# Collateral Replacement Cost Risk: What Every Lender and Investor Needs to Know

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Effective November 1, 2005, FNMA (Fannie Mae) mandated use of the new Uniform Residential Appraisal Report (URAR), form 1004 for 1 – 4 unit properties, with Freddie Mac following suit on January 1, 2006. The forms included changes that removed the requirement for the Cost Approach to Value, added new certifications for the appraiser and required that the lender be able to recreate the appraisers cost approach calculations.

Reaction to the new forms exposed the existence of a significant disconnect in the mortgage industry regarding i) how the proper amount of replacement cost hazard coverage is determined, ii) who should validate and maintain hazard insurance sufficiency, and iii) the intersecting roles of the insurance agent, the borrower, the appraiser and the originating lender relative to hazard insurance sufficiency.

The issue of collateral replacement cost is significant given that the latest industry statistics indicate that 59% of homes are underinsured by an average of 22%.[1] The timing of the release of the new appraisal forms came in the wake of the most devastating natural disasters on record[2], a rationalizing real estate market and regulatory and investor scrutiny of the origination process. As we approach the one year anniversary date of the new forms, an ever increasing number of originators and investors are examining the operational and financial risks of certain mortgage practices relating to underwriting guidelines and the sufficiency of current collateral risk information and required replacement cost coverage.

This white paper examines the current practices and rationale of property insurers, originators, appraisers and borrowers on the issue of collateral replacement cost requirements, and offers the reader a comprehensive high level overview of the basis of the “disconnects” and the risks associated with the ineffective practices.

## HISTORICAL OVERVIEW

## I. Who Should Decide the Proper Amount of Hazard Insurance Coverage?

### A. Insurers are not Responsible for Coverage Amounts

Who should decide the proper amount of hazard insurance? Before this question can be answered, it must be understood that insurers are not responsible for hazard insurance coverage determination. While most residential mortgage loan programs require replacement cost coverage in an amount sufficient to rebuild the home in the event of loss, a misconception exists that the insurer is responsible for ensuring sufficient coverage is in place. However, insurers have successfully litigated the industry wide position that they do not have liability for coverage amounts they recommend to a homeowner for a replacement cost policy.[3] Instead, insurers maintain the position that the consumer is ultimately responsible for determining how much insurance is necessary to replace a home in the event of loss.

### B. Understanding the Guaranteed Replacement Cost Policy vs. Replacement Cost Policy

After the Oakland firestorm of 1991[4], the Laguna Beach fires, and the 1994 Northridge earthquake, the “guaranteed replacement cost” (GRC) policy became virtually extinct.[5] The GRC policy promised to rebuild a house regardless of the amount of insurance coverage. However, insurers experienced claims payouts that significantly exceeded policy limits.[6] This meant that insurers were not collecting premiums commensurate with the payouts. Most insurance companies ceased offering a GRC policy to homeowners and adopted a new watered down “replacement cost” (RC) policy in its place. The RC policy, still the most predominately offered homeowners policy today, promises to replace

[1] Insurance Information Institute of NY, citing to study by Marshall & Swift, (2006)
[2] Seven of the 10 most expensive hurricanes in US history occurred in the fourteen months from August 2004 to October 2005: Katrina, Wilma, Charley, Ivan, Frances & Jeanne. Insurance Information Institute, (02/ 06).
[3] Gibson v. Geico (1984) 162 Cal.App.3d 441, 447.
[4] Morris Newman, *Collecting on Insurance in Oakland's Fire*. The New York Times, FOCUS (Jan. 24, 1993)
[5] Scott Glovsky, *Liability of Insurance Agents and Brokers for Under-Insuring Homes*
[6] The Oakland firestorm resulted in a $1.7 billion insurance industry payout, covering approximately 3,300 houses



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collateral in the event of loss, but caps the insurer liability to the specified amount of dwelling coverage.[7] Although this change accommodated the financial interests of the insurers, it shifted the risk of underinsured loss from the insurer to the consumer and mortgagee.

### C. Shifting the Risk of Loss to the Homeowner and Lender

The shifting of the risk of loss from the insurer to the homeowner and mortgagee has not gone unnoticed. Commencing with the vanishing of the GRC policy, and punctuated by every disaster since, victims of underinsurance have garnered significant media attention, spawned class action litigation and been the basis for legislative debates at the state and federal level. The issue has predominately been between the insurer and the homeowner, the latter being represented by consumer protection advocates and state insurance commissioners.[8] The homeowner arguing for the insurer to take responsibility for coverage recommendations while the insurer maintaining that the responsibility must remain with the homeowner.

