placement, tracking, and notification focuses on homeowners LPI and the corresponding CFPB regulations, rather than flood LPI.

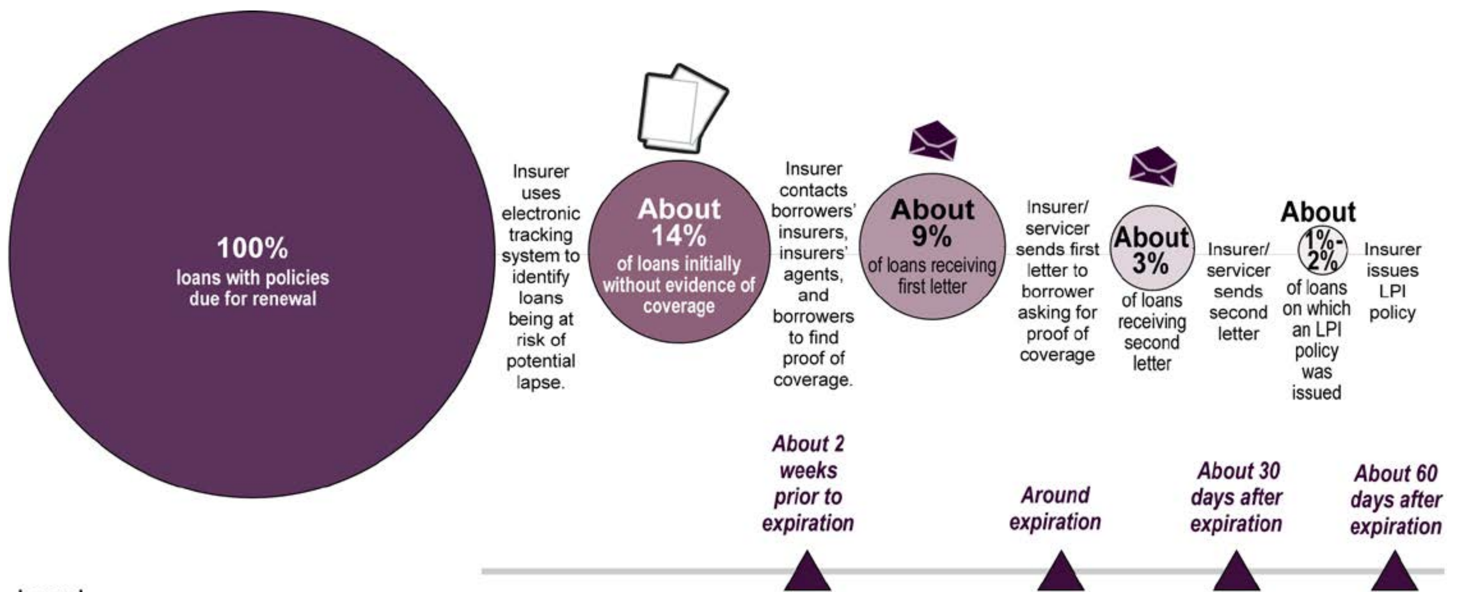
[22]This number reflects the overall placement rate and is higher than the initial placement rate mentioned later because it includes LPI policies that have been renewed.

period of time in some states, keeping the placement rate above its pre-crisis level. However, they said that they expected the rate to continue to decline as older foreclosures were resolved.

As discussed earlier, some LPI insurers perform tracking and notification services for servicers both to manage their exposure and to meet the needs of servicers. As part of the tracking process, the insurer (or insurer's agent) monitors mortgages on behalf of the servicer for possible lapses in borrower-purchased coverage—for example, when coverage has been canceled or is about to expire. One industry official said that this process involves obtaining and reviewing millions of insurance documents each year, many of which are in hard copy and not in a standardized format, and updating the servicers' records accordingly. Industry officials said that within about 2 weeks of a borrower-purchased policy's expected renewal date, the insurer generally receives renewal documentation on behalf of the servicer, and at this point, they have confirmed coverage for all but about 14 percent of mortgages (see fig. 4). If the insurer does not receive this documentation, it contacts borrowers' insurers, their agents, and the borrowers themselves for proof of coverage. This process typically reduces the number of mortgages whose coverage status is unknown to about 9 percent around the expiration date. If renewal documentation does not arrive and the renewal date passes, the insurer sends a first letter to the borrower asking for proof of coverage.[23] If the borrower does not provide proof of coverage, the insurer must send a second letter at least 15 days before charging the borrower for LPI (and at least 30 days after sending the first notice), this time with the cost or a reasonable estimate of the LPI policy's premium. This second letter is sent to about 3 percent of loans whose coverage status has not yet been confirmed. Industry officials said that insurers had such notification procedures in place prior to the CFPB regulations, but noted that the regulations had helped standardize and clarify the notification letters.

[23]12 C.F.R. § 1024.37(c)(1)(i). CFPB regulations require servicers to wait at least 45 days after sending this letter before charging the borrower for LPI coverage.

Figure 4: LPI Insurer Tracking and Notification Process



Source: GAO analysis of information provided by insurers. | GAO-15-631

By the end of this process, the insurer is generally able to confirm borrower-purchased coverage for most of the mortgages in a servicer's portfolio, but servicers ultimately place new coverage on the approximately 1 percent to 2 percent of borrowers who do not respond to the notifications.[24] Industry officials said that because CFPB regulations require servicers to complete the 45-day notification process before charging for LPI coverage, most LPI policies are not issued until at least 60 days after the borrower's insurance lapses. However, they said that most LPI policies are retroactive to the date of the insurance lapse. Industry officials said that LPI policies had a 1-year term but that most were canceled before the policy expired because borrowers eventually obtained the required borrower-purchased coverage to replace the LPI policy.

[24]This number reflects the initial placement rate and is lower than the overall placement rate mentioned earlier, which includes LPI policies that have been renewed.

LPI Is Most Often Placed on Non-Escrowed Mortgages When Borrowers Stop Paying Required Homeowners Insurance Premiums

According to industry officials and consumer advocates with whom we spoke, most LPI policies are placed on mortgages without escrow accounts when borrowers stop paying premiums on their required homeowners insurance policies. Industry officials said that mortgages with escrow accounts require LPI less often, because Regulation X requires mortgage servicers to use escrow funds to maintain borrower-purchased coverage—even when the escrow funds are insufficient.[25] Industry officials noted that these regulations had had little effect on the LPI industry because servicers already maintained coverage for escrowed borrowers, including when escrow funds were insufficient. Additionally, industry officials with whom we spoke also estimated that 60 percent to 75 percent of U.S. mortgages had escrow accounts. Industry officials said that mortgages without escrow accounts are more likely to require LPI because servicers do not have escrow accounts to draw on to continue paying borrower-purchased insurance premiums.

However, CFPB regulations do not require servicers to maintain borrower-purchased coverage for mortgages with escrow accounts if they believe the property is vacant or that the borrower-purchased coverage was canceled or not renewed for reasons other than nonpayment.[26] Regulatory and industry officials said that, as a result, LPI placement on escrowed mortgages primarily occurred when the previous insurer canceled or declined to renew coverage. Regulatory and industry officials said that cancelation or nonrenewal happens for a number of reasons, most commonly because of a change in occupancy status, especially vacancy, often in connection with a foreclosure. They also cited other reasons, including a history of large losses on the property, a change in the condition or risk of the property, the borrower's failure to maintain or repair the property, a misrepresentation of the property's characteristics on the insurance application or other violations of the insurance contract, or a desire by the insurer to limit their concentration of risk in a particular high-risk geographic area. Even state residual insurance programs, which are designed to be insurers of last resort, may refuse to insure some high-risk properties, particularly those that are vacant. In addition, industry officials said that high risks in some areas could make borrower-purchased coverage difficult to obtain—for example, parts of the Gulf Coast and especially Florida—and result in placement of LPI. Industry

[25]*See* 12 C.F.R. § 1024.17(k)(5).

[26]*See* 12 C.F.R. § 1024.17(k)(5).

officials said that a much less frequent cause of LPI placement was administrative errors that occurred, for instance, when a mortgage was transferred to a new servicer and the insurer was not notified. Industry officials said these errors were rare, but they did not provide more specific data.

Insurers Said They Refund Premiums on about 10 Percent of Policies

LPI insurers with whom we spoke said that they used the tracking and notification process to ensure that flood and homeowners LPI placement was as accurate as possible. However, industry officials and a consumer advocate said that insurers generally determined that placement was unnecessary for about 10 percent of the LPI policies they issued. Industry officials said that this unnecessary placement usually occurs because the borrower does not provide proof of coverage until after the LPI policy is placed, despite multiple requests from the servicer. CFPB regulations require the insurer to cancel the LPI and refund all homeowners LPI premiums and related fees for any overlapping coverage within 15 days of receiving proof of coverage.[27]

Industry officials told us that insurers had no incentive to place LPI unnecessarily, because doing so generated administrative expenses without a corresponding receipt of premium. For example, insurers incur expenses for corresponding with borrowers through calls and letters, issuing the policy, processing the cancelation, and issuing the premium refund. In addition to avoiding unnecessary expenses, industry officials said that insurers also want to avoid exposing their clients (the servicers) to borrower dissatisfaction and complaints. However, consumer advocates have cited unnecessary placements as an issue that needs to be addressed. While borrowers eventually receive a full refund of any unnecessary premiums, they may also be inconvenienced by having to initially pay the premium and go through the process of getting the policy canceled. One consumer advocate also cited concerns about unnecessary placement of flood LPI, particularly that borrowers incurred costs, such as hiring surveyors, to refute the servicer’s determination that flood insurance was necessary.

