OPENING STATEMENT – SUPERINTENDENT OF FINANCIAL SERVICES BENJAMIN M. LAWSKY

FORCE PLACED INSURANCE HEARINGS

THURSDAY, MAY 17, 2012

- Good morning everyone. Welcome to the first of three days of hearings that the Department of Financial Services is holding on the workings of the force placed insurance industry.

- Thank you to all of our witnesses today who have agreed to come testify at these hearings. We look forward to hearing from all of you and engaging in a dialogue with you.

- Thank you also to the team here at DFS that has worked so hard to put these hearings together. Joining me up here to participate in the hearings are Joy Feigenbaum, Executive Deputy Superintendent for the Department's FFCPD, and Daniel Alter, the General Counsel of the Department. They will both be participating in the dialogue we have with witnesses as well.

- Force placed insurance, as most of you probably know, is insurance placed on a home by a lending institution when the homeowner's insurance lapses. It is designed to maintain continuous coverage and protection for properties and does serve an important purpose.

- In recent years, the force placed insurance market has grown immensely. Largely as a result of the downturn in the housing market and the foreclosure crisis, premiums have risen from $1.5 billion in 2004 to $5.5 billion in 2010. The numbers are likely even higher now. With this massive spike in premiums have come enormous profits for the insurers and the banks. At Balboa, for example, profits went from $177 million in 2006 to $1.178 billion in 2010 (on premiums of $1.545 billion).

- This inquiry into the force placed insurance market is incredibly important. It impacts homeowners and investors, and falls, really, at the intersection of banking and insurance. DFS, as you all know, is the product of the merging of the banking and insurance departments into a larger and more robust, overall financial regulator – so force-placed insurance is smack in the middle of our jurisdiction as it spans both the banking, mortgage and insurance industries.

- These hearings are intended to be fact-driven and exploratory. This will not be an inquest or a witch hunt. We want to hear all sides of the issues and delve deeply into the subject in a fair and balanced way.

Red Flags

- With that said, our initial inquiry into the operation of the force placed insurance market has raised a number of serious concerns and red flags.

1. Premiums for force placed insurance seem high and in many cases are exponentially higher than regular homeowners insurance.

2. Loss ratios (or the percent of premiums actually spent to cover claims) seem extraordinarily low. On a typical homeowner's policy, at least 63 cents of every dollar goes to pay claims. But for force placed policies, the loss ratios drop precipitously often below 25 cents and sometimes as little as 17 or 18 cents on the dollar is going to pay claims. The rest is mostly profit.

3. The high premiums can push distressed homeowners over the foreclosure cliff; they also impact investors in mortgage securities. That's because the banks often advance the high premium payments themselves and then pull the funds back out of the property's value once there is a foreclosure or a short sale, etc.

4. There appears to be a severe lack of competition among the few firms that provide force placed insurance. In New York, just two companies, Assurant and QBE, represent more than 90 percent of the market. (So we're seeing high premiums, low loss ratios, and very little if any competition to keep rates down.) And it's no different nationwide.

5. As I mentioned, in the wake of the financial crisis and the bursting of the housing bubble there has been a huge uptick in force placed insurance and it has become a major profit center for both banks and insurers. Force placed premiums increased to $5.5 billion, a more than 265 percent increase between 2004 and 2010.

6. Amidst this boom in premiums and profits, there also appears to be a web of tight relationships between the banks, their subsidiaries and insurers that have the potential to undermine normal market incentives and may contribute to other problematic practices.

- In some cases this takes the form of large commissions being paid by insurers to the banks for what appears to be very little work. In other cases, banks have set up reinsurance subsidiaries who take over the risk from the insurance companies. Thus, the banks pay high premiums for coverage that is highly profitable and then those big profits revert right back to the banks through reinsurance agreements.

- JP Morgan Chase, for example, pays very high premiums to a single insurance company, Assurant. Assurant then turns around and reinsures 75 percent of the risk through JP Morgan's Vermont-based captive insurance subsidiary. JPM is, in effect, paying itself high premiums and making big profits without having to provide much coverage, all seemingly at the expense of homeowners and investors.

- In sum, when you combine this close and intricate web of relationships between the banks and insurance companies on the one hand, with the high premiums, low loss ratios and lack of competition on the other hand, it raises serious issues and questions that we need to explore in these hearings.

Issues Raised

- During these hearings we would like to explore whether these apparent red flags are indeed indicative of a problem, and if so, what conclusions we can draw from them.

- On the surface at least, our initial investigation raises the question of whether the normal insurance market incentives to keep prices down are upside down when it comes to force placed insurance. In other words, the banks purchasing this insurance seem to have little incentive to keep prices down and often, depending on their relationships with the insurers, they may have an incentive to find the most expensive coverage. This perverse incentive, if it exists, would appear to harm both homeowners and investors while enriching the banks and the insurance companies.

- If these inverted incentives exist, and we combine that the scant competition in the market, then we may have a situation where certain dominant players have become dominant, not by offering the best prices, but by offering the best deals back to the banks through commissions or reinsurance quota shares or other services and benefits. This again enriches the banks but keeps premiums charged to homeowners who are already in distress very high.

Root Causes

- All of this also raises the question of how did the market get this way. While force placed insurance is, on the one hand, an insurance product, at the same time has clearly become a profit center for the banks.

- Insurance regulators are used to seeing insurance companies competing for customers by keeping prices low. Thus, insurance regulators are usually focused primarily on whether insurance companies are keeping premiums high enough to ensure the future solvency of the companies which protects all policyholders.

- When the insurers last submitted rates to the Insurance Department, they estimated loss ratios of approximately 55 percent. In fact the actual loss ratios turned out to be far lower and usually less than half of what the Department was led to believe they would be. For example, Assurant filed an expected loss ratio of 58.1% to justify its rates. Its actual loss ratios from 2000-2011 was less than 25%.

- This raises the very important question of whether the insurers had an obligation to reassess their prices and business models and resubmit their rates given that

their predicted loss ratios were turning out to bear little resemblance to reality year after year after year.

- As for bank regulators, it appears that until recently force placed insurance was viewed primarily as an insurance product issue best left to the insurance regulators. Bank regulators have thus been largely unfocussed on banks' conduct within this market even as it boomed into a major profit center for the banks.

- The fear then is that over the years the conduct of the force placed insurance market has been operating in the shadows with little regulatory oversight or supervision.

- The Department of Financial Services was created to avoid these types of regulatory blind spots and gaps, and hopefully these hearings will shine a bright light on all of the conduct in this industry. Our hope, again, is to look deeply, carefully, and fairly at this markets to consider what if any fixes and reforms are appropriate.

Potential Reforms

- Some potential reforms are fairly obvious – the affiliated relationships appear to be driving a lot of the inverted incentives and promote little competition. We should consider whether banning these relationships makes sense.

- Separately, we should explore at these hearings whether we should be requiring a minimum loss ratio ("MLR") like we do in the health insurance marketplace. On the health insurance side, we also require insurers who fail to meet their MLR to refund premiums back to consumers to make up the difference. This would obviously be more complicated in a situation with many investors and a foreclosed property but it is worth considering and discussing during the course of these hearings.

- So, we are very much looking forward to probing these issues and many others as we proceed through these hearings and hear from all sides of these issues. Thank you.

- Our first panel today will consist of homeowners who have been impacted by force placed insurance. Then we will hear from Robert Hunter, the Director of Insurance from the Consumer Federation of America, and an expert on force placed insurance. Our third panel will consist of several foreclosure prevention advocates. And our fourth panel will be representatives from the two biggest force placed insurers in New York, Assurant and QBE, who together make up more than 90 percent of the market. Tomorrow, we will hear from several of the banks and reinsurers, including JP Morgan Chase, Bank of America, and their affiliates.

- I would now like to turn it over to Joy Feigenbaum to set forth the procedures and rules for the hearings and then we will hear from our first panel.