While the debate is complex, it is centered on facts that demonstrate that the typical homeowner has no idea how much collateral protection will be required to effectuate replacement cost of his home.[9] According to a November 1, 2005 study by JD Powers of 9040 homeowner insurance policy holders, 59% of homeowners do not feel that they are responsible for their coverage limits, but rather believe that the insurance provider or agent bears the responsibility in determining and maintaining replacement cost coverage amounts necessary to replace their home in the event of loss.[10] This misconception persists despite media attention and typical disclaimer language found on the face of an insurance binder receipt. An example of the relevant language is:

> **REGARDING INSURANCE TO VALUE….** The State Farm replacement cost is an estimated replacement cost based on general information about your home…. The actual cost to replace your home may be significantly different. State Farm does not guarantee that this figure will represent the actual cost to replace your home. **You are responsible for selecting the appropriate amount of coverage**… (emphasis added)[11]

Similarly, The Homeowners Consumer Center in Irvine, California conducted a hazard insurance telephone survey and found that out of 1197 policy holders interviewed, an overwhelming 85% did not understand their insurance policy.[12] Yet, insurers remain successful at maintaining the shift of responsibility for adequate coverage to the homeowner.

Insurance industry *Risk Shifting* to the consumer was accomplished in large part through product offerings where nomenclature was subtly changed, while substantially changing the substance of the product benefits. By insurers merely dropping the term "*guaranteed*" from the "*guaranteed replacement cost*," consumers and the mortgagees holding the notes on the collateral appear to believe the change between *guaranteed replacement cost* and *replacement cost* is a distinction without a difference. This is not the case. The modern day replacement cost policy will replace the home, but only to the extent that the cost to replace the home does not exceed the pre-determined amount of dwelling coverage purchased by the borrower (and approved by the lender), including any extended replacement cost endorsements. Everyone with an interest in the underlying collateral of a residential mortgage loan must not only be concerned that the insurance type is ***replacement cost insurance***, but must pay equal attention to the ***coverage limits,*** at origination and throughout the life of the loan. A binder must contain both sufficient coverage limits and a replacement cost endorsement for the hazard insurance to be adequate. The two are not mutually exclusive.

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[7] See: HO-3 Standard Policy. An "extended replacement cost" endorsement is also offered by most insurers, which will add a percentage of coverage to a policyholder's dwelling limits for an additional fee, but is predicated on the contractual language:… "*You must insure your dwelling to 100% of the replacement cost…*" for the additional coverage to trigger.

[8] e.g. United Policy Holders and California's Insurance Commissioner, John Garamendi have been strong proponents of insurer liability in the area of replacement cost coverage determination.

[9] Ramsey & Heffernan, UNDERINSURANCE, A Consumer Fraud, Not an Agent Error of Omission.

[10] JD Powers, Consumer Satisfaction Survey (Nov.1 2005): average length of homeownership among study participants was 16 years. Only half of the study participants updated their replacement cost coverage limits during homeownership. Out of the 41% who made significant improvements to their residence, 37% did not notify their insurance carrier.

[11] Relevant language taken from State Farm Insurance Binder Receipt, form 535-2540 CA.30 Rev.( 06-10-2003)

[12] Homeowners Consumer Center, Irvine California, (May 2006)



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## THE LENDERS WORLD

### II. A Lenders Duty of Due Diligence

#### A. Fannie Mae & Replacement Cost Hazard Insurance Requirements

Fannie Mae recognizes that although insurers may provide some guidance about how much replacement cost insurance should be placed on a home, the insurers consider the coverage limits to be the responsibility of the homeowner.[13] Fannie Mae also recognizes that this is significant given the general lack of "guaranteed replacement cost policy endorsements" available and because some states prohibit the lender from requiring levels of hazard insurance in excess of the replacement cost for the property.[14]

