

## **Protecting the house: A movement to actual cash value in homeowners' policies invites issues with roof claims.**

CLM

By: Dean Jarvis The tragic Moore, Okla., tornado has jump-started what could be a very active tornado term that precedes the start of the Atlantic hurricane season. When these wind-related storms strike, it's inevitable that roofing claims will follow. This reality comes amidst a trend over the last year by insurers to revise the coverage terms of their homeowners' policies, moving from replacement cost value (RCV) to actual cash value (ACV) for the settlement of roof claims. Many (but not all) state insurance departments allow insurers to settle roof claims on an ACV basis, and it can benefit insurers that are seeking to restore profitability to their homeowners market. Rather than increase premiums and potentially lose market share due to the higher costs related to RCV, they can reduce coverage to ACV. However, these policies—many of which were implemented in late 2012 and have yet to be tested during significant windstorm seasons—are beginning to draw legal scrutiny and questions about whether or not they meet requirements to protect the collateral of mortgage investors. Regulatory Conflict Why all the scrutiny? Roof claims settlements on homeowners' policies that only offer ACV pose significant problems going forward because of the lack of uniformity between state insurance regulators and the federal government-sponsored entities (GSE) of Fannie Mae and Freddie Mac. On its face, settling roof claims on an ACV-basis seems like an issue for policyholders and insurers only. Digging deeper exposes some problems with that conclusion. For instance, consumer advocacy organizations have protested that the claims settlement practice of using ACV appears to be predatory against consumers, but experts in insurance, mortgage finance, securities, real estate, and credit ratings also have failed to recognize that Fannie Mae and Freddie Mac have guidelines that require claims to be settled on an RCV-basis. This requirement brings yet another party into the equation when homeowner roof claims are not settled on an RCV basis: unwitting mortgage investors are harmed when mortgage-backed securities (MBS)—yes,

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they're back—are improperly packaged and unloaded by Fannie Mae and Freddie Mac. Mortgage lenders and servicers are tasked with providing replacement cost coverage for mortgaged properties. The practice of insurers settling claims on an ACV-basis is a sure sign that the controls of lenders and servicers have failed and that false representations and warranties are being made to Fannie Mae and Freddie Mac. Respected credit raters have published articles and provided commentary about the unusual practice of settling roof claims at ACV while leaving the rest of the dwelling coverage at RCV, which is a strategy that some insurers are employing. All of this means some tough questions need to be answered: Do state insurance departments have a responsibility to enforce acts similar to the Unfair Trade Practices and Unfair Claims Settlement Act of 2009 in Tennessee? Do insurers have a legal liability to provide evidence of insurance binders that accurately reflect their claims settlement practices in the forms and endorsements section of the binder? Do mortgage lenders and servicers have a legal obligation liability to detect when insurers' claims settlement practices no longer comply with GSE guidelines? Do GSEs have a legal liability to alert lenders and servicers about insurers that no longer settle roof claims on an RCV-basis? The aforementioned sequence is important because enforcement at the top solves the problem of evidence of insurance binders that conflict with an insurer's claims settlement practices. It makes it much easier for lenders and servicers to understand when insurers are no longer in compliance, which will significantly reduce the false representations and warranties made to the GSEs. Conversely, a lack of enforcement at the top of the list provides immunity for insurers that furnish evidence of insurance binders that conflict with their claims settlement practices, making it virtually impossible for lenders and servicers to detect the conflict, thereby creating the problem of the GSEs improperly packaging securities that contain false representations and warranties. Therefore, it is vitally important that the evidence of insurance binders and policy booklets match up with the claims settlement practices of an insurance company. Insurers will need to address this incongruity before Fannie Mae and Freddie Mac figure out if they will become proactive in enforcing their guidelines or strike the RCV requirements from their selling and servicing guidelines. Other Exposures There are many other questions that need to be answered, including: Will insurers and E&O providers accept legal liability for agents who provide evidence of insurance binders that conflict with their company's claims settlement practices? Will agents have some type of safe harbor protection for violating acts similar to the Unfair Trade Practices and Unfair Claims Settlement Act of 2009 in Tennessee? Will publicly traded insurers face stock-drop securities litigation for unintentionally misleading investors when they were unfamiliar that GSE guidelines could derail their business projections? Will Fannie Mae and Freddie Mac blindside

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homeowners by hitting them with very expensive force-placed coverage for purchasing policies that settle claims at less than RCV? If Fannie Mae and Freddie Mac continue to ignore their own guidelines that require RCV, how long can compliant insurers continue to compete at what amounts to a competitive disadvantage against insurers that do not comply with GSE guidelines? Will credit raters downgrade insurers that don't settle claims on a RCV-basis? The issue is so pervasive that many homeowners who are paid less than replacement cost to settle their roof claims later find out they are unable to sell their homes until they repair or replace their roofs when they attempt to list their homes for sale with real estate agencies. Furthermore, insurers who pay claims directly to policyholders without involvement or oversight from lenders and servicers set the stage for homeowners to walk away with a check in hand while their homes go into foreclosure with damaged roofs. Addressing the Issue One way to protect homeowners and mortgage investors in the claims settlement process is to require the mortgagee to be listed on any claims check for dwelling damage. That extra step will ensure that unwary homeowners follow through with the repair or replacement of roof damages rather than sabotaging themselves by pocketing claims dollars that were paid on an ACV-basis, forcing them to pay the replacement costs at a later date when they attempt to sell their homes. Many homeowners are unaware that they will be funding the difference between their claims settlement and the cost of repairing or replacing their roofs before they sell their homes. Likewise, many mortgage investors are unaware that homeowners can pocket claims checks to repair or replace their properties without following through to protect their collateral. Another effective strategy to detect the root cause of these problems is to review the wording in the forms and endorsements section on the evidence of insurance binders and compare it with the claims settlement practices of the insurer. Insurers that continue to deliver evidence of insurance binders without disclosing that their claims settlement practices have changed from RCV to ACV could encounter litigation. It is unfair to expect policyholders and mortgage investors to possess the expertise to realize the extent to which they are harmed when insurers fail to settle roof claims in a compliant manner. Unfortunately, they have been put into a "buyer beware" situation because of a lack of transparency from GSEs that are familiar with the problems. However, the simplest solution to allow for a level playing field is for Fannie Mae and Freddie Mac to drop all pretenses that their securities are packaged properly to protect investors, strike the RCV requirement for claims settlements from their guidelines, and allow mortgage investors to "take one for the team" in much the same manner as GM bondholders did to help the automaker survive. Federal funds earmarked to subsidize Fannie Mae and Freddie Mac should be escrowed for mortgage investors to cover increased losses. Mortgage investors put their capital at risk in

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good faith, only to purchase improperly packaged securities that ensure the survival of cash-strapped insurers. They deserve better than being thrown under the bus by the GSE's willingness to market improperly packaged securities. It remains to be seen if Fannie Mae and Freddie Mac will eventually enforce their guidelines that require insurers to settle claims on an RCV-basis or continue to rely on taxpayer generosity to cover potential litigation costs. But insurers should consider getting out in front of the issue before it's too late. The Option to Decline? Insurers that offer the option for homeowners to choose between replacement cost value and actual cash value coverage on their insurance policies may want to reconsider the approach. Consider the following scenario: If someone owns a personal automobile, he has the option to purchase collision and comprehensive coverage. However, if the vehicle is being leased or financed, lienholders require buyers to purchase and maintain collision and comprehensive insurance to ensure the protection of their assets. Putting homeowners in the position of making policy choices that could result in false representations and warranties to mortgage lenders like Fannie Mae and Freddie Mac—which require home purchasers to buy and maintain replacement cost value coverage in their insurance policies in order to protect their collateral—could create potential bad-faith or error and omission situations if and when a claim occurs. After all, who wants to explain to a homeowner who has just experienced a loss that a policy decision shouldn't have been a decision at all? Dean Jarvis is an insurance agent with State Farm in Maryville, Tenn. He has been a CLM Fellow since 2013 and can be reached at (865) 748-0771, [I\\_dean\\_jarvis@yahoo.com](mailto:I_dean_jarvis@yahoo.com).

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