Chapter 2

Loan Documents

This chapter focuses on the loan documents that most borrowers encounter when they buy a home. After consulting this chapter, financial and legal counselors will have an even fuller background to discuss the documents and the issues that arise from them at the first meeting, and perhaps even at later meetings, with the majority of home buyers concerning the most frequently encountered lender force-placed insurance practices.

2.1 Introduction

Between 2005 and 2008, thirteen major banks, most of them investment banks, issued $2 trillion in residential mortgage-backed securities.[1] When the total amounts paid or projected to be paid in mortgage-securities-related settlements with agencies of the United States are considered as a cost of doing business, the resulting figure is 2 percent.

Taking this view means considering the costs of settlement with the U.S. government for all claims made or that could be made by all of its agencies arising out of residential mortgage-backed securities as additional costs of doing business over the course of only four years. Looked at in that way, these additional costs of doing business in residential mortgage-backed securities during those four years were 2 percent of the revenue generated by those costs for the thirteen biggest banks in that line of business during that time.[2]

Only a fraction of the approximately $120 billion in total settlements made and projected with U.S. government agencies over residential mortgage-backed securities includes the settlement of claims over conduct related to lender force-placed insurance (LFPI). That amount is unknown to the public.

The total amount of money paid in settlements in individual LFPI cases simply cannot be calculated. In the first place, pleadings, testimony, and documentary evidence that would ordinarily reveal these figures are almost always kept secret.[3] However, even if secrecy was removed as an obstacle, all settlements arranged in class action cases that have been found have included both the payment of money and the performance of services that do not include money and that have not been reduced to verifiable monetary value in any case and in any electronic court file that has been examined.[4]

The amount of money received by some banks and their successors and servicers for force-placing insurance on homeowners-mortgagors can be estimated, but only roughly. The exact amount of money received for force-placed insurance is a secret. If it has ever been revealed in any testimony or other filings in the federal court files that are reflected on PACER, the public's access to federal courts' electronic records, then it appears that the secret has been kept by the device of secrecy stipulations requesting U.S. district judges and magistrate judges to approve them, which they generally do.[5]

Publicly available information about the income from force-placed insurance policies has been located that relates to at least one lender-servicer, however. The publicly available information apparently does not include ease of reference to its market share in force-placed insurance, meaning that no information has been found that tends to show what percentage of all LFPI is attributable to it, nor over what period of time. Individuals may unearth these facts in the future, but at this time it appears that we will know little more than that the lender-servicer in question was a big purchaser of LFPI over some period of time after the beginning of the twenty-first century.

With that backdrop kept in mind, some testimony and documents are available for review on this subject. In a federal case, the rule 30(b)(6) corporate representative of that lender-servicer's captive insurance agency (a subsidiary or affiliated company) testified that the lender-servicer in question received commissions on "aggregate annual net written premium" of force-placed insurance in the amount of $400,000,000 each year in 2008, 2009, and 2010 and projected the same amount for 2011.[6]

The aggregate annual net written premium on insurance force-placed by that one particular lender—and only by that one particular lender—for that period of just four years would total $1.6 billion.

People suing in LFPI cases allege that extra money inflates the already high premiums carried by force-placed insurance policies. They allege in general that extra money is paid to lenders and servicers by way of reinsurance premiums paid to their captives and subsidiaries, that force-placed insurance policies are backdated with unnecessarily high premiums to cover periods when no loss occurred, that unnecessary insurance policies were placed by force in certain cases, and that insurance policies have been placed with unjustifiably high policy limits at higher premiums, all billed to borrowers-homeowners.

No pleadings have been located that allege the total amount of all reinsurance premiums, if any, that were paid on account of that aggregate annual net written premium on force-placed insurance that the particular lender placed during those four years. No testimony or documents have been discovered from court files either tending to establish that amount in an evidentiary form acceptable to most courts.[7] However, there is some evidence of the amount of reinsurance premiums received by another lender for a different period of time.

In an application for attorney's fees in an LFPI class action case involving a different lender than the one just discussed, the plaintiffs' attorneys represented to the court that they should be awarded attorney's fees in part because the lender received "revenue arising from quota-share reinsurance agreements" totaling "more than $600 million in revenues during the Class Period" of January 1, 2008, to October 4, 2013. During this period of five years and nine months, the lender in that case would have to average receipts of over $100 million per year in reinsurance premiums in order to reach total revenues of $600 million from reinsurance premiums.[8]

To the author's knowledge, pleadings, testimony, and documents have not, however, been unearthed in sufficient numbers to gauge

- the extent of backdating,[9]
- the amount of premiums charged on unnecessary insurance,[10] or
- the extent of premiums derived from excessive policy limits on force-placed insurance policies.[11]

Testimony under oath, filed in a court file of a different case also publicly available on PACER, reveals that the force-placed insurance carrier most favored at the time by one lender—which with related insurance companies provided the force-placed insurance policies to that lender—paid a commission of 11 percent directly to the lender's subsidiary or affiliated insurance agency (i.e., its "captive" insurance agent) "for all Lender Placed Insurance ('LPI') premium transactions prior to March 24, 2012." The corporate representative designated by the captive insurance agent further testified that the force-placed insurance carrier paid commissions pursuant to a contract with the captive insurance agent for 11 percent "of the net written premium amount" of the lender force-placed insurance during those years.[12]

Eleven percent of $1.6 billion is $176 million. That is how much one force-placed insurance carrier paid to one lender's captive insurance agent considering only "commissions" in the four years from 2008 through 2011, inclusive, according to the lender's captive insurance agent itself testifying through its corporate representative.[13]

Not only did one lender-servicer bill mortgagees $1.6 billion for insurance to protect itself and to which it did not contribute a penny of its own but also that same one lender-servicer generated income of $176 million from force-placing that insurance during that same period. That may be all we can know without even more exhaustive investigation in the face of many obstacles including so-called confidentiality agreements or secrecy stipulations.[14] But it may be enough to know that much about the income-generating practices of lender force-placed insurance.

