

EXHIBIT NO. 4
DATE 3/11/05
BILL NO. HB 557



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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.

690-167.009 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.iaaa.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