[27] 12 C.F.R. § 1024.37(g).

FEMA Offers Flood LPI, but Servicers Prefer Private Coverage

LPI is also used when mandatory flood insurance policies lapse. The Flood Disaster Protection Act of 1973 requires flood insurance for properties in special flood hazard areas located in communities participating in NFIP that secure mortgages from federally regulated lenders.[28] FEMA offers flood LPI coverage through MPPP, but most servicers obtain coverage through private insurers. FEMA officials said that as of March 2015, MPPP had about 800 policies, a small number compared with the approximately 5.2 million policies in its National Flood Insurance Program, the primary provider of borrower-purchased flood coverage. Industry officials told us that MPPP was mostly used by smaller servicers that did not have access to LPI insurers that offer flood LPI.

Industry officials cited a number of reasons that servicers preferred to do business with private flood LPI insurers rather than FEMA's MPPP. First, industry officials said that private insurers would provide coverage from the date of lapse. Industry officials said that MPPP policies, in contrast, do not allow for automatic coverage upon lapse of borrowers' policies, resulting in the possibility of short periods with no coverage in place, while investors require the servicer to ensure continuous coverage. Second, industry officials said that private flood LPI rates are lower than MPPP rates, although they are still higher than rates for borrower-purchased flood insurance. For example, some told us that MPPP policies were about 4 times more expensive than private LPI flood policies, making MPPP a less attractive option. Further, some industry officials said that using MPPP for flood LPI would require servicers to have two insurers, one for homeowners LPI and one for flood, but that most servicers preferred to have the same insurer for both lines.

[28]Flood Disaster Protection Act of 1973, Pub. L. No. 93-234, § 102, 87 Stat. 975, 978 (1973) (codified as amended at 42 U.S.C. § 4012a).

Stakeholders' Views on LPI Rates and Practices Were Mixed

Industry Officials Provided a Number of Reasons for LPI's Higher Premium Rates

According to one actuary who works with LPI, premium rates are determined by looking at expected losses (both catastrophic and noncatastrophic), expected other expenses, and target profit commensurate with the exposure and risk. Several industry officials said that some of the ways that LPI insurance differs from typical homeowners insurance can make LPI rates higher than borrower-purchased insurance. These differences include the following:

- **Covering all properties regardless of associated risk:** LPI insurers do not underwrite individual properties, but instead agree to cover all properties in a servicer's mortgage portfolio and cannot reject coverage for high-risk borrowers. Insurers told us previously that to manage risk, they need the ability to accept and reject applicants as necessary.[29] Some industry officials told us that because of the lack of information on the risks associated with the covered properties, insurers set LPI premium rates higher than rates for fully underwritten borrower-purchased insurance.
- **Higher geographical concentrations of high-risk properties:** Some industry officials told us that the inability to reject coverage for high-risk borrowers resulted in LPI insurance portfolios having large concentrations of high-risk properties—including in coastal states prone to catastrophic damage—that did not generally exist in borrower-purchased insurance portfolios. For example, one LPI insurer said that approximately 70 percent of its premiums in 2014 were in what it considered to be hurricane-exposed states.[30]
- **Higher concentrations of delinquent mortgages:** Several industry officials said that LPI policies were more likely than borrower-

[29]GAO, *Flood Insurance: Strategies for Increasing Private Sector Involvement*, GAO-14-127 (Washington, D.C.: Jan. 22, 2014).

[30]The insurer said it considered the following states and territories to be hurricane exposed: Alabama, Connecticut, Delaware, Florida, Georgia, Hawaii, Louisiana, Maryland, Massachusetts, Mississippi, New Jersey, New York, North Carolina, Puerto Rico, Rhode Island, South Carolina, Texas, the U.S. Virgin Islands, and Virginia.

purchased insurance policies to cover mortgages that were in delinquency and foreclosure. According to one insurer, 30 percent to 35 percent of its LPI policies as of March 2015 were on mortgages that had been delinquent for at least 90 days.[31] Several industry officials said that properties in foreclosure are often vacant and inadequately maintained, increasing the risk and therefore the potential cost to the insurer.

- **Additional administrative costs:** Several industry officials also told us that LPI policies carried additional administrative costs. These costs can include tracking mortgages, obtaining reinsurance, and notifying homeowners of potential lapses. According to one LPI insurer, these efforts require significant and ongoing investments in technology that help effectively manage risk exposure and lower unnecessary placements. Further, several insurers said they also incur costs for communicating with borrowers during the notification process and when LPI is placed unnecessarily.

Several industry officials also pointed out that investors and servicers bore at least some of the cost of LPI, especially on delinquent mortgages. One LPI insurer said that based on its own calculations, 35 percent of LPI premiums were paid by someone other than the borrower, usually the investor, and that this percentage had decreased in recent years.[32] According to industry officials, when borrowers do not recover from delinquencies, investors—which could include Fannie Mae and Freddie Mac—typically reimburse servicers for the cost of LPI premiums once the foreclosure process is complete, which in some cases can take years.

Stakeholders' Views Differed on the Appropriateness of LPI Premium Rates

According to several consumer advocates and state regulators, some LPI premiums were higher than they should be. NAIC's general principles for determining premium rates state that they should not be inadequate, excessive, or unfairly discriminatory. Some of the advocates and regulators cited low loss ratios—claims and adjustment expenses as a percentage of premiums—as evidence that the policies were priced too highly. For example, one study by a consumer advocate examined loss

[31]According to the Mortgage Banker's Survey, the 90-day delinquency rate on all single-family residential mortgages was 2.25 percent in 2014.

[32]According to the LPI insurer, this percentage had decreased from about 50 percent during the mortgage crisis.

ratios from 2004 through 2012 and found that the average LPI loss ratio was 25.3 percent, compared with 63 percent for borrower-purchased insurance.[33] Further, it found that the LPI loss ratio was lower than the borrower-purchased loss ratio in each of the 9 years in that time period.

Industry officials responded to these assertions by noting that LPI claims were highly volatile and needed to be examined over much longer loss histories. They said that insurers set rates prospectively using models to estimate the full range of expected losses before they occurred and that these rates were reviewed by most state regulators as part of the rate filing process.[34] They added that a loss ratio analysis, instead, is a retrospective process because it examines rates after the losses have occurred and is only one of many factors that state regulators consider when conducting an actuarial review of the filed rates.

Some insurers also said that the potential for catastrophic losses in some years requires rates that may exceed losses in other years. For example, some LPI insurers have said that LPI may have lower losses in many years but significantly higher losses in catastrophic years, offsetting the profits from lower loss years. However, California and New York required insurers in their states to resubmit rate filings with lower rates because, based on their review of some insurers' loss histories in recent years, they did not see the pattern of profits from lower loss years offsetting significantly higher losses in catastrophic years.

[33]Birny Birnbaum, *Overview of Lender-Placed Insurance Products, Markets, and Issues*, Lender-Placed Insurance Regulatory Working Group Outreach Session (June 13, 2013).

[34]Specifically, one actuary stated that a calculation of actuarially sound rates involves the following formula: (1) expected noncatastrophe loss per policy in prospective rate period, (2) expected catastrophe loss per policy in prospective rate period, (3) expected loss adjustment expense in prospective rate period, (4) expected expense during prospective rate period, and (5) target profit and contingencies commensurate with exposure and risk.

Some Consumer Advocates and State Regulators Said Several Factors Resulted in Higher Rates and Other Practices That Harmed Consumers, but Industry Officials Disagreed

Consumer advocates said that the primary cause of higher LPI rates was reverse competition—a market structure that drives up prices for consumers because insurers compete for mortgage servicers' business rather than consumers' business—by providing financial incentives to the servicer. They said that borrowers had little or no influence over the price of the insurance because the servicer was responsible for selecting it and that the costs of the financial considerations were passed on to the borrower. They also said that some insurers have paid commissions to servicers or servicers' agents and that the servicers and agents did little work to justify them. They said that these commissions contribute to higher premium rates. One industry official, however, said that commissions were a standard industry practice and that their costs were within reasonable ranges. After reviewing proposals from Fannie Mae and Freddie Mac on reducing expenditures related to LPI, FHFA in November 2013 instructed the enterprises—i.e., Fannie Mae and Freddie Mac—to prohibit servicers from receiving commissions paid for LPI. FHFA, as well as an insurer and a servicer with whom we spoke, told us that the use of commissions had decreased since then.

Some state regulators noted that some insurers provided tracking and other services for free or below cost, benefitting the servicer, but included the costs of such services in what they charge consumers. One regulator and a consumer advocate said that some LPI insurers have purchased reinsurance at inflated prices from reinsurers owned by the lender. They said this overpayment to the reinsurer affiliated with the servicer could be a benefit to the servicer for purchasing LPI coverage from the insurer. One insurer and an industry official with whom we spoke commented that the use of affiliated reinsurers had decreased in recent years, with the industry official adding that this was at least in part due to the enterprises' guidance, which also prohibited their servicers from entering into reinsurance arrangements with LPI providers.