In its chapter on Coverage for Home Mortgages, Fannie Mae states that property insurance for home mortgages must protect against loss or damage from fire and other hazards covered by the standard extended coverage endorsement. The coverage should be of the type that provides for claims to be settled on a replacement cost basis, **and assigns the responsibility to *lenders* to ensure that the homeowner obtains insurance policies in line with underwriting requirements.[15]** Additionally, when Fannie Mae purchases or securitizes a second mortgage, the lender must ensure that the existing hazard insurance coverage for the first mortgage meets their requirements. To do this, Fannie Mae requires that the lender obtain a copy of the policy and review it carefully to determine that the coverage is adequate to protect the security of both the first and second mortgages.[16]

Fannie Mae provides a formula for determining the amount of hazard insurance coverage generally required for first mortgages. On reverse mortgages, 100 percent of the insurable value is required. For any other first lien home mortgages, coverage must be equal to the lesser of either the insurable value of the improvements or the unpaid principal balance, as long as it equals the minimum amount of 80 percent of the insurable value of the improvements required to compensate for damage or loss on a replacement cost basis. If it does not, coverage that does provide the minimum required amount must be obtained.[17]

When the existing coverage for a property that secures a second lien home mortgage does not provide coverage equal to the lesser of 100% of the insurable value of the property improvements or the combined unpaid principal balance of the first and second mortgages (as long as it equals 80 percent of the insurable value of the improvements), the lender must require the borrower to obtain appropriate endorsements to bring the coverage consistent with requirements.[18]

#### B. Freddie Mac and Replacement Cost Insurance Requirements

Freddie Mac has also recognized that proper hazard insurance is critical noting in its Bulletin that seven of the twelve costliest insured disasters in United States history have occurred in the past two years.[19] Freddie Mac requires that the hazard insurance amount must be at least equal to the higher of either the unpaid principal balance of the Mortgage or 80% of the full replacement cost of the insurable improvements.[20]

#### C. Due Diligence Compromised by a Confusion of Rights and Duties at Origination

If the lender defers to the insurer, who in turn offers replacement cost suggestions but relegates responsibility and liability onto the borrower for the amount of coverage, the lender is in effect accepting the borrowers' determination as to the sufficiency of the replacement cost of the insurable improvements. This is problematic because the majority of consumers lack the requisite knowledge about what it will cost to rebuild his home. Combine this lack of reconstruction knowledge with a consumers' propensity to price shop for the lowest premium and you have a practice that can and does produce significant inadequacies which are risky in today's lending environment. Recently, main

[13] Fannie Mae Revised Property and Appraisal Report Forms, FAQ's (11/1/2005)
[14] *Id.*, FAQ # 12
[15] Fannie Mae, Chapter V, 302: Coverage for Home Mortgages (03/20/96)
[16] *Id.*
[17] Fannie Mae V, 302.01: Amount of Coverage (06/30/02)
[18] *Id.*
[19] Freddie Mac Bulletins, (05/30/2006)
[20] Freddie, CH. 58.2: Minimum property insurance types and amounts (10/06/06)



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stream media has suggested that when insurers compete for business, the borrower may get the price they want, but not the coverage they need.[21] Consider a following typical scenario:

- **<u>Insurance Company A</u>** offers a policy for $1,000 dollars a year on 123 Main Street USA with dwelling coverage limits of $300,000.
- **<u>Insurance Company B</u>** offers a policy for $800 dollars a year to the same borrower and property, but recommends dwelling coverage limits of $220,000.
- Both are replacement cost policies and both promise to replace the home in the event of loss up to the limits of liability.
- The borrower will likely select **<u>Insurance Company B</u>** – saving $200 a year, with no regard to the amount of coverage.

By the lender deferring to the property insurer, without more, the lender gets the coverage *the consumer decided* was in his best interest to purchase which may not have a rational relationship with the loan's underwriting guideline requirements or what it would cost to rebuild the improvements.

The confusion of rights and responsibilities between the effected parties leaves everyone except the insurer at risk because the risk of physical loss to collateral may or may not be sufficiently transferred to the third party insurer in accordance with the hazard insurance underwriting guideline.