In contrast to the huge returns on investment for investors in residential mortgage-backed securities, force-placed insurance charges to individual residential borrowers are individually small. Further, the borrowers in these cases do not generally claim that they should be repaid the entire amount of the force-placed insurance premium, unless they contend that the lender should never have placed the insurance at all.

Residential homeowners in these cases mostly claim instead that they should not have been forced to pay some add-on charges. The amounts these borrowers go to court over are generally additional charges that lenders have billed to them for LFPI. These surcharges, or charges placed within other charges, include alleged total commissions, reinsurance premiums, and kickbacks that the lender force-placed insurers paid to the banks in order to be the insurance company that force-placed the insurance on the homeowner.

The premiums for LFPI reported in these cases are in relatively small amounts:

- $5,154.04, representing the difference between the LFPI annual premium and the annual premium the homeowner's prior insurance carrier would have charged. Apparently, the homeowner in this case was charged monthly. This would mean a difference of about $430.00 added to each monthly mortgage payment.[15]
- $1,743.00 for six months of LFPI premiums.[16]
- $276.00 per month for LFPI.[17]
- An increase of $1,478.12 for one homeowner in the annual premium of lender force-placed flood insurance and a total annual premium for lender force-placed flood insurance for another homeowner in the amount of $2,250.00.[18]
- $192.00, less a refund of $18.00, representing the difference in premium taken out of a homeowner's escrow account for a lender force-placed flood insurance policy that bridged the gap over which one lender forced coverage between the policy limit of the flood insurance policy carried by the homeowner and a higher policy limit that the lender demanded.[19]

However, again, the homeowners in these cases did not sue to recover the total amount of the LFPI premiums they were charged. Rather than challenging the full amount of premiums charged to them for LFPI, the homeowners-borrowers who are most successful in alleging their claims against lenders in the courts challenge instead "the allegedly unfair practice of arranging for kickbacks in return for force-placing unfairly expensive insurance policies. The increased premiums (including the kickbacks) are the measure of damages caused by the allegedly unfair business practices."[20]

The homeowners-borrowers in these cases did not request recovery of the entire amount of LFPI but instead sought to get back the far smaller amounts by which their insurance premiums and insurance-related costs increased as a result of the insurance companies allegedly paying commissions, reinsurance premiums, and kickbacks to the banks:

- $1,575.00 charged to a homeowner on a home equity line of credit on which she had a zero balance.[21]
- $1,425.00, which was the difference between one month of the homeowner's increased monthly fees paid out of escrow that increased to $1,924.81 after FPI, from $499.31 paid out of the homeowner's escrow account each month for homeowner's insurance before the LFPI.[22]
- FPI with a policy limit of $253,600.00 and an annual premium of $5,049.00, where the homeowner did not borrow more than the original loan amount of $159,000.00.[23]
- Two sets of force-placed flood insurance, one with a 90-day insurance binder for $893.00 and a second again with a 90-day binder for $780.90. Each time the flood FPI policy limit was $250,000.00. The original mortgage loan was for $115,371.00, and the homeowner's unpaid balance was approximately $113,000.00.[24]
- $19.00 for a "standard flood hazard determination" charged for analysis of whether flood insurance might be required by federal rules and regulations, versus $6.00 paid by the homeowners themselves and $5.00 actual cost.[25]

The individual amounts homeowners ask to recover in litigated cases then are different from person to person and case to case, but they have at least one thing in common: the individual amounts are small.

The homeowners all share something else as well: each of their cases and situations started with a contract for a loan.

Force-placed insurance or lender-placed insurance is generally, if not always, authorized by a contract. The loan documents are collectively recognized as many parts of one loan contract. Taken together, the documents make up a legally enforceable contract for lending and repaying money.

Agreements for force-placed insurance are prevalent. They are a part of our daily lives. We make these agreements to allow lenders to force-place insurance in all kinds of contracts, including loan contracts we make so that we can purchase cars and large appliances.

Out of the many types of collateral protection insurance, this book focuses on the force-placed collateral protection insurance agreement by which a lender places insurance on someone's home under a residential mortgage.[26]

2.2 The Lender's Risk of Not Being Repaid

Very few if any of us have the kind of wealth that might make a lender extend credit without protecting the lender's right to be repaid. The right to be repaid has a value. It is protected by collateral, which is something that the person asking for the loan pledges to support that person's promise to repay the loan. If the borrower, the person promising to repay the loan, does not repay it, then the lender's right to be repaid is protected by the collateral, which the lender can sell if necessary to repay the loan.

There are cases when the present value of collateral is not enough to guarantee that the borrowers will still repay the loan. Even if the borrowers are used to making sacrifices in order to pay their debts, there are two important realities at work here. First, although lenders may or may not know that the borrowers are willing to make sacrifices to pay their own debts, lenders do know that there are also many people who are unwilling to make the same kinds of sacrifices in order to pay the lenders' loans. Second, on some future day it is conceivable that even trustworthy borrowers may be unable to repay a loan depending on circumstances.

So, even if collateral for a loan was once valuable enough at the beginning of the loan to guarantee or pledge repayment of the entire loan amount, it may have been destroyed or become impaired. For example, a borrower may give the lender a mortgage on the borrower's house. The borrower then is also called a mortgagor and the lender a mortgagee. However, the house may burn down. In that case, the house will not have much value