Some consumer advocates also said that the concentrated LPI market further contributed to high premiums. Two insurers account for most of the LPI market, with estimates of their market share ranging from 70 percent to 90 percent. Industry officials said that the two largest insurers had extensive systems to track large servicers' mortgage portfolios, and one consumer advocate said that the expense of setting up such systems could be a barrier to entry for smaller insurers that must often outsource tracking services to independent agents. Some industry officials said that recent state and federal actions—for example, state actions establishing minimum loss ratio requirements—could have the unintended consequence of forcing smaller insurers out of the market because of

increased compliance costs. This limited competition, they said, could contribute to higher premium rates. One insurer said that there were at least 10 major LPI insurers in the United States in 1992. The insurer said that since then, catastrophic losses—notably Hurricane Andrew in 1992—and other related factors have resulted in the majority of them choosing to exit the market. The insurer told us that most insurance companies were not willing to assume the level of risk involved in LPI.

Finally, consumer advocates and some state regulators said that LPI had other negative effects on consumers in addition to the financial hardship of higher premiums. For example, they said LPI offers more limited coverage than borrower-purchased insurance. In particular, the policies purchased by the servicer for the borrower to protect the mortgage holder do not cover contents (personal property), liability, or additional living expenses. The servicer, not the borrower, is typically the primary insured party on an LPI policy and therefore determines the amount of coverage. Some state regulators said that as a result, the servicer may, in some cases, select coverage for the mortgage's unpaid principal balance, which would not cover the property's replacement cost. Some industry officials, however, said that servicers prefer to use the coverage amount the borrower had in place for the lapsed policy when it is known.

Some State and Federal Regulators Have Taken Actions Related to LPI, but Incomplete Data Limit Oversight

State Oversight of LPI Varies

Oversight of homeowners LPI varied across selected states in terms of requirements, reviews of LPI practices, and the rate filing process. NAIC does not have a model law or guidelines to address LPI for real

property.[35] We found variations in the regulatory treatment of LPI among the seven states we reviewed. For example, of the states we reviewed, only New York had adopted regulatory requirements applicable to LPI insurer practices.[36] New York's LPI regulations applicable to insurers include requirements for insurers and affiliates to notify the borrower before issuing LPI and for renewing or replacing LPI. Additionally, the New York LPI regulations prohibit the amount of LPI coverage from exceeding the last known coverage amount and prohibit insurers from engaging in several practices, including issuing LPI on property serviced by affiliated servicers, paying commissions, and providing insurance tracking to a servicer or affiliate for free or reduced charge. Six of the states (California, Florida, Illinois, Ohio, New Jersey, and Texas) did not have statutory or regulatory requirements specifically for LPI insurers in connection with mortgages (see table 2).

Table 2: Summary of Selected States' Regulatory Oversight of Lender-Placed Insurance (LPI) for Real Property, as of 2015

	LPI-specific laws and regulations		
State	**For insurers**	**For creditors/servicers**	**Rate filing method for LPI[a]**
California	No	No	Prior approval
Florida	No	No	File and use or use and file
Illinois	No	Yes	No filing system
New Jersey	No	No	No filing system
New York	Yes	Yes	File and use based on loss ratio; must file every 3 years or following any year in which an insurer's actual loss ratio is lower than 40 percent
Ohio	No	No	File and use
Texas	No	Yes	File and use

Source: GAO summary of information from the National Association of Insurance Commissioners and state regulators and state laws and regulations. | GAO-15-631

[a]States using the prior approval system review must approve the insurers' rates before they enter the market for sale to consumers. With the file and use system, insurers can use the rates in the market after filing them with the state. With the use and file system, insurers must file rates by a specified time period (such as 30 days) after they enter the market.

[35]NAIC developed a model law for personal property LPI in 1996. Personal property comprises movable goods such as automobiles and can include manufactured homes with a chassis. Real property is fixed and includes land and buildings. In May 2015, NAIC appointed a Creditor-Placed Insurance Model Act Review Working Group to consider updates to the model law and whether real property should be included.

[36]N.Y. Comp. Codes R. & Regs. tit. 11, §§ 227.0-227.8.

Some states had LPI laws and regulations for mortgage servicers in addition to what the federal regulators required, as the following examples illustrate.

- The Texas Finance Code includes a chapter on LPI, which requires that the creditor (servicer) notify the debtor (borrower) no later than 31 days after the LPI is charged to the debtor.[37] It also provides that a creditor may obtain LPI that will cover either the replacement cost of improvements or the amount of the unpaid indebtedness. The debtor is obligated to reimburse the creditor for the premium, the finance charge, and any other charges incurred by the creditor in connection with the placement of insurance.
- Illinois has a law that applies to servicers using LPI.[38] Specifically, the law requires that notification forms include language similar to the "Notice of Placement of Insurance" forms set out in the act. The notice must be provided within 30 days following the purchase of the insurance. In 2014, the Illinois Collateral Protection Act was amended to provide that a servicer subject to Regulation X that places LPI in substantial compliance with Regulation X would be deemed in compliance with the Illinois law.[39]
- New York has emergency regulations setting out business conduct rules for mortgage loan servicers.[40] Servicers are prohibited from placing homeowners or flood insurance on the mortgaged property when the servicer knows or has reason to know that the borrower has an effective insurance policy. Servicers also must provide written notice to a borrower on taking action to place LPI on a property.

LPI premium rates are subject to different levels of review across states. In most states, LPI is considered commercial lines coverage—that is, the policy is considered to cover the interests of a business (the servicer) rather than a consumer. NAIC officials stated that LPI is usually considered commercial lines coverage because insurers typically sell LPI to the servicer as a commercial product. States can use different rate

[37]Tex. Fin. Code Ann. §§ 307.001-307.058 (Vernon 2015).

[38]815 ILL. COMP. STAT. ANN. 180/1-99 (West 2015).

[39]2014 Ill. Legis. Serv. P.A. 98-1120, § 5(b) (codified at 815 ILL. COMP. STAT. ANN. 180/40(b)).

[40]N.Y. Comp. Codes R. & Regs. tit. 3, §§ 419.1-14 (2015).

review systems for commercial insurance, and some states may not have a rate review system for all commercial lines.

According to NAIC officials, state regulators generally review every rate filing for personal lines coverage but may review only some rate filings for commercial lines. The officials told us that state insurance regulators often decided how to allocate resources for rate reviews based on consumer complaints, and personal lines typically generated more complaints than commercial lines. The seven states we selected all considered LPI to be commercial insurance but varied in whether they conducted rate reviews, how they conducted rate reviews, and how often rates were reviewed (see table 2), as the following examples illustrate.

- In New Jersey, commercial lines are subject to the use and file system—that is, the insurers can begin using new rates before filing but must file within a specified period. However, New Jersey does not require insurers to file LPI rates because the state considers it to be a deregulated product.
- In Ohio and Texas, commercial lines are subject to the file and use system, which, unlike use and file, generally allows them to begin using rates as soon as they are filed while the state regulator reviews the filing.
- In Florida, commercial lines and LPI are subject to the file and use system, which as previously noted, requires approval before the rates can be used, or use and file, which allows insurers to use rates as soon as they are filed as long as they are filed no later than 30 days after implementation, subject to refunds if the rates are determined to be excessive.[41] Additionally, Florida requires annual rate filings from its top two LPI insurers.
- In California, commercial lines are subject to the prior approval system, which requires insurers to get state approval before using new rates. For example, after the first filing, California requires property-casualty insurers, including LPI insurers, to refile whenever their rates become inadequate or excessive.

[41]Florida has a fixed amount of time from the date of filing to approve or disapprove a “file and use” filing. If the state does not approve or disapprove the rate within the allotted timeframe, the rate is deemed approved. Filings for commercial lines other than residential commercial lines, excluding certain lines such as medical malpractice and workers compensation, are made on an informational basis, subject to audit to determine if rates are excessive, inadequate, or unfairly discriminatory.

- New York uses the file and use rating system for commercial lines. New York also requires LPI insurers to file rates that reflect loss ratios of at least 62 percent and to refile rates following any year in which the actual loss ratio falls below 40 percent. As of 2015, New York required LPI insurers to file rates at least every 3 years.
- Illinois does not have a rate filing system for all commercial lines.

As with reviews of rate filings, reviews of LPI insurer practices also differed across states. Of the states we selected, those with the highest incidence of LPI were generally the most active in overseeing LPI. According to 2012 NAIC data, California, Florida, New York, and Texas were the top four states in LPI premium volume. Since 2011, three of them—California, Florida, and New York—have reviewed LPI practices in their states in response to increased attention from consumer advocates and NAIC. For example, the New York State Department of Financial Services (NYDFS) took several steps to review LPI practices in its state, which resulted in development of regulations on the LPI activities of insurers and servicers. According to NYDFS officials, the department began an investigation of LPI in October 2011 after receiving complaints from consumer advocates that LPI loss ratios were significantly lower than loss ratios for borrower-purchased insurance. In May 2012, NYDFS subpoenaed LPI insurers and servicers and held public hearings on LPI premiums and the financial relationship between servicers and insurers. In March, April, and May 2013, when NYDFS reached settlements with the four largest LPI insurers, the agency noted in its findings that payments of commissions to affiliated servicers and reinsurance agreements could have led to the high premium rates. The settlements required the LPI insurers to refile premium rates with a permissible loss ratio of 62 percent; to refile rates every 3 years; to annually refile any rates that have an actual loss ratio of less than 40 percent; to have separate rates for LPI and borrower-purchased insurance; and prohibited certain practices, including the payment of commissions. The settlements also required the four LPI insurers to pay restitutions to eligible claimants and pay a combined total of $25 million in civil money penalties to NYDFS. Additionally, four other LPI insurers agreed to sign codes of conduct implementing New York's LPI reforms. As noted earlier, effective February 2015, New York regulations began addressing several practices, including the use of affiliated insurers, commissions, tracking services, loss ratios, and borrower notification. NYDFS officials stated that since these hearings and settlements, LPI insurers had reduced their rates in New York.