### 1. The Borrowers Duty to the Lender

The borrower agrees that as a condition of receiving financing, he will keep the collateral insured in accordance with the **lenders requirements** for the duration of the loan.[22] To this extent, *<u>the borrower has a contractual duty to the lender</u>*. The requirement is designed to transfer the risk of physical loss to a third party insurer as required by the terms of the loan. For this objective to be met, the lender must advise the borrower what the hazard insurance requirements are, in both type **and** in sufficiency of coverage, and take reasonable steps to independently ensure that the coverage meets loan requirements at loan inception and throughout the life of the loan. This is similar to lenders informing borrowers of other loan requirements and validating borrower documentation. It is not a prudent or a reasonable practice for a lender to expect the borrower to surmise what the lender deems "sufficient" without disclosure.

### 2. The Insurers Duty to the Lender & Borrower

In a replacement cost policy, the Insurer <u>does not</u> have a duty to guarantee that the amount of coverage in an insurance policy is sufficient to replace the improvements in the event of loss.[23] The insurer's duty is to honor its commitments subject to conditions and exclusionary language contained in a policy for insurance, and to pay covered claims up to the limit of coverage. Simply, if an insured property suffers a covered loss, the insurer is only required to pay to repair or replace the improvements subject to the dwelling limits of liability.

### 3. A Lenders Duty to the Borrower

All states prohibit a lender from requiring a borrower to use a particular insurance agent or insurance company when securing hazard insurance for real property. At least twenty three states prohibit lenders from requiring more than the "replacement cost amount of improvements" from borrowers as a condition of financing.[24] Alabama, Iowa, Mississippi, Ohio and South Dakota are either silent on how much hazard insurance a lender may require, or have codified laws that there is no set limit on the amount of insurance a lender may require. Louisiana allows the lender to require hazard insurance up to the loan amount. At least thirteen states leave the amount of hazard insurance required up to the lender, but with the proviso that there must be a rational relationship between the amount of insurance required by

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[21] Selina Maranjian, Many Home Insurers Undercharging, The Motley Fool, (01/13/ 06)

[22] See language in typical residential Mortgage ***Deed of Trust*** for requirements of borrower regarding maintenance of hazard insurance as a condition.

[23] See FN 2 & FN 11. Note that in a Presidential Policy or a Guaranteed Replacement Cost policy (not offered by more than a few companies today) the insurer does have a duty to guarantee the limits are sufficient.

[24] Arizona, Maine, Massachusetts, California, Colorado, Connecticut, Florida, Idaho, Indiana, Michigan, Minnesota, Missouri, Nevada, Montana, New Jersey, New York, North Carolina, Oklahoma, Rhode Island, South Carolina, Tennessee, Texas and Washington.



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the lender, and the lenders interests, risks, or the property value.[25] Wisconsin's Department of Financial Institutions has issued an industry alert to mortgage lenders regarding allowable policy limits for homeowners that adopt Fannie Mae's hazard insurance requirements as they are representative of many lender and investor requirements.[26] Oregon law refers the lender back to the requirements of the loan. Only three states, Arkansas, Delaware and New Hampshire limit the amount of insurance a lender may require to the value or improvements, or actual cash value.[27] Almost all states afford lenders statutory rights to refuse to accept the borrower's insurance binder for reasonable cause based on uniformly applied lending practices. Reasonable cause includes inadequate or inappropriate terms of coverage.[28] The lender also has the right to *force place* hazard insurance coverage when the insurance does not meet the lenders requirements.[29]

While a lender has statutory and contractual mechanisms in place that limit how much insurance the lender ***may*** require, these mechanisms exist in concert with other mechanisms that dictate how much hazard insurance the lender ***must*** require on a loan. Therefore, the lender must not require too much hazard insurance and violate applicable state statutes governing maximum allowable limits while simultaneously ensuring that there is sufficient hazard insurance in place pursuant to the underwriting guidelines of the loan.

### 4. A Lenders Duty to its Investors

The lender has a fiduciary and often contractual duty to its investors and secondary market participants that purchase and/or fund its loans. The loans are funded based on a representation and warranty by the lender that the guidelines and requirements of a loan are satisfied. This representation comes from the funding source, which in turn has the duty to fund and/or sell loans only in accordance with underwriting guidelines. This duty exists solely as an independent duty between the lender and its investors.

