NMSA

NATIONAL MORTGAGE SERVICING ASSOCIATION

DISASTER PREPAREDNESS: Three Things Mortgage Loan Servicers Can Do to Get Ready for Storm Season

SUMMER 2018

PREPARED BY NMSA ASSOCIATE MEMBER

DIMONT

Modern Technology. Nostalgic Service.

July 9, 2018

Dear Colleagues,

The unprecedented natural disasters that occurred in Southeast Texas, Florida, and Puerto Rico during the latter half of 2017, affected more than just the homes within the geographic locations where they occurred. They affected the very fabric of our industry, pushing us to evaluate every business process and practice to ensure continuity of service and protection for the customers that we serve. Incumbent in that in the evaluation process is a renewed commitment to preparedness on the part of all mortgage servicing organizations, planning now for the disasters of tomorrow.

To assist all National Mortgage Servicing Association member organizations in their disaster preparations, associate member DIMONT has prepared the enclosed white paper entitled "Disaster Preparedness: Three Things Mortgage Loan Servicers Can Do to Prepare for Storm Season." The paper outlines the issues that servicing executives should be thinking about now to mitigate potential of catastrophic damage to their portfolio and set themselves up for effective navigation of the insurance claims process when disaster strikes.

I have every confidence that the occurrence of the next disaster will find the mortgage industry better prepared and better equipped to face the unique challenges that preparedness and recovery present. We look forward to continuing to work with the industry on the development and distribution of best practices that benefit homeowners.

Sincerely,

Ed Delgado
President & CEO
Five Star Institute

DISASTER PREPAREDNESS:
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EXECUTIVE SUMMARY

2017 was a catastrophic year for storms, wildfires, and other natural disasters, leaving many mortgage servicers unprepared for the resulting high volume of damage claims, coverage questions, and customer service issues. In response, DIMONT, an industry leader in insurance recoveries and specialty collateral loss avoidance services, has prepared the following disaster preparedness guide featuring three essential components of storm season readiness for servicers: ensuring appropriate insurance coverage, communicating effectively with borrowers in the aftermath, and navigating the complex insurance claims process. This guide is designed to inform servicers on sound insurance practices to help mitigate collateral losses.

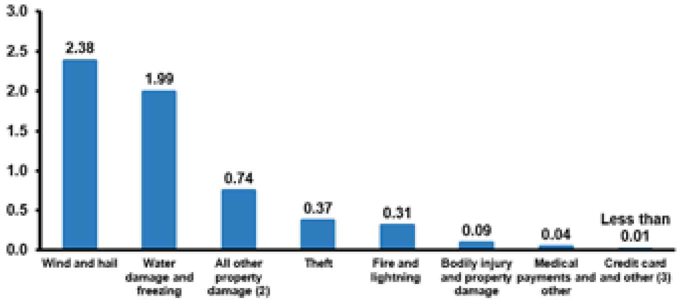
DISASTER PREPAREDNESS FOR MORTGAGE LOAN SERVICERS

Storm season in the United States calls for servicers to prepare for claims and increased risk of loss. However, stories surface too often of disaster-damaged properties going through disorganized insurance claims processes, causing delayed repairs, distraught borrowers, and servicers with jeopardized reputations. This scenario was especially prevalent during 2017's hurricane season, which was the U.S.'s costliest season on record with insured losses estimated at $80 billion[1].

Each year from 2012 to 2016, an average of 3.43 hazard claims (wind, hail, fire, lightning, and all other property damage excluding vandalism) and 1.99 water damage (flood) claims were filed for every 100 policies. It is important to note, however, that these statistics do not even include Alaska, Texas, or Puerto Rico due to the high storm activity of those three jurisdictions.

IN THE FIRST NINE MONTHS OF 2017, IT WAS ESTIMATED THAT DIRECT INSURED PROPERTY LOSSES FROM CATASTROPHES STRIKING THE UNITED STATES WERE BETWEEN $36 BILLION AND $40 BILLION[2],

Homeowner Losses Ranked by Claims Frequency, 2012 - 2016



(1) Claims per 100 house years (policies).
(2) Includes vandalism and malicious mischief.
(3) Includes coverage for unauthorized use of various cards, forgery, counterfeit money and losses not otherwise classified.
Source: ISO®, a Verisk Analytics® business.

Although 2012 to 2016 brought a considerable amount of hazard and flood claims, the 2017 hurricane season overwhelmed the mortgage servicing industry with an unprecedented number of hazard and flood claims. In the first nine months of 2017, it was estimated that direct insured property losses from catastrophes striking the United States were between $36 billion and $40 billion[2], resulting in more claims than servicers were prepared to handle. Because of these excessive claims clogging up servicers' tracking systems, many customer experiences suffered.

The delays and disconnected practices within the industry stem from outdated manual processes and a lack of transparency between servicers and borrowers. Preparation beforehand and a smooth response process during storm season will not only ensure reduced expenses and risk avoidance, but it will also help borrowers through a stressful life experience. In this regard, our guide below features three best practices for servicers to utlilize in preparing for the upcoming storm season.

THREE BEST PRACTICE TIPS FOR SERVICERS TO PREPARE FOR STORM SEASON

1. BEFORE THE STORMS HIT: ENSURE CORRECT INSURANCE VALUATIONS OF ALL PROPERTIES

Servicers face increased risk of loss when they have insufficient insurance coverage or the wrong kind of insurance coverage on a property that serves as collateral for a mortgage loan. Making sure the coverage is both sufficient and of the proper type is critical for effective risk mitigation.

To avoid the risk of financial loss, servicers need to maintain proper records of insurance on all properties and ensure that the policies are sufficient; even hazard insurance comes in many varieties and not all risks to the property are covered by every policy. For example, "named peril" policies provide limited protection and too often the servicer is unaware of the limitations on coverage until after damage has occurred. The solution to this problem is to check the binders for every property to ensure that insurance coverage exists for the right perils at the time the loan is secured. In that regard, servicers must ensure that collateral properties are protected from losses due to vandalism, hail damage, bad rain storms, fire damage, and other risks to the property; a good hazard insurance policy will provide that coverage and benefit both the homeowner and the servicer/investor.

The lack of oversight of insurance effectiveness is even more acute in the flood insurance domain: Of the 90 million residential structures in the United States, approximately 10 percent are in Special Flood Hazard Areas, yet only about half of those structures carry flood insurance[3]. Although flood coverage can also be purchased as a standalone policy from the National Flood Insurance Program (NFIP), people who don't necessarily live in flood zones often underestimate the risk of storm damage and therefore neglect to protect their homes with flood insurance[4].

> OF THE 90 MILLION RESIDENTIAL STRUCTURES IN THE UNITED STATES, APPROXIMATELY 10 PERCENT ARE IN SPECIAL FLOOD HAZARD AREAS, YET ONLY ABOUT HALF OF THOSE STRUCTURES CARRY FLOOD INSURANCE[3].

The risk of hazard losses, while disconcerting, can be greatly outweighed by the risks of flood losses in certain areas. For example, 2017's Hurricane Harvey disaster in Texas caused roughly $125 billion in damages, making Harvey second only to Hurricane Katrina as the most expensive natural disaster in U.S. history[5]. Unfortunately, less than 20 percent of Harvey's flood damage victims had flood insurance on their properties[6], contributing tremendously to the discrepancy between $80 billion in insured losses and $125 billion in overall damages in 2017.

When compared to hazard insurance, analyzing the appropriateness of flood insurance coverage requires a more in-depth process. If the property in question lies within a Special Flood Hazard Area (SFHA), it's required under the NFIP to carry flood insurance. However, it is the responsibility of the servicer to ensure the property carries the right amount of flood coverage. The Biggert-Waters act of 2012 requires that OCC-regulated banks have a demonstrable process for evaluating flood coverage[7], and the fines for non-compliance can be severe. Of course, having a well-defined coverage review process is also widely viewed in the industry as just good business practice.

Determining proper flood insurance coverage involves ascertaining the number and types of structures on a property, which requires research and thorough analysis of insurance eligibility. Flood insurance policies are written on a per-building basis-each structure on a property requires its own policy–so servicers must correctly determine whether a property has multiple residential buildings or a single building with multiple units. Then the servicer must correctly determine the cost value of the structures, applying the unpaid principal balance of the loan against all structures.

Failing to account for these factors leads to coverage adequacy issues. A proper cost analysis is required and it should not be based on the appraised value of the property or estimates based on the value used for hazard insurance. Federal regulators have stated that using either of these methods will lead to systemic errors that will result in the servicer either over-insuring, which causes unacceptably high premiums; or under-insuring, which causes inadequate coverage in the event of a loss. The level of risk when the incorrect method is applied to an entire portfolio is serious when considering the enormous valuation range of structures in flood zones. For example, if the servicer arbitrarily assigned full FEMA limits coverage of $250,000 to all loans in flood zones in its portfolio, that coverage would be appropriate on a $500,000 property, but a $150,000 property would be over-insured and generate a compliance violation.

The law is not explicit about the method that a servicer should use to determine the cost value of a property. Some servicers will opt to make adjustments to the appraised value as a cheaper alternative than hiring a qualified firm to perform a detailed cost analysis. In the short term, this may be faster and less expensive, but the downside risk of over-insuring makes this a dangerous move. The OCC, FDIC, or other federal regulators can impose penalties on any servicer that it finds to be systematically over-insuring properties, levying fines up to $2,000 per loan, with no cap on the total amount of fines. On top of that, the threat of consumer lawsuits present additional legal and reputational risk.

HURRICANE HARVEY DISASTER IN TEXAS CAUSED ROUGHLY $125 BILLION IN DAMAGES, MAKING HARVEY SECOND ONLY TO HURRICANE KATRINA AS THE MOST EXPENSIVE NATURAL DISASTER IN U.S. HISTORY[5].

The best approach is to apply a proper cost analysis to the structures on a property. This requires the servicer-or a qualified flood valuation partner-to determine that cost. Construction prices vary by location, but not nearly as much as property values. For instance, a 1,000 square-foot condominium in downtown Manhattan overlooking Central Park could cost more than a million dollars to buy. The same size condo in another city could be bought for considerably less, so the appraised value of the two will not be comparable. Instead, to ensure appropriate flood insurance coverage, a structural cost analysis must be undertaken. In this case, the cost of rebuilding the two condos could very well be comparable for the purposes of flood insurance, despite their disparity in property values.

Calculating the required amount of coverage for a property is a complex process, and it must be done correctly every time to avoid potential compliance violations. When floods are a threat to property, being underinsured is a nightmare. On the other hand, insuring a property for too high an amount puts the servicer's reputation, regulatory compliance, and finances at risk. Working with a qualified partner will help servicers arrive at a valuation for flood insurance that provides the appropriate coverage levels and meets all regulatory requirements, thereby reducing the risk of OCC penalties and borrower-driven litigation.

2. IN THE AFTERMATH: COMMUNICATE EFFECTIVELY WITH BORROWERS

Naturally, borrowers will have extremely pressing questions on their minds when a natural disaster affects their property:

» Will they get a break on mortgage payments for an uninhabitable home?
» How long will they have to wait to receive their insurance proceeds?
» When and how often will they hear from their bank regarding property status?
» When can repairs and property inspections be scheduled?

Regardless of the outcome of the storm, the servicer has a duty to ensure that loan payments continue and that the collateral is appropriately remediated. On the other hand, victims of natural disasters just want to get on with their lives. Unfortunately, in the aftermath, lack of communication transparency by servicers and delayed claims processing often compound borrowers' frustrations. People with disaster-affected property are going through one of the worst times in their lives; trying to simultaneously wrap their heads around insurance claims, valuations, and repair inspections can easily compound an already tough situation.

Instead, servicers can help reduce borrower stress through effective, pre-planned communication. The first step is determining the borrowers' actions, options, and intentions:
» Have they evacuated or are they in the house?
» Have they filed a claim, and have they received a decision?
» Is there intent to repair/rebuild or move to higher ground?
» Have they applied for loans available from the SBA, state, or federal sources?
» Are they aware of any forbearance options?

During this time, servicers can be of great assistance to their borrowers, generating goodwill with them and their communities. Servicers should set their priorities on customer service and collateral protection, determining:

» How will you be communicating with your borrowers and with what frequency?
» Should you have “boots on the ground”-do you need more information than the typical property inspection report?
» With what frequency will you want to re-evaluate borrowers’ progress on claims; i.e., what is the inspection frequency?

A servicer’s job involves both keeping the borrower informed and keeping them educated on claims processes. One of the most pressing concerns for a borrower with property damage is receiving loss draft funds. Loss drafts are multi-party checks for insurance proceeds that are meant to assist in paying for repairs or paying off the remainder of a mortgage loan if the balance is less than the claim amount.

The biggest concern with the loss drafts process is the delay in resolution stemming from the lack of transparency in the request status between the borrower and lender. The loss drafts process is very cumbersome, riddled with manual processes that require back and forth communications via phone or letter between the lender and borrower. Since the borrower has a general lack of understanding of the inspection, repair, and loss draft negotiation process, they may not know what needs to happen next, causing delays and leaving them with feelings of discontent about the process and, in turn, about their servicer.

In the meantime, the servicer bears considerable risk when it comes to a damaged property. Asset protection is always important, but particularly in the case of a borrower who may be delinquent or who may become delinquent if they decide that repairing the property will require too much effort or additional out-of-pocket expenses. Servicers should do all they can to ensure the process is swift, intuitive, and easy for the borrower to navigate. Since loan servicing systems do not have robust tracking options for following the status of a loss draft request, investing in technology that will allow the status of a request to be tracked from the beginning-at notification of the claim-through repairs and final funds disbursement will provide the servicer with the data it needs. The solution should also allow for constant and consistent messaging to their borrower, so all parties to the action know the status of the request at any given time as well as the next steps towards resolution.

The purpose of the loss draft process should be to provide a secure funding method that expedites the remediation of the property. Loss draft systems that leave little guesswork involved increase collaboration and transparency between borrowers and servicers while ensuring the efficient application of available insurance claim proceeds to the repair efforts. The end result should be a fully-restored property and an ongoing, mutually beneficial relationship between the borrower and the servicer.

3. DURING THE CLEAN-UP: EFFECTIVELY NAVIGATE THE INSURANCE CLAIMS PROCESS

Following a disaster, people instinctively think that insurance carriers will automatically respond and assist homeowners in rebuilding their homes; however, that is not always the case. The reality is that navigating the insurance claims is a complex process, with many opportunities for pitfalls along the way. For example:

» Flooding is a non-covered peril under a typical homeowner’s policy (flood insurance must be obtained in a separate policy provided through the National Flood Insurance Program);
» The exclusions, endorsements, and exceptions contained in hazard insurance policies are not uniform - each policy must be examined carefully; and
» The claims practices of carriers varies widely - some carriers will have a “deny-first, ask questions-later” response.

There are a tremendous number of details to be considered when preparing damage claims and reviewing repair bids. As a result, servicers need vendor partners that employ experienced and licensed insurance adjusters to help them navigate the complex world of claims analysis and maximizing recoveries. In the United States, 45 states require the use of licensed adjustors for processing hazard insurance claims. These adjusters undergo extensive testing and certification processes, as they need to understand the varying state regulations and to stay up-to-date with changes by participating in comprehensive training and continuous education. Damage-related issues that professional adjusters encounter regularly and know how to handle include:

» If glass is found in the carpet or if the color or quality of damaged carpet can’t be matched, then the entire carpet must be replaced. If hardwood flooring is replaced, the bid must include sanding, staining and sealing as well as the flooring replacement. Furthermore, any flooring claim should have a 10 percent cushion added for waste.

» If there is a fire loss, the cleaning and repainting need to be included in the claim. When there is smoke damage, thermal fogging of the entire house must be undertaken to remove the smell, even if the smoke was contained to only one room.

» When replacing the roof, you must ensure that the felt is replaced as well as the shingles, and the minimal acceptable shingle life is 25 years. If roof replacement is due to hail storm damage, the entire roof should be replaced, not just a section.

The coverage issues that arise as a result of hazard claims can also be arcane and multifaceted. For example, servicers who handle their own insurance claims often overlook recoverable depreciation (RD), which is a significant portion of the difference between replacement cost and actual cash value. When homeowners' insurance policies include coverage of the property's replacement cost, recoverable depreciation-the replacement cost of a damaged property minus the property's actual cash value (ACV)[8]-can be claimed. A simplified example of RD is pictured below:

Example of Recoverable Depreciation

Replacement cost value	**$1,000**
Less depreciation	- 400
Actual cash value	**$600**
Less deductible	- 500
Net claim	**$100**
Total recoverable depreciation	**$400**
Net claim if depreciation is recovered	$500

Source: https://www.travelers.com/claims/understanding-depreciation.aspx

RD is essential for Federal Housing Administration (FHA) properties due to the FHA's requirement that the property be in conveyance condition (ICC) for a servicer to file a claim on the FHA guaranty; RD claims help significantly in offsetting corporate expenses relating to ICC. Typically when a damage claim is filed, as much as 30 to 40 percent of the settlement is not immediately available. If repairs are made within the policy guidelines, RD may be available to offset corporate expenses used to get properties into conveyance condition. However, if repairs are not made in a timely manner, these additional funds from the insurance settlement may not be available.

To further ensure that ICC is achieved within FHA guidelines, servicers should have a system of checks and balances in place to ensure vendors are not including items in their repair bids that would not be recoverable to the servicer. Repair bids that don't capitalize on the entirety of the claim being filed equal wasted time and avoidable financial losses for both the servicer and the borrower. Servicers should consider utilizing a vendor with experience in claim recovery issues to provide oversight to the repair bid process to ensure that only appropriate repairs are made and that they are completed timely.

We have described just a few specific examples of the complexities surrounding the impact of insurance before, during and after a disaster. The intricacies of the process are compounded by state-specific laws and the insurance policies themselves. Adjusters licensed in the various states have the ability to apply their expertise efficiently in times of disaster when the sheer number of claims exceeds a servicer's ability to respond. It is in moments of catastrophe that a servicer and the investor have the most to lose if the opportunities for both the initial claim and the follow up recovery after repair are not maximized.

ABOUT DIMONT

Since 1996, DIMONT has helped mortgage servicers and investors reduce operating expenses and avoid losses on collateral properties across the United States. DIMONT's hazard insurance adjusting, loss draft management, flood coverage auditing, and investor claims solutions leverage proprietary technologies to drive efficiencies from integrated processing. Our adjusters are all fully licensed and trained to maximize recovery to the servicer on every claim we handle, and we are dedicated to helping servicers exude excellence throughout all other phases of collateral loss mitigation. As specialists in insurance and negotiation, DIMONT's mission is to facilitate simple, intuitive solutions customized to support the needs of our clients and leverage the unique skill sets of DIMONT's expert staff and significant scale to avoid losses stemming from regulatory risk, penalties, and processing errors.

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