California's and Florida's actions did not result in revised regulations, but both states did require reduced LPI rates. Officials from the California Department of Insurance said that in March 2012, they contacted LPI insurers and ultimately required four of them to refile their LPI rates. They said that after examining the insurers' annual financial statement data, they found that the insurers' loss ratios were low, and required four insurers to lower their rate schedules. The officials said that these refilings resulted in rate reductions ranging from about 21 percent to 35 percent. Similarly, officials from the Florida Office of Insurance Regulation said that the New York settlements, NAIC hearing, and information from consumer advocates on LPI prompted them to review LPI practices. In July 2012 and May 2013, it held public rate hearings on two of its LPI insurers. Both hearings resulted in orders for the insurers to reduce rates and other reforms, including a prohibition on payment of commissions to the mortgage servicer, borrower notification requirements, and annual rate filings. Florida officials said that the annual rate filings have resulted in rate reductions of about 14 percent and 22 percent for the two insurers. In a 2014 filing, a third LPI insurer agreed to reduce its rates by 4 percent.

According to NAIC data, Illinois, New Jersey, Ohio, and Texas were among the seven states with the highest market share of LPI premiums, but officials from these states stated they have not taken specific actions regarding LPI. Illinois officials stated that although they had not taken actions related to LPI, their market conduct unit was conducting examinations of three LPI insurers and planned to publish the findings in 2015. New Jersey officials stated that in the past 2 years they had received one consumer complaint related to LPI. They added that in general when they receive consumer complaints about any issue, they conduct market examinations and consider regulatory changes if the issue is widespread. Ohio officials said that they had not received consumer complaints related to LPI or identified any issues related to LPI in their state.

Federal Regulators Have Long-standing Procedures for Overseeing Servicers' Flood LPI Activities and Are Implementing Recent Regulatory Changes for Homeowners LPI

Federal regulators have recently revised regulations related to flood and homeowners LPI. In 2010, the Dodd-Frank Act amended RESPA to add provisions on homeowners LPI, which CFPB implemented through amendments to Regulation X. Federal regulators have monitored mortgage servicers' flood LPI activities since the 1994 amendments to NFIP. The Flood Disaster Protection Act of 1973 made flood insurance mandatory for properties with mortgages from federally regulated lenders in special flood hazard areas and in communities participating in NFIP.[42] Among other things, the Flood Disaster Protection Act required regulators—including FDIC, the Federal Reserve, NCUA, OCC, the Federal Home Loan Bank Board (FHLBB), and the Federal Savings and Loan Insurance Corporation (FSLIC)—to issue regulations prohibiting lending institutions from approving loans without adequate flood insurance where available. The National Flood Insurance Reform Act of 1994 (1994 Act) included specific provisions on placement of flood insurance by lenders.[43] The 1994 Act also replaced the FHLBB and FSLIC with the Office of Thrift Supervision and added FCA as a regulator for flood insurance compliance, and required the six regulators to impose civil money penalties for patterns or practices of violations of the mandatory flood insurance purchase requirement, including violations of flood LPI rules.[44] The 1994 Act also required regulated lending institutions to notify borrowers of a coverage lapse and to purchase flood LPI on their behalf if the borrower failed to obtain coverage within 45 days after notice. The 2012 Biggert-Waters Flood Insurance Reform Act (Biggert-Waters Act) included new requirements for flood LPI, among other items.[45] Like the Dodd-Frank Act for homeowners insurance, the Biggert-Waters Act established rules for refunding flood LPI premiums when the borrower provided proof of existing coverage and clarified that the lender could charge for flood LPI from the date the borrower-purchased insurance lapsed. The act also increased the civil money penalty amounts for

[42]Flood Disaster Protection Act of 1973, Pub. L. No. 93-234, § 102, 87 Stat. 975, 978 (1973) (codified as amended at 42 U.S.C. § 4012a).

[43]National Flood Insurance Reform Act of 1994, Pub. L. No. 103-325, Tit. V, § 524, 108 Stat. 2255, 2259 (1994) (codified as amended at 42 U.S.C. § 4012a(e)).

[44]The Dodd-Frank Act dismantled the existing federal thrift regulatory structure, abolished the Office of Thrift Supervision, and transferred responsibility for thrift supervision to the banking regulators. Pub. L. No. 111-203, §§ 312, 313, 124 Stat. 1376, 1521, 1523 (2010) (codified at 12 U.S.C. §§ 5412, 5413).

[45]Biggert-Waters Flood Insurance Reform Act of 2012, Pub. L. No. 112-141, § 100244, 126 Stat. 916, 966 (2012) (codified at 42 U.S.C. § 4012a(e)).

violations of flood insurance requirements and eliminated the per year cap on the amount of civil money penalties for regulated institutions. In March 2013, the regulators published interagency guidance on amendments resulting from the Biggert-Waters Act with a section specifically about flood LPI.[46] In July 2015, the regulators published a joint final rule implementing the provisions of the Biggert-Waters Act related to LPI.[47]

Each of the five financial regulators has adopted flood insurance examination procedures that address flood insurance requirements, including requirements for LPI. Specifically, the examination procedures discuss borrower notification regarding the need to purchase an adequate amount of flood insurance, and as required by statute, provide that if the borrower does not purchase such coverage within 45 days from notification, the lender or servicer will purchase insurance on behalf of the borrower and may charge the borrower for the cost of premiums and fees incurred in purchasing the insurance. To enforce the flood insurance requirements, the regulators identify flood insurance-related violations, including flood LPI violations, through their examinations. These examinations are risk based, so examiners may not address all policies and procedures or review flood LPI policies and procedures during every examination. For example, NCUA's examiner's guide states that although they must review flood compliance in every examination, depending on scope, an examiner may review one or more of the following: coverage and internal controls, property determination requirements, LPI requirements, and flood insurance checklists.

Since the amendments to Regulation X became effective in 2014, the five financial regulators and CFPB have been responsible for supervising the regulated entities' activities related to homeowners LPI. Rule-making authority for Regulation X, which implements RESPA, was transferred to

[46]Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, National Credit Union Administration, and Farm Credit Administration, *Interagency Statement on the Impact of Biggert-Waters Act* (Mar. 29, 2013).

[47]80 Fed. Reg. 43,216 (July 21, 2015). Among other things, the July 2015 final rule amended the agencies' regulations to clarify that a lender or its servicer has the authority to charge a borrower for the cost of flood insurance coverage commencing on the date on which the borrower's coverage lapsed or became insufficient. The final rule also stipulates the circumstances under which a lender or its servicer must terminate LPI coverage and refund payments to a borrower.

CFPB from the Department of Housing and Urban Development under the Dodd-Frank Act. As discussed earlier, for homeowners LPI, Regulation X, as amended, requires servicers to send two notices to borrowers to confirm that the borrowers do not have the required homeowners insurance before charging the borrower for LPI. Among other requirements, the regulation also prohibits servicers from obtaining LPI if the borrower has an escrow account for homeowners insurance, unless the servicer is unable to disburse funds from the account.[48] Under the regulations, inability to disburse funds does not exist when the borrower's escrow account contains insufficient funds to pay the premiums, but it exists when the servicer has a reasonable basis to believe either that the borrower's coverage has been canceled (or not renewed) for reasons other than nonpayment of premiums, or that the borrower's property is vacant.

Of the five financial regulators and CFPB, CFPB, FCA, FDIC, the Federal Reserve, and OCC have adopted revised examination procedures for RESPA compliance, including compliance with homeowners LPI requirements. NCUA is in the process of updating its examiner's guide and related materials to include the new requirements for homeowners LPI. CFPB's, FDIC's, the Federal Reserve's, and OCC's manuals discuss RESPA requirements for escrow accounts, notifying borrowers, and canceling and renewing LPI, among other requirements. Similar to the procedures they use for flood LPI, examiners also identify violations of homeowners LPI through risk-based examinations of financial institutions.

Because Regulation X's mortgage servicing requirements for homeowners LPI became effective in January 2014, regulators had limited data on the servicers' compliance with them compared to the data on compliance with flood LPI requirements as of May 2015. CFPB officials said that because consumers might not know about LPI until their coverage lapsed, there might be a greater lag in complaint and violations data than there would be for other housing issues. Of the six regulators responsible for enforcing homeowners LPI rules, CFPB, FDIC, Federal Reserve, and OCC had cited violations as of June 2015. The regulators

[48]Regulation X exempts small servicers (in general, servicers that service, together with any affiliates, 5,000 or fewer mortgage loans; a Housing Finance Agency, regardless of size; or certain non-profit entities) from this requirement if the cost of LPI is less than the amount that will be disbursed from the borrower's escrow account to pay for the borrower's coverage.

may also impose civil money penalties for servicer violations of homeowners LPI requirements under RESPA and Regulation X, but they stated that as of June 2015 they had not imposed any.