Specific warranties include warranties made by the lender about hazard insurance. For example, Fannie Mae requires that the lender warranty that, i) a hazard insurance policy on the property is in effect, ii) the policy is written by a generally acceptable insurance company, and iii) the policy provides fire and extended coverage for an amount *at least equal* to the amount required by their Guides.[30]

A Hazard Insurance Policy and Receipt are included in the delivery of documents to a purchaser of mortgage loans to evidence the obligation of the mortgagor and to demonstrate compliance with regulatory and underwriting requirements.[31] Post closing, the loan purchaser will typically request a representation by the seller that either the mortgaged property is appropriately covered by hazard insurance or that the seller has a blanket policy that covers the property.[32] Due diligence reviews typically contain documentation reviews for the purpose of assessing the overall quality of the seller's origination process and documentation. Hazard insurance reviews include checking the amount and type of coverage.[33] The lender must demonstrate through documentation that it has performed the requisite due diligence and is in compliance with applicable state laws and underwriting guidelines on hazard insurance requirements. This duty continues for the life of the loan and is owed by the servicing lender.

While the borrower has a legal responsibility under its financing agreement to maintain the required hazard insurance coverage, the borrower's duty to the lender should not be confused with the lenders independent obligations to its investors. Additionally, there is no duty owed by the insurance company to the lender with respect to sufficiency of coverage.

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[25] Alaska, Illinois, Kansas, Kentucky, Maryland, Nebraska, New Mexico, North Dakota, Utah, Vermont, Virginia, West Virginia, Wyoming, Puerto Rico.
[26] See http://www.wdfi.org/fi/mortbank/IndustyAlertHomeownersInsurance.htm
[27] Note that not all states are mentioned.
[28] Non exclusive list: Cal. Ins. Code 382.5, Cal Civ. Code 2955; Del. Code Ann. Tit. 25; Md. Code. Ann. Com. Law 12-124; Iowa Code 5___; Mich. Comp. Laws Ann. 445, 500.1242 (24); Neb. Rev. Stat 44-1526; Minn. Stat 65A.03(2).N.D. Cent Code 26.1-39-23; S.D. Codified Laws 58-33-31; Wis. Stat.134.10(1,2);Conn. Gen. Stat. 38a-816; Me. Rev. Stat. Ann. Tit 9-33, 503; Mass. Gen. Laws ch. 183, Sec. 66) N.H. Rev. Stat. Ann 417.4; N.Y. Comp. Code R. Regs. Tit. 3, 38; Vt. Stat. Ann. Tit. 8, S. 4725 (a)(2); R.I. Gen. Laws S. 27-29-4(9),(10); Ariz.; Id. Rev. Stat. Ann. S. 6, 909 P, 6-947.O; Colo. Rev. Stat S. 10-3-1105; MO. Rev. Stat, S. 375.937;Okla. Stat. tit. 36; Ga. Code Ann. S. 33-6-4(b)(11); Ky. Rev. Stat. Ann S. 304.12-140(2); N.C. Gen Stat. S. 58-3-140; Tenn. Code Ann. S. 56-8-106 (a)(3); W. Va. Code 46A; P.R. Laws Ann. Tit. 26, 2713; Alaska Stat. S. 21.36.165; Haw. Rev. Stat 431:13-104; Mont. Code Ann S. 32-5-306(3);Nev. Rev. Stat S. 686A.200, 687B.186;Utah Code Ann. S 31A-23a-402(5); Wa. RCW 48.30.260(3)(b); Wyo. Stat Ann. 26.13.118(a)(i);
[29] Also see state laws on collateral protection or force place coverage.
[30] Fannie Mae, Ch. IV, A: Specific Warranties, No. 16. (07/05)
[31] A.S. Pratt & Sons, Secondary Market Residential Mortgage Transactions, *The Correspondent Arrangement & Flow Agreements*, Ch. 1, 1.02, (12/ 05).
[32] *Id*. Pratt, Ch. 4.03(8)(B) *The Purchase or Sale Agreement*.
[33] *Id*. Pratt, Ch. 3.10(6)(C) *Due Diligence With Respect To The Documents*.



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Furthermore, if the borrower or the insurance agent presents a binder for hazard insurance coverage during the mortgage finance transaction, the lender must determine if the substance of that binder satisfies the underwriting guideline. This requires the performance of reasonable due diligence to ensure that the insurance coverage *and* limits of liability required by the loan and as stated in the insurance binder sufficiently transfers the risk of loss to a third party.

## III. The Status Quo and Why it's a Dangerous Game

### A. The Cost Approach to Value as a Tool for Insurable Replacement Cost Determination

The most common method used by lenders to determine and validate hazard insurance sufficiency requirements is reliance on the 'cost to replace new' calculation contained in the cost approach of a URAR 1004 appraisal.[34]

Upon release of the new URAR, originators, appraisers and lawyers began to openly discuss lender reliance on the cost approach for hazard insurance purposes. Many originators revealed that they were not relying on the cost approach for a secondary indication of value, which is the intended purpose of the Cost Approach to Value. Rather, lenders were extracting one calculation out of the cost approach for hazard insurance coverage amount validation. Additionally, many of these same originators are supplying the cost approach portion of the URAR to the insurance agent to aid the agent in an understanding of the appraiser's opinion of the 'cost to replace new' of the subject property. Originators continue to express their concern that appraisers may no longer provide the cost approach to value, potentially leaving them in a bind for validating replacement cost coverage.[35]

Appraisers remain reluctant to provide the cost approach due to the increased exposure and awareness that valuation data from the cost approach was being extracted from their appraisal form for an unintended purpose. With the additional accountability and liability imposed by the new URAR 1004 certifications, and concern over *scope of work* and *intended user issues*, providing the cost approach was a risk some appraisers were not willing to take. With the new URAR 1004 clearly stating that ***"the lender must be able to reproduce your calculations"*** a new level of appraisal accountability had been established.[36]

The lawyers of course are concerned about appraiser liability. Today, almost a year into the new forms, originators are now reporting that many investors continue to require the cost approach as a condition of purchasing the loan.[37] In a market where appraisal work is down as much as fifty percent, some appraisers have been forced to make a business decision to either provide the cost approach regardless of liability concerns over the scope or work or intended user issues, or lose the business.

### B. The 'Cost to Replace New' in the Cost Approach to Value – Not Reliable

Exacerbating appraisers' reluctance to provide the cost approach was a quiet but compelling awareness of an industry wide practice of the use of certain methods to calculate the cost approach numbers, resulting in rough and crude calculations. The 'best guess' practice of determining calculations makes lender reliance on the 'cost to replace new' calculation an industry wide concern.[38]

#### 1. Survey Reveals Risk for Appraisers, Lenders, Investors and Consumers

In a survey of appraisers, lenders, Appraisal Management Companies (AMC) and other industry leaders by Strategic Development Worldwide of California and sponsored by Bluebook International, *Cost Approach Industry Survey (Sept. 2006), hereinafter The Survey*, the majority of participants reported that calculations in the cost approach are "backed into" or the appraiser simply "wings" the numbers, giving the cost approach calculations little reliability at best.[39]

The Survey revealed that all parties believed that the assumed inaccuracy created risk for appraisers, lenders, investors and the borrower. The Survey also revealed that the mortgage industry is very aware of the lack of reliability

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[34] Cost Approach Survey, Strategic Development World Wide, (09/06).
[35] Based on interviews and discussions with originators interested in the Bluebook InsureBASE product.
[36] FNMA URAR 1004, Cost Approach to Value, (11/01/05).
[37] See, FN. 34
[38] Cost Approach Survey, Strategic Development World Wide, (09/25/06).
[39] *Id.*



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of the cost approach calculations, yet lenders continue to place reliance on the 'cost to replace new' calculation for hazard insurance validation purposes.[40]

National Claims Counsel for Liability Insurance Administrators, an E & O provider for Appraisers, stressed the potential liability exposure of the appraiser if the cost approach analysis contained in a URAR is used for the purpose of obtaining insurance coverage or determining insurable value. They also stress that an appraisal completed for a lender/client in connection with mortgage lending should not be used or relied on for insurance purposes.[41] That same alert sets forth defensive writing suggestions whereby the appraiser is instructed to disclaim any use of the cost approach, in whole or in part, for hazard insurance determination purposes.

This is not to say that the appraiser can not provide an insurable value report to the lender, outside of the cost approach if the appraiser can meet USPAP competency requirements for insurable replacement cost assignments.

