Montana State Legislature

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EXHIBIT 3
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HB 557

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Back to Education Library

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INSURING FOR THE MORTGAGE AMOUNT

When an insurance company provides coverage on a structure, they strive to write an amount of insurance that is equal to the current replacement cost. Current replacement cost is best described as what it would cost (in today's dollars) to rebuild only the structure from the slab up. That figure can be determined from a contractor's estimate, an appraisal showing the "estimated cost new," or by an insurance agency figuring the estimated replacement cost using methods which account for local costs and classes of construction. The insurance policy does not insure the land. The insurance policy is not based on any other figure, such as mortgage value, assessed value, appraised value, or market value.

Often a mortgage lender will ask that the insurance policy provide coverage equal to the mortgage amount. However, the mortgage is made based on the value of the house and land. Since the insurance policy not cover land, the two figures have nothing to do with each other...but try convincing the lender of that.

For example, let's assume that someone purchases a lot worth $100,000 and then builds a house that costs $100,000 to construct. The house and land have a total "market value" of $200,000 and the lender may loan $160,000 on the property. Since the house has a replacement cost of $100,000 that is all the insurance policy should provide. The lender may say, "We have to protect our interest so we want $160,000 of insurance." Since the insurance company only insures the house itself, the company should not provide the amount of coverage the lender has requested. The lender has its interest protected because even if the house is totally destroyed they still hold a mortgage on the land, which has a value of $100,000, plus the insurance company will pay them for the loss of the house.

When your client has trouble explaining this to the lender tell them the Florida Administrative Code prohibits a mortgage lender from requiring insurance in an amount that exceeds the replacement cost of the home.

> ***69O-167.009 Mortgage Fire Insurance Requirements Limited***
> *No mortgage lender shall, in connection with any application for a mortgage loan in this state which is secured by a mortgage on residential real estate located in this state, require any prospective mortgagor to obtain by purchase or otherwise a fire insurance policy in excess of the replacement value of the covered premises as a condition for granting such a mortgage.*

Another article dealing with this subject, including information on Florida and a host of other states, can be found on the web site of the Independent Insurance Agents and Brokers of America's Virtual University, http://vu.iiaa.net/. In the research library under "personal Lines" and "Homeowners" is an article titled "Don't Insure for the Mortgage Amount (Regardless of What the Bank Says.)"

Additionally, there may be some help available from another industry trade association. The Florida Bankers Association, in their February, 2002 *Florida Banking Magazine,* published the following article. Should an agency experience a situation where a bank requests an incorrect amount of insurance it may be appropriate to refer that bank to their trade association.

Florida Bankers Magazine, February, 2002

Should the mortgagor insure for replacement cost or the entire mortgage amount?

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Imagine: A customer of your bank purchases a lot worth $100,000 and then decides to build a house that costs $100,000 to construct. The house and lot have a total market value of $200,000. As the lender, you decide to loan $160,000 on the property. Now, an issue has arisen from the above scenario: Should you require the customer to obtain a fire insurance policy to cover the amount of the mortgage, to protect your interest, or the replacement cost of the house? A common practice may be to require the customer to obtain a fire insurance policy to cover the entire amount of the mortgage. Such a requirement may be in violation of an insurance rule. The purpose of this article is to attempt to clarify the rule and its application.

Pursuant to section 624.308(1), Florida Statute, the Florida Department of Insurance has promulgated a rule to govern the above scenario. Rule 4-167.009 of the Florida Administrative Code provides the following:

No mortgage lender shall, in connection with any application for a mortgage loan in this state which is secured by a mortgage on residential real estate located in this state, require any prospective mortgagor to obtain by purchase or otherwise a fire insurance policy in excess of the replacement value of the covered premises as a condition for granting such a mortgage.

Under a strict interpretation of this rule, which regulators tend to do, no mortgage lender, which includes financial institutions acting as a mortgage lender, may require a customer who secures a loan for residential real estate to obtain a fire insurance policy for the entire amount of the mortgage, which many times is in excess of the replacement cost of the house. The rationale for this rule may be twofold. First, it can be argued that between the replacement cost and the underlying value of the lot on which the residential property was built, the mortgage lender has adequate coverage to protect its interests. Secondly, unless carefully monitored, conditioning the granting of a mortgage on obtaining certain fire insurance coverage may run afoul of section 626.955(1), Florida Statute. Broadly speaking, this section provides for consumer protection measures by prohibiting any person from tying the extension of credit with the purchase of an insurance product from a favored agent or insurer.