CFPB and several state regulators have reached joint settlements with some servicers for alleged violations of federal and state laws, including some violations related to homeowners LPI.[49] In February 2012, 49 states and the District of Columbia (excepting Oklahoma) and federal government partners reached a settlement with banks and mortgage servicers over similar mortgage servicing violations, including LPI, requiring them to provide $20 billion in consumer relief and $5 billion in other payments.[50] In December 2013, CFPB, along with 49 states and the District of Columbia, filed a civil action against a nonbank mortgage servicer alleging misconduct related to servicing mortgages. The complaint identified mortgage servicing violations, including the placement of LPI when the servicers knew or should have known that borrowers already had adequate coverage. In February 2014, CFPB and the states reached a settlement with the servicer, requiring the servicer to pay over $2 billion to borrowers and to follow certain servicing standards.[51] Additionally, in December 2014, NYDFS reached a settlement with this servicer over mortgage servicing rules, alleging the servicer had conflicts of interest related to LPI, among other violations.[52] CFPB and the same states also reached a joint settlement with another servicer in September 2014 over similar mortgage servicing violations.

[49]Under the Dodd-Frank Act, CFPB has the authority to take action to prevent a covered person or service provider from committing or engaging in an unfair, deceptive, or abusive act or practice under federal law in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service. 12 U.S.C. § 5531.

[50]The National Mortgage Settlement was reached with the Bank of America Corporation, Bank of America N.A., BAC Home Loans Servicing, Countrywide Home Loans, Inc., Countrywide Financial Corporation, Countrywide Mortgage Ventures, LLC, Countrywide Bank, FSB, Citigroup, Inc., Citibank N.A., Citimortgage, Inc., JPMorgan Chase & Company, JPMorgan Chase Bank, N.A., Residential Capital, LLC, Ally Financial, Inc., GMAC Mortgage, LLC, GMAC Residential Funding Co. LLC, Wells Fargo & Company, and Wells Fargo Bank, N.A.

[51]*Consumer Fin. Prot. Bureau v. Ocwen Fin. Corp.*, No. 1:13-cv-02025-RMC (D.D.C. 2014).

[52]*N.Y. State Dep't of Fin. Serv. v. Ocwen Fin. Corp.* (2014) *available at* http://www.dfs.ny.gov/about/ea/ea141222.pdf.

The consent judgment required the servicer to pay $540 million to borrowers and to follow certain servicing standards.[53]

FHFA has also taken actions to address LPI concerns (as noted earlier). In November 2013, FHFA instructed Fannie Mae and Freddie Mac to prohibit their servicers from receiving commissions for LPI and from using servicer-affiliated entities to insure or reinsure LPI. Effective June 2014, Freddie Mac prohibits servicers from receiving commissions from LPI insurers, and Fannie Mae requires servicers to exclude from premiums charged to borrowers any commissions received from LPI insurers. Also in June 2014, FHFA's Office of Inspector General (OIG) published a report on FHFA's oversight of LPI and stated that in 2012 the enterprises paid approximately $360 million in LPI premiums, including, potentially, an estimated $158 million in excessive LPI rates.[54] The FHFA OIG noted that during a foreclosure, the enterprise that owns or guarantees the mortgage is responsible for the cost of the borrower's unpaid LPI premiums. The OIG recommended that FHFA assess whether the enterprises should pursue litigation against their servicers and LPI insurers to remedy potential damages caused by past abuses in the LPI market. FHFA accepted the recommendation and stated that they completed the assessment in June 2015.

Insurer Data for Assessing the LPI Industry Are Unreliable Despite Efforts to Collect More Complete and Consistent Data

Limited reliable data exist at the state and federal levels to evaluate the LPI industry and ensure that consumers are being protected. As part of its efforts to collect financial data on the insurance industry, NAIC updated its Credit Insurance Experience Exhibit (CIEE) in 2004 to require insurers to submit data on LPI to NAIC and state regulators. NAIC and state regulators are responsible for reviewing and analyzing data from insurers, including the CIEE. The CIEE data include information on premiums, claims, losses, compensation, and expenses. However, we determined that these data were unreliable for our purposes.[55] For example, a number of LPI insurers did not submit data to state regulators for CIEE,

[53]*United States v. Suntrust Mortgage, Inc.*, No. 1:14-cv-01028-RMC (D.D.C. 2014).

[54]Federal Housing Finance Agency, Office of Inspector General, *FHFA's Oversight of the Enterprises' Lender-Placed Insurance Costs* (Washington, D.C.: June 25, 2014).

[55]We had planned to use these data to compare premiums and claims of the LPI industry to that of the borrower-purchased insurance industry.

as required.[56] Also, data in some states and for some years were incomplete. For example, one company reported data for some states but not for others. NAIC officials stated that another company reported LPI data in the wrong section of the CIEE. NAIC officials stated that they performed some basic reviews and tests to identify data errors, such as significant fluctuation between years related to premiums and claims, and worked with the state regulators to address such issues. However, they said that state regulators were responsible for resolving incomplete submissions, such as ensuring that insurers provided answers for every field. Each state, for example, determines its own policies and procedures for reviewing annual statements, including CIEE data, from insurers. As a result, states may not review and analyze similar levels of LPI data. In addition, NAIC officials stated that in 2013 they updated their data submission instructions to request that the insurers report LPI data separately from the borrower-purchased data. NAIC officials said that state regulators allocate their resources on what they deem to be the most cost-effective activities. LPI is a relatively small insurance line, representing only about 0.1 percent of the overall U.S. insurance industry, but its relatively high premium rates can have a significant impact on affected consumers. Given recent state and federal actions regarding the LPI industry, it has become more important for NAIC and state regulators to have adequate data to effectively oversee the industry. Without more comprehensive and reliable data and adequate policies and procedures to ensure the usefulness of the data, NAIC is limited in its ability to coordinate LPI regulation nationwide, and state and federal regulators lack reliable data about the industry. As a result, they are unable to analyze the relationship between LPI prices and the underlying costs to make sure premium rates are reasonable and cannot ensure that consumers are receiving fair and equitable treatment from the LPI industry.

Recognizing a need to better understand the LPI industry, federal and state regulators have begun coordinating in recent years to collect more detailed data about the LPI industry. FHFA and NAIC officials stated that in 2013 they held discussions about LPI and potential strategies for collecting data to better understand the LPI industry and evaluate whether

[56]The two largest LPI insurers—Assurant and QBE—did submit CIEE data, but a number of the next largest insurers did not, including American Modern, Great American, and Lloyd's of London. See Birny Birnbaum, *Overview of Lender-Placed Insurance Products, Markets, and Issues* (Washington, D.C.: June 13, 2013).

recent concerns raised were valid. These discussions resulted in an interagency working group, consisting of state and federal regulators, to discuss LPI. FHFA officials said that in addition to examining the need to obtain more data on the LPI industry, this working group opened a dialogue between several entities, including state regulators, insurers, and servicers. The working group created a template to obtain about 80 LPI industry data variables and tasked a committee with requesting the LPI data (the data call effort). The 80 variables included the type of loan; whether the mortgage had an escrow account; the property's occupancy status; the reason for the coverage lapse; and the company, premium, coverage amount, and deductible for the LPI policy as well as the last known borrower-purchased policy. These data are more granular than what is collected through the annual CIEE in that they include policy-level data that would, among other things, allow for a more direct analysis of LPI premium rates, whereas the CIEE data contain substantially fewer variables and are aggregated at the state and insurer level.

According to NAIC officials, NAIC tasked the Mississippi Insurance Department's Commissioner, chair of NAIC's Property and Casualty Committee, to lead the data call effort. Mississippi officials requested that the top three LPI insurers—which NAIC estimated accounted for about 90 percent of the LPI market—provide the 80 variables. Mississippi officials requested the data in April 2014 for submission by July 2014. However, the insurers and servicers did not submit their final data until December 2014. NAIC and Mississippi officials said the delay was due to the need to clarify data issues with the insurers and correct errors, such as missing fields and missing and outlier values. But the final data lacked values for many of the variables, and some insurers and servicers said that certain information was not available. For example, all three insurers reported annual LPI premium amounts, but only one insurer reported the premium amount of the last known borrower-purchased insurance, and only for some policies. Both of these variables are necessary to determine the difference in cost between LPI and borrower-purchased insurance and understand whether premium rates are reasonable. Additionally, only one insurer reported the lapse date of the borrower-purchased insurance, which would help determine how quickly insurers and servicers are identifying coverage lapses, but this insurer did not consistently report the lapse dates for all policies. According to NAIC and Mississippi officials, one insurer said it did not maintain much of the requested data itself and was unable to get approval from many of its servicers to release the data. As a result, state and federal regulators lack the comprehensive and reliable data necessary to assess LPI industry practices and premium rates and their effects on consumers.

NAIC and Mississippi officials said that they were surprised that the insurers were unable to produce some of the requested data because much of the data seemed necessary for the insurers to maintain. As a result, NAIC members have opened multistate examinations of the LPI practices of the top two LPI insurers which, among other things, officials expected would help produce the remaining data. As of August 2015, 42 jurisdictions—mostly states—had committed to participate in the examinations, and officials expect to have preliminary findings in the fall of 2015. NAIC is working to address the issue of missing data through the multistate examinations, but it is unclear when such data will be available.

Conclusions

Some state and federal regulators have taken action to improve oversight of LPI. However, NAIC and state insurance regulators lack comprehensive and reliable data on LPI premium rates and industry practices to assess their effects on consumers. For example, NAIC has attempted to collect some data aggregated at the state and company levels, but these efforts have yielded incomplete data. Recognizing the need for more robust data on the LPI industry, NAIC and FHFA have coordinated to collect policy- and servicer-level data on LPI. However, LPI insurers and their servicers did not provide all of the requested data. NAIC was created to coordinate insurance regulation across states, and the agency needs quality information to evaluate the LPI industry and the effects of its premium rates and practices on consumers. Although NAIC is working to obtain the missing data, it is unclear when such data might be available, or that its efforts will be effective without additional action. Without more comprehensive and reliable data, state and federal regulators are lacking an important tool to help them fully evaluate the LPI industry and ensure that consumers are adequately protected.

Recommendations for Executive Action

To help ensure that adequate data collection efforts by state insurance regulators produce sufficient, reliable data to oversee the LPI market, we recommend that NAIC:

- work with the state insurance regulators to develop and implement more robust policies and procedures for the collection of annual data from LPI insurers to ensure they are complete and reliable; and
- work with the state insurance regulators to complete efforts to obtain more detailed national data from LPI insurers.

Agency Comments

We provided a draft of this report to NAIC, as well as CFPB, FCA, FDIC, Federal Reserve, FEMA, FHFA, FIO, FTC, NCUA, and OCC for their review and comment. NCUA provided written comments that we reprinted in appendix II. CFPB, FCA, FDIC, Federal Reserve, FHFA, NAIC, NCUA, and OCC provided technical comments that were incorporated, as appropriate. NAIC officials said they understand the importance of ensuring reliable data and will consider the recommendations as part of NAIC's continuing work in the area, which includes multistate examinations and potential revisions to model laws.

We are sending copies of this report to the appropriate congressional committees and the agencies listed above. In addition, the report is available at no charge on the GAO website at http://www.gao.gov.

If you have any questions about this report, please contact me at (202) 512-8678 or cackleya@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix III.

Sincerely yours,

Alicia Puente Cackley
Director, Financial Markets and Community Investment

Appendix I: Objectives, Scope, and Methodology

We were asked to review the lender-placed insurance (LPI) industry and the role of federal and state regulators in monitoring LPI practices. This report (1) describes the extent to which LPI is used, (2) discusses stakeholder views on the cost of LPI, and (3) describes state and federal oversight of LPI.

To address these objectives, we reviewed relevant laws and regulations on lender-placed insurance. We conducted a literature review and reviewed relevant articles, hearings, settlements, and agency guidance on the LPI industry. We also reviewed past GAO reports on homeowners and flood insurance. We interviewed officials from federal agencies, including the Board of Governors of the Federal Reserve System, Consumer Financial Protection Bureau, Department of the Treasury's Federal Insurance Office, Farm Credit Administration, Federal Deposit Insurance Corporation, Federal Emergency Management Agency (FEMA), Federal Housing Finance Agency (FHFA), Federal Trade Commission, National Credit Union Administration, and Office of the Comptroller of the Currency. We selected these agencies because they regulate mortgage servicers' LPI activities or might have an interest in LPI issues. Further, we interviewed officials from the National Association of Insurance Commissioners (NAIC) as well as officials from seven state insurance regulators—California, Florida, Illinois, New Jersey, New York, Ohio, and Texas. We selected these states because they had higher LPI premium volumes and some had taken regulatory action in LPI. In selecting states, we also reviewed publicly available information as well as LPI laws and regulations, whether they had adopted NAIC's model law for personal property LPI and adapted it to real property LPI, whether they had separate banking and insurance offices, and rate approval methods. This selection of states is not generalizable to all states. In addition to the selected states, we met with officials from Mississippi's insurance department to discuss their involvement in NAIC's LPI data request. Finally, we met with four LPI insurance providers of varying sizes, as well as four mortgage servicers, four industry associations, and two consumer advocates. We selected these stakeholders based on their level of involvement in the LPI industry and mortgage servicers to get a mix of bank and nonbank servicers with large and mid-sized mortgage volume. When we refer to "industry officials" in this report we mean officials of the insurance industry associations, insurance companies, and bank and nonbank mortgage servicing companies we interviewed.

To describe the extent to which LPI is used, we reviewed studies, testimonies, and public comments on related regulations to obtain a wide variety of views on how LPI operates. We interviewed the same

consumer advocates, industry associations, and a selection of state insurance regulators, insurers, and mortgage servicers to better understand how each party is involved in LPI and the circumstances surrounding its use. Specifically, we interviewed insurers and servicers to understand their processes for tracking mortgage portfolios, notifying borrowers, and placing LPI. We also interviewed FEMA to understand its flood LPI program—the Mortgage Portfolio Protection Program—and the reasons servicers might choose it versus private flood LPI coverage.

To discuss stakeholder views on the cost of LPI, we interviewed state insurance regulators, consumer advocates, and industry officials about their opinions on the reasons for differences in premium rates between LPI and borrower-purchased insurance and their opinions on the effects on consumers. We reviewed studies, testimonies, and public comments on proposed regulations on flood and homeowners LPI. We obtained premiums and claims data for LPI and borrower-purchased insurance so that these might be compared. We first reviewed NAIC's Credit Insurance Experience Exhibit (CIEE) database—financial data collected annually from insurers that are aggregated at the state and company levels—with the intended purpose of comparing LPI premiums to those of borrower-purchased insurance. However, we determined that these data were unreliable for our purposes. For example, a number of LPI insurers did not submit CIEE data, and there appeared to be missing data in some years. Further, NAIC officials said that they perform some basic tests on the CIEE data to identify data errors but that state regulators are responsible for resolving incomplete data submissions. We discuss these data issues in greater detail in the report. We also obtained and reviewed data from a data call effort coordinated by NAIC and FHFA that requested policy- and servicer-level data from what they believed to be the top three LPI insurers to get a better understanding of the LPI industry. NAIC and FHFA estimated that these three insurers represented 90 percent of LPI premium revenue in the U.S. However, the total number of LPI insurers as well as the total LPI premium volume are unclear because of a lack of comprehensive national data on the LPI industry. Further, we cannot assume that these three insurers are representative of the other insurers in the industry. Moreover, most of the variables were incomplete for one or more of the insurers. To address these omissions, we limited our analysis to high-level figures summarizing variables that were at least 90 percent complete for each of the top two insurers. We determined that variables where more than 10 percent of the values were missing could produce invalid results. Because of the missing data, we were unable to analyze most of the variables, including those that could have compared

LPI premiums to the premiums of the last-known borrower-purchased policies.

To describe state and federal oversight of LPI, we reviewed and summarized federal laws, regulations, and policies and procedures relating to agencies' enforcement of LPI-related requirements. Further, we interviewed federal agency officials, including examiners and enforcement officials, on flood and homeowners LPI monitoring and enforcement activities. We interviewed insurers, mortgage servicers, and lenders for their perspectives on federal regulations and their enforcement. We reviewed and summarized selected state laws and regulations related to LPI, particularly those related to rate setting, and interviewed NAIC officials and selected state insurance regulatory officials on LPI oversight activities.

We conducted this performance audit from March 2014 to September 2015 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Comments from the National Credit Union Administration

National Credit Union Administration
Office of the Executive Director

August 12, 2015

SENT BY E-MAIL

Ms. Alicia Puente Cackley
Director
Financial Markets and Community Investment
Government Accountability Office
441 G St., NW
Washington, DC 20548

Dear Ms. Cackley:

Thank you for the opportunity to review and comment on the Government Accountability Office (GAO) report entitled *Lender-Placed Insurance: More Robust Data Could Improve Oversight* (GAO 15-631). The report addresses the availability of data on lender-placed insurance (LPI) used to protect the collateral on mortgages when borrower-purchased homeowners or flood insurance coverage lapses.

The National Credit Union Administration understands the importance of accurate and timely data to evaluating LPI premium rates and industry practices. We also understand that a lack of comprehensive data limits oversight of the LPI market. The recommendations provided by GAO are designed to enhance the availability of data about this important market. We appreciate the opportunity to comment on the report.

Sincerely,

Mark A. Treichel
Executive Director

OCP/JG
SSIC 1930

1775 Duke Street – Alexandria, VA 22314-3428 – 703-518-6300

Appendix III: GAO Contact and Staff Acknowledgments

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In addition to the contact named above, Patrick Ward (Assistant Director); Christopher Forys (Analyst-in-Charge); Abby Brown; Emily Chalmers; William Chatlos; Juliann Gorse; Camille Keith Jennings; John Karikari; John Mingus; Patricia Moye; Jena Sinkfield; and Heneng Yu made key contributions to this report.

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Executive summary

As early as 1946, American magazine *Popular Science* concluded that: "*Drones, as the radio-controlled aircraft are called, have many potentialities, civilian and military.*"[1]

Seventy years later that potential is now being realised. Exponential advances in sensor technology; satellite positioning systems; communication links and computer processing power have given drones a wide range of applications, many unthought-of even a decade ago. Such innovative applications fall into two key areas:

- **Measurement, including environmental monitoring, photography and filming**
  For example, the BBC World Service now uses drones,[2] Kenya is deploying drones to monitor poaching on game reserves,[3] and the first marketing companies have been censured for using drones to collect and monitor cell-phone activity.[4]

- **Transport, including targeted delivery**
  Drones have been used to deliver textbooks[5] and medicine to remote locations.[6] In Japan, around 40% of the rice crop is sprayed using drones.[7] And, in cities such as London, the first drone delivery services are already in operation.[8]

The potential of drones is hard to deny. However, concerns around safety, security and surveillance could pose significant risks to users of this nascent technology. This is, of course, true of many emerging technologies. However, drones are expected to receive particular scrutiny because of the technology's military heritage and surveillance capabilities. Adequate insurance coverage will likely be of particular importance to protect users against emerging risks.

This report identifies five fundamental risks facing the sector:

- **Negligent or reckless pilots:** the 'human factor' will be a key consideration for insurers. The development of training and licensing schemes will be important to provide assurance of the capability of operators. Insurers can be expected to have particular concerns about moral hazard, as operators on the ground could feel disassociated from risks occurring in the air. Lead insurers may require a higher risk retention unless/until the operators can demonstrate responsible and safe behaviour.

- **Patchy regulatory regimes:** regulation is developing but is inconsistent between international jurisdictions. A robust regulatory framework is expected to be crucial to the provision of insurance for drone operations. Harmonised international standards and clarity on third-party liability will likely be important factors determining the effectiveness of any regulatory regime.

- **Poor enforcement:** the industry is growing too rapidly and unevenly for regulators to provide strong oversight without technological support. Tracking/monitoring technology could also help operators avoid breaking laws in the first place, such as by supporting the development of 'geo-fencing' technology to ensure drones do not stray into controlled airspace.

- **Vulnerability to cyber attack:** drones could be vulnerable to cyber attack with some reports suggesting a thriving community of 'drone hackers' is already established. Cyber security measures will likely be increasingly significant for underwriters' risk assessment of commercial drone operations.

- **Privacy infringement:** this is perhaps the most cited public concern about drones. Professional indemnity insurance can cover the cost of damages awarded for breach of privacy against drone operators. Key requirements for insurance are expected to include the completion of privacy impact assessments, and compliance with applicable regulations and laws.

Drones have the potential to enhance a huge range of activities. However, manufacturers, regulators and early adopters will need to work together, on a global basis, to ensure this technology is used safely and responsibly. Lloyd's, by putting a price on risk, intends to work to support and inform those conversations.

Introduction

Drone technology is now available for a diverse array of users and tasks, and effective risk management is expected to be critical for the integration of drones into society. This is true of many emerging technologies. However, Lloyd's expects risk management for drones to receive particular scrutiny due to public concern about the technology's military heritage and its capacity for surveillance and data-gathering. Insurance will likely be a key component of the risk management framework, and this report outlines the key issues in the development of insurance solutions for drones.

Applications of drones

The drone sector has been identified as the most dynamic component of the global aviation industry, with global expenditure on drones acquisition expected to double to $91bn in the 10 years to 2024.[9] Military applications continue to dominate the drones sector. However, civil usage is growing and meeting an expanding range of applications, as illustrated below:

Current insurance coverage

Insurance products are being developed to meet the needs of drone manufacturers, distributors and operators. Standard drone insurance programmes cover third party liability (compulsory in the EU for drones above 20kg),[16] physical loss and damage to the system components during operation or transit. These policies can be tailored to suit individual exposures, and may also include Directors' and Officers' liability, professional indemnity, employers' liability, product liability, cargo liability, terrorism, war and hijacking.

For insurance purposes, drones could present the properties of an aviation risk and/or a liability risk. While the market for drone insurance is relatively small at present, the projected expansion of the market, and the diversity of potential applications, means that Lloyd's anticipates significant growth in the need for insurance solutions. Insurers are expected therefore to require detailed insight into potential risks to enable accurate risk-based pricing, and to manage aggregate exposure.

Sector	Applications	Example
Agriculture	Crop monitoring	Drones can survey at a much higher resolution than satellites and at a third of the cost.[6] More accurate monitoring of crop growth is generating efficiencies, for example in the use of fertiliser, estimated to have increased revenue by ~ EUR50.[6]
	Precision agriculture	In Japan, around 40% of the rice crop is sprayed using drones. Over 2,400 drones are now in service.[7]
Public Services	Border control	Predator drones patrol the US borders with Mexico and Canada. They have been credited as a major contribution to border security.[10]
	Assisting emergency services	In the UK, the West Midlands Fire Service uses drones to collect information for use in firefighting, such as surveying the extent of the fire, identifying access points and locating casualties.[11]
Logistics	Parcel deliveries	In Australia, drones have been used for over a hundred test deliveries of textbooks.[5]
	Delivery of medical supplies	In Germany, a drone has been used to deliver medicine to remote locations.[6]
Wildlife protection	Prevention of poaching/ hunting	Kenya is due to deploy drones into all of its national parks following a successful pilot project where the use of drones reduced poaching by 96%.[3]
Media	News production	News media organisations are increasingly making use of drones to enhance their coverage.[12]
	Film and entertainment	Drones have been used for the production of several feature films including 'Wolf of Wall Street' and 'Skyfall'.[13]
Research	Data gathering	Researchers have used drones since 2010 to collect breath samples from sperm whales as part of the Cetacean Health and Life History Programme to assess their health.[14]
	Analysis	Archaeological mapping of a former Inca settlement in Peru has been achieved by a drone equipped with a high resolution camera.[15]

Regulation

Effective regulation is a key factor for insurers' confidence in any emerging technology. Regulatory authorities around the world are already considering how drones can be integrated into existing airspace controls and legal frameworks. Here, we identify the shape that regulation could take in order to mitigate risk.

Enforcement

The rapid expansion of drone ownership and operation could present a significant challenge to regulators. A regulatory system that relied heavily on responsible behaviour and/or the threat of sanctions could generate significant uncertainty for insurers, owing to the difficulty in monitoring compliance. This could make some operations or territories not suitable for insurance. A key measure that could assist insurers' confidence in the effectiveness of regulation includes the development of central databases of approved operators,[17] and the use of serial numbers marked on fire-proof plates to assist in identifying operators after an incident.[18]

Additional technological measures could also assist in the enforcement of regulation, notably:

- Tracking/monitoring technology, incorporated as an integral component of platform design, could provide an effective means to gather evidence of transgressions.
- 'Geo-fencing' technology could reduce the risk of a drone straying outside a defined area, or into controlled airspace.

Licensing

The ability to assess operator competence is an essential consideration for the provision of insurance. As the number and diversity of individuals and organisations operating and manufacturing drones grows, so the requirement for mandatory, standardised licensing is expected to become increasingly important. Initiatives such as the Basic National Unmanned Aircraft Systems Certificate – Small (BNUC-S, commissioned by the UK Civil Aviation Authority) and the Remote Pilot Qualification – Small (RPQ-S) are very positive developments.

The projections for the growth in drone operations mean that these types of licensing schemes – together with enforcement – will likely be required on a greater scale, and with as much consistency as possible around the world. This could provide insurers with a tangible measure of operator risk, and allow a key source of risk uncertainty to be quantified and managed. This also raises the difficult question of how such licensing schemes would be paid for, which is unclear at the present time.

Third party liability

Liability considerations are expected to become increasingly significant for drone operations as they expand in scope.[19] Third party liability could be especially prominent, as the greater intensity of use and variety of tasks will likely mean that drone operations interact with a much greater range and value of third party interests. Two recent examples demonstrate the potential exposure.

Third party liability incidents involving drones

- April 2014: an Australian triathlete sustained minor head injuries after a drone fell from the sky. The photographer operating the vehicle claimed that an attacker had wrested control from him.[20]
- December 2014: a patron at a restaurant in New York was injured by a drone being used to take images of diners.[21]

The above examples reflect recent liability incidents involving drones that could give rise to a third party claim – however, as the technology continues to develop and commercialise, larger damages are an increasing threat. For example, substantial damages and legal fees could be incurred if a drone were to collide with a commercial passenger aircraft, causing it to crash.

The potential legal costs attached to third party claims would be an important risk rating factor for insurers, and are likely to vary in proportion to the scale of damages. A study commissioned by the European Commission found that drone operations do carry the potential to generate liability claims requiring lengthy and complex legal proceedings.[22] A further consideration for insurers is the potential for moral hazard among drone operators. This is predominantly an issue with individual operators who will have a variety of different skill and experience levels of flying drones. Commercial insurers have the opportunity to encourage good practice in commercial operators by varying terms and conditions, risk retention (deductibles or excess) and premiums on the basis of the quality of clients' risk management.

In the EU, commercial operators using drones of greater than 20kg mass must comply with Regulation (EC) 785/2004 on Insurance Requirements for Air Carriers and Air Operators.[23] This regulation establishes minimum third party insurance requirements linked to the size (maximum take-off mass) of any aircraft, including drones. Given the relatively small size of the aircraft, drones generally attract the lowest band of third party insurance requirement, approximately £0.7m.[24] This can be considered to be a very low limit, given the considerations described above, and many clients choose to purchase higher limits of cover on specialist advice.

Harmonisation

As regulatory regimes develop, the degree of international harmonisation could be a key factor in enabling the development of standard insurance wordings and cover for drone operations.
The degree of co-ordination between regulators and insurers, and consistency between international regimes, is expected to have a very significant influence on the development of the market for drone insurance. Different national authorities have, to date, pursued different approaches to the regulation of drones, and this serves to add complexity and uncertainty for insurers.[25] Effective collaboration and a consistent multinational approach would be of benefit to all parties with an interest in the regulation of drones. The advantages of harmonisation should not, however, be interpreted as a basis for a 'one-size-fits-all' approach: the diversity of tasks undertaken by drones means that the permissions and competence required should be tailored according to the varying level of risk attached to different classes of operation.[6]

Safety

Statistics on safety incidents involving civilian drones are sparse. The absence of historical data is an impediment to insurers, but risk assessment can be achieved through examination of variables other than past accident rates. Two safety factors are expected to be key considerations for insurers.

The human factor

The technology component of drones has developed rapidly in recent years, and, as with much new technology, the human operators' capacity to learn and adopt safe operational procedures can be a critical factor driving the rate of safety incidents. Mandatory licensing of operators linked to comprehensive training could be expected to greatly enhance insurers' ability to assess the risk attached to drone operations. A recent initiative announced in the Netherlands for a drone training facility catering for both military and commercial operators[26] is an example of development in this area.

Training and certification schemes are being developed, and they show promise for providing a level of certainty that a drone will be operated by a competent individual. In the UK, the Civil Aviation Authority (CAA) recognises the BNUC-S and RPQ-S as evidence of competence suitable for permission to operate drones for commercial purposes. BNUC-S is also recognised in other jurisdictions. Both of these qualifications consist of a ground-based knowledge exam, a test flight to determine proficiency, and requirements to maintain a logbook and complete an annual renewal.[26, 27]

Collision avoidance

Many of the applications envisaged for drones, especially those in urban areas, will require them to operate in busy airspace. The Federal Aviation Authority estimates that over 7,000 aircraft are airborne within US airspace at any given time,[13] and the safe integration of drones with other aircraft operations will emphasise the importance of drones having a robust 'sense and avoid' capability. This technology is in development, but is not yet mature enough to meet the requirements of regulators such as the CAA.[28]

The potential for increased drone operations to raise the threat of collision between aircraft will likely be a key risk aggregation issue for insurers. Reports of 'near miss' events involving drones have begun to appear, and effective airspace control and collision avoidance technology will therefore be essential requirements for the insurance of drones operating in busy airspace.

Security

Cyber attack

Drones are exposed to a range of methods of cyber attack, and the expanding variety and value of tasks they undertake are expected to make them a target of interest for a growing range of hostile actors.[29]

Most civilian drones rely on unencrypted data links for command and control and navigation, meaning they are particularly vulnerable to jamming, interception and manipulation. Researchers have highlighted the ease with which drones can be attacked electronically,[30] and some reports have suggested that a thriving community of 'drone hackers' is already established.[31] Equipment capable of generating 'spoof' signals that enable a third party to control or disrupt a drone, together with jamming equipment able to block the satellite navigation signals that many drones rely on, is widely available at relatively low cost.

Vulnerability to cyber attack has not yet emerged as a major factor for insurers' assessment of drone risks, but it is likely that cyber security will be an increasingly important consideration for commercial drone operations.

Privacy breach

In the UK, the Information Commissioner's Office has included the use of drones within its 2014 CCTV Code, describing them as having a high potential for collateral intrusion due to inadvertent filming of individuals.[32] The CCTV Code suggests that operators perform robust privacy impact assessments before operating drones for surveillance purposes; as part of this there is a recommendation that the recording system is not continuous to help avoid inadvertent and unnecessary filming.[32] In the future it is possible that privacy impact assessments will become an integral part of authorisation to operate drones with surveillance capabilities.

Privacy concerns related to drone operations have become a particularly strong issue in the USA; some observers believe that this has been a key factor inhibiting the adoption of drones, and some local jurisdictions have debated legislation designed to authorise individuals to shoot down drones believed to be infringing privacy.[33]

Professional indemnity insurance can cover the cost of legal fees and damages awarded for breach of privacy against drone operators. Demand for this type of cover is emerging, and key requirements for insurance will likely be the completion of privacy impact assessments and compliance with applicable regulations and laws (such as the Data Protection Act in the UK).[32]

Drone manufacturers

Innovation and intellectual property

The growth in applications for drones relies predominantly on innovation by manufacturers. Intellectual property theft is a growing concern for many sectors in the context of emerging cyber threats, and insurance cover for drone manufacturers increasingly contains an element of intellectual property cover.

Product Liability

Past experience has shown that emerging technology often suffers some degree of malfunction or failure. Experience from other manufacturing sectors shows that manufacturers' liability does not end with the product leaving the production line - in the case of drones, rigorous research and testing before a product is released are essential to minimise risk.

Liability in the event of damage or bodily injury arising from an incident involving a drone is subject to some uncertainty. Regulatory requirements generally dictate that a human operator maintains active control of the aircraft, meaning that strict liability is retained by the operator. Nevertheless, a technical malfunction or failure (or indeed malicious attack, as described in Cyber attack) outside of the operator's ability to control could generate a significant incident and lead to claims for liability against a wider range of parties. Product liability therefore has the potential to be a significant risk exposure for drone manufacturers. Insurance solutions are available from specialist insurers, and these rely very heavily on drone manufacturers adopting robust testing, quality control and risk assessment procedures.

Conclusion

Drone technology has significant potential but is a particularly novel – and controversial – emerging technology. Insurance is expected to be a key component of the risk management framework that will need to be developed for the systems to operate safely and with due regard for third party interests. This report has identified three key areas that are likely to influence the availability of insurance solutions:

- **Regulation** is developing, albeit inconsistently between international jurisdictions. A robust regulatory framework is expected to be crucial to the provision of insurance for drone operations. Enforcement, licensing, harmonisation and clarity on third party liability will likely be important factors determining the effectiveness of any regulatory regime.
- **Safety** is expected to be a key public concern. As the technology matures, operator competence is likely to be the most important factor determining safety. Training and licensing schemes are emerging, and it is expected that these will be essential for the insurance of commercial drone operations. The integration of drones into busy airspace will likely also require further enhancements in 'sense and avoid' technology in order to achieve satisfactory de-confliction with other aircraft.
- **Security** risk has emerged owing to the vulnerability of drones to cyber attack, and their potential to infringe privacy. Cyber security could become an increasingly important consideration for the insurance of drones. Privacy considerations are driving demand for professional indemnity insurance, and management of this risk will likely require privacy impact assessments as well as compliance with applicable legislation.

As the market for drones continues to expand, manufacturers can expect to face increasingly complex and high value risk exposures. Protection of intellectual property and the management of product liability will also likely need to be considered in the scope of insurance cover.

Drones have the potential to enhance a significant range of activities. However, manufacturers, operators and regulators will need to work together, on a global basis, to ensure this technology is used safely and responsibly. Lloyd's, by putting a price on risk, intends to work to support and inform these conversations.

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Connecticut Insurance Market Brief: The Role of Advanced Analytics

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Customer behavior affects the insurance industry in fundamental ways, from product development, marketing and distribution to inforce management, financial reporting, and risk management. Although insurers have been behind the curve with using advanced analytics to better understand customers, more insurers are beginning to use advanced analytics for designing products, segmenting markets, developing distribution strategies, managing inforce business, setting assumptions for financial reporting, and developing metrics for risk management.

Many insurers have developed a Center of Excellence (COE) to serve the increasing need for data analysis, predictive analytics, and behavioral simulations. The COE works with actuarial, distribution, marketing, underwriting and inforce management areas to address:

- How do we improve the sales productivity and profitability of our agency force?
- How can we more quickly and accurately identify emerging experiences?
- How should our capital allocation strategy respond to different economic or regulatory changes?

Understanding customer behavior requires a change in insurers' mindset in viewing the customer not just individually, but as part of a household. Coupled with customer behavior simulations under multiple scenarios, it can help insurers develop a more holistic understanding of the choices policyholders make. Behavioral simulations are possible because vast amounts of digital data can now be stored inexpensively and the computational speed of computers allows insurer to analyze diverse data sources and form connections that were inconceivable 10 years ago.

Advanced analytics place a strong emphasis on collaboration, and are not just the domain of IT or actuaries.

Furthermore, advanced analytics have given birth to a host of new and emerging technologies, such as in-memory technology and natural language processing that are radically different from the legacy technologies that most insurance companies use today. As technology advances, companies are using a broad range of traditional and advanced modeling techniques to generate insights. As early adopters of these new technologies emerge and disrupt business as usual, others will discover a change in "mindset" is required to exploit these technologies.

Finally, advanced analytics place a strong emphasis on collaboration. Professionals have to become increasingly specialized, because there is only so much information one person can master. Accordingly, different disciplines have to

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(continued)

collaborate because the best insights from advanced analytics lie at the intersections of disciplines. In many instances, this may require an effective change management program to break down silos.

Implications

- Consistent, high-quality data that informs decisions throughout the organization is at the core of insurance modernization. Effective analytics make that data truly useful and help insurers more effectively price risk, develop and market products, and target customer segments.
- A modernized company that uses data effectively likely will have a more holistic view of customers, the market, and opportunities than it did pre-modernization.
- Effective analytics require the contributions of everyone in the organization, not just IT and actuaries. This means that organizational models in modernized companies will be less siloed than in traditional ones, and that employees from different functions will need to closely collaborate to develop and share the knowledge and insights that inform good business decisions.

This article is reprinted from PwC's 2015 Connecticut Insurance Market Brief and was written by Dr. Anand S. Rao, a Principal in PwC's Insurance Advisory Services Practice and Louis Lombardi, a Principal in PwC's Life Actuarial Practice.

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