### 2. Why the Cost Approach Calculations are Not Considered Reliable

The Survey participants reported numerous reasons why cost approach numbers are not considered reliable, including but not limited to:

- Appraisers don't think the cost approach is important and therefore don't give it serious consideration;
- Insufficient training on how to use cost data solutions correctly;
- It is faster and easier to "wing" the numbers because most appraisers don't have sufficient knowledge of building construction practices;
- Calculating depreciation is complex and difficult;
- The industry has not stressed the cost approach calculations as important, creating a climate where appraisers don't consider it an important part of the valuation process in practice;
- There is a lack of available land sales;
- No one checks the accuracy of cost approach calculations. [42]

According to numerous USPAP instructors who teach cost approach classes, the average appraiser has not taken the time to learn complicated cost approach software or books correctly, nor do they utilize the tools with any seriousness. The predominate cost data software comes with a 233 page manual and requires a 6 hour training class. Appraiser knowledge that the lender will fund on the market value as determined by the comparison approach, and only glance at the cost approach value for consistency with the comparison approach further exacerbates the already noted lack of seriousness paid to the integrity of cost approach calculations.

### 3. Disclaimers Being Used and Ignored

Disclaimers in the URAR are frequently being used by the residential appraiser expressly advising that the calculations contained in the cost approach are not to be relied upon in whole or in part for insurance purposes by the lender or any third party.[43] Yet lenders report that disclaimers do little to dissuade them from utilizing the appraisers cost calculations for insurance determination and validation purposes.[44]

The lender who relies on the cost approach for hazard insurance purposes assumes significant risk given i) that extracting one calculation from the whole for an unintended purpose skews reliability as applied, ii) the existence of the general appraisal practice of winging or backing into the numbers in the cost approach, iii) express appraiser disclaimers against reliance on the calculations in the cost approach for insurance purposes by the lender or any third party, iv) insurer relegation of the ultimate responsibility to determine hazard insurance coverage amounts to the borrower/homeowner, and v) that the average consumer lacks the requisite skill to determine the cost to rebuild his home in the event of loss.

## C. Fannie Mae's Position on Lender Reliance on Appraisers for Hazard Insurance Limits

The Fannie Mae Nov. 1, 2005 FAQ's on the new URAR advised that **if** a lender chooses to rely on an appraiser to determine the dwelling limits of a hazard policy, the lender should request the appraiser to utilize the "Cost Approach

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[40] *Id.*
[41] *The Cost Approach, To Do or Not to Do*, Liability Insurance Administrators. (05/06)
[42] *Id.* – for a comprehensive list of opinions on why appraisers wing the numbers, see complete Survey posted on www.bluebook.net
[43] *See FN 37,40.*
[44] *Id, The Survey.*



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to Value" on either the Revised 1004 or Revised 2055, or to report the information as an attachment to the appraisal report form.[45]

It is significant to note that Fannie Mae *did not* recommend that an appraiser provide the cost approach valuation for the purpose of establishing hazard insurance replacement cost limits, nor did Fannie Mae condone insurers' reluctance to set replacement cost limits. Further, the FAQ does not suggest that a lender should rely on the borrower's determination of what is sufficient hazard insurance to satisfy Fannie Mae hazard insurance requirements. While this FAQ directive provides the lender with guidance **in the event the lender chooses to rely** on the appraiser's determination, it does not advise that the appraiser's assessment in this format, without more, satisfies the lender's duty of due diligence to Fannie Mae. This is consistent with Fannie Mae's position that it remains the lender's responsibility to ensure that there is sufficient insurance on the collateral to meet the loan guideline for replacement cost coverage in an amount sufficient to replace the home in the event of loss.

Reliance on the cost approach for hazard insurance purposes is a significant issue posing risk to all parties in the mortgage finance transaction. Its perils must be weighted against its convenience by each originating entity, the investors that purchase these residential loans, and the appraiser whose calculations are being utilized for this purpose.

## IV. Lender Reliance on the URAR Cost Approach for Insurance

### A. Important Considerations

First and foremost, if a lender relies upon the cost approach to determine replacement cost limits sufficient to satisfy lender compliance with underwriting guidelines, the lender must ensure that the appraiser certifies that the scope of the appraisal includes an estimate of the "insurable replacement cost" of the subject property. Consider that a 'cost to replace new calculation' is different in scope than an insurable replacement cost calculation. The performance of each will likely produce different numbers when analyzed correctly. (e.g.: an insurable replacement cost should include debris removal while a cost to replace new for value purposes would not.)

Secondly, the appraiser providing estimates of cost-new for insurance purposes should have sufficient technical knowledge and practical experience in the disciplines of building design, construction and cost estimating. This is a requirement of the competency provision of USPAP. The lender is entrusting the appraiser with his fiduciary and regulatory responsibilities as if the lender himself made the determination absent some additional "check" against the amount of insurance set forth in the insurance binder.

Third, it is clearly inappropriate to rely upon a cost approach for insurance purposes when the appraisal report contains language that disclaims the use of the cost approach for insurance purposes by the lender and/or any third party. Such reliance does not meet the fiduciary obligations of the lender because the lender is using one calculation in the cost approach for a purpose outside the scope of its utility.

### B. Cost Approach 'Cost to Replace New' Not the Best Choice

Aside from issues of sufficient competence in the area of building design, construction and cost estimating on the part of the appraiser, the lender should also examine whether or not the cost approach is the proper tool for an insurable replacement cost determination during origination. Several factors affect this analysis.

First, the cost approach was never intended to be used to determine an insurable replacement cost value. Its intent was to determine the value of the subject property as a whole to support the appraiser's opinion of market value. Hence, Cost Approach *to Value*. It gained use in the area of setting hazard insurance limits because it was readily available to the lender and insurer, and lenders did not have any other efficient or cost effective tools to utilize for meeting their due diligence obligations.

Second, many appraisers are not performing the cost approach analysis independent of the market approach value. A typical appraiser will perform the market approach, obtain a value, and ***then*** perform some kind of cost approach

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[45] Fannie Mae FAQ No. 12, (11/01/05).



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analysis, hence "backing into" the number.[46] The cost approach analysis is frequently guided by the desired result of value determined by the market approach.[47] Because market value is derived by what a ready, willing and able buyer will pay for a home, combined with what the last three purchasers paid for comparable homes in the area, the cost approach methodology is often perceived by the appraiser as an annoying exercise in futility.[48] As mentioned, the cost approach was designed to indicate the "value" of the subject property by adding up the raw land plus the depreciated amount of any improvements. Funding on the market value has rendered the utility of the cost approach inapplicable in many appraisal scenarios. This practice of "backing into" the value determined by the market approach, thereby potentially effecting the result of the "cost to replace new" figure contained in the URAR cost approach should serve as a red flag to lenders choosing to rely on cost approach for insurance purposes. The "cost to replace new figure" is suspect depending on the appraisers' propensity to just "wing it" or "back into" the calculations and because it is one part of a larger whole. Its use for insurance purposes by the lender can be clearly misguided, and may in fact be a major contributor to the significant underinsurance problem in the United States, affecting trillions of dollars in pools of underinsured collateral where the risk of loss is not sufficiently transferred to a third party insurer.

### C. So What if Loans Aren't Funded According to Underwriting Guidelines?

When it comes to the underwriting guideline of hazard insurance on residential loans, too often the "so what" argument raises its complacent head when the question is posed to originators.

In our recent past, the housing market has been thriving due to low interest rates and plentiful capital offered to the consumer through innovative loan products designed to make almost anyone a homeowner. Originations were high, and everyone from the correspondent loan broker to the traders in the secondary market was making money, including the homeowner whose home was appreciating at the double digit rates. The demand for real estate financing created an environment of quick funding. Rolling the dice on proper hazard insurance was of little concern to lenders who accepted that the market value of collateral was increasing at near record rates, thereby reducing the risk of their potential loss. Now that the Federal Reserve has increased interest rates 17 times, the flow of money has tightened and inventory of homes for sale is at a ten year high. The median home price has dropped for the first time in ten years,[49] payment reset shock is just beginning to be felt and REO departments and review appraisers are gearing up for the volume of expected defaults.

The era of double digit property appreciation is gone for the foreseeable future. The supply and demand cycle has turned a sellers market into a buyer's paradise. However, buyers have become hesitant to buy. News of heavily concentrated areas of underinsured mortgage backed securities in devastated areas buttressed by fraud issues combined with a market that is declining, rationalizing or correcting, all add up to constructive notice to the industry that rolling the dice on underwriting guidelines is no longer an option. The passage of Reg. AB, approach of Basel II and Sarbanes Oxley all require more disclosure of risks, policies and procedures, operations and plainly an attention to detail in the mortgage finance transaction. Underwriting guidelines requiring replacement cost hazard insurance in an amount sufficient to replace the improvements in the event of loss exists because it