6/9/04 David Thompson

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Don't Insure for the Mortgage Amount (Regardless of What the Bank Says)

Bill Wilson

Abstract
Every agency has experienced this to one degree or another: A client buys a house and the replacement cost of the dwelling is considerably less than the mortgage amount. The insurer refuses to issue a policy with a Coverage A amount greater than the replacement cost, but the lender insists on a policy limit equal to the mortgage amount....

Here's a typical situation:

Q. "We need your help! We're getting beat up by lenders insisting that we insure a home for the loan amount rather than replacement value. In our area, selling price values are soaring but replacement values are steady. People are refinancing with lower interest rates, starting a vicious battle between the loan officer (representing the lender) and us (representing the insurance company).

"Here lies the problem: the loan officer will absolutely accept nothing short of the loan amount and they become angry and very threatening if we don't do exactly as they demand. The insurance companies demand some type of proof as to why we are requesting an increase (and a refinance is not the reason).

"A typical situation is as follows: The bank faxes our office a request to change the mortgage clause and increase coverage to the loan amount. We respond that we need an appraisal showing replacement value from them to increase coverage. They normally supply an appraisal which agrees with our current coverage. We then advise them that we cannot increase coverage as we currently insure at replacement value and that their appraisal agrees. Now the trouble starts. We normally receive multiple calls from the loan officer calling us illegal, unprofessional, not serving our client, threatening to take the business away from us, and on and on. The calls start at the CSR level, then move up to the personal lines manager, and sometimes moves up to me, the owner, with each one of us explaining the same thing.

"This problem is only getting worse and I'm afraid it could get a lot worse.

I'm concerned that banks will use this issue as leverage to rewrite our policies into their markets.

"I contacted the local insurance department office and he advised I could lodge an individual complaint on each situation with them. We're getting about 7 to 8 requests per day of which 1 or 2 can get real ugly."

A. The lender's position is understandable, but misguided. Clearly, they want to protect their investment. That investment consists of two components: (1) the real estate (land, home, outbuildings, etc.), and (2) the loan itself. Insurance is the mechanism designed to protect against the pure risk of loss to the real property. However, the loan itself is a speculative business risk...that's not the function of insurance.

As an example, let's say the purchase price and loan amount for a home is $200,000...for the sake of simplicity, we'll forget about any down payment. This $200,000 represents *market value*, not insurable value. The cost to rebuild the home itself might be $140,000, with the $60,000 balance being the value of the land and other structures. The purchase price includes the value of land, all structures, and even other property that may not be covered by a homeowners policy.

The purchase price may also include the "value" of the location. I once looked at two new homes, both built from the same floor plan by the same contractor. The asking price for one of the homes was 50% higher than the other based SOLELY on the location of the home in a "preferred" neighborhood. The cost to rebuild the homes would be virtually identical.

Under a homeowners policy, the insurance company would never pay more than $140,000 if the home was completely destroyed unless required to by a state's valued policy law (which is another reason for not insuring the loan amount). There has been no damage to the land or the "location value" (or at least the policy isn't going to pay that amount), so it would largely be pointless to insure the property for more than the structural replacement costs.

It does not serve the bank's interest in any way to be the mortgagee on a policy with a policy limit equal to the loan amount because neither the insured nor the bank will ever collect that amount. The policy will only pay an amount based on the valuation method included in the contract. Again, this is the case if no valued policy law applies...if it does, then the insured could actually profit from the loss by insuring the loan amount rather than the replacement cost of the property. This would violate one of the fundamental tenets of insurance and, conceivably, could create a moral hazard.

If an insurance company issues a replacement cost (or, worse, an ACV) policy with a limit greater than the actual cost to repair or replace, they may be in violation of the insurance laws in most states. I'm pretty sure all states require that rates/premiums be adequate, not excessive, and not unfairly discriminatory. What these banks are asking is that the insurance company issue a policy with an excessive premium (payment for coverage the insured can never collect without a total loss and triggering of a valued policy law, which has a likelihood of maybe 1-3%) and that's probably illegal.

For example, **Tennessee** has an "Unfair Competition and Deceptive Practices" statute regarding loan amounts that exceed the value of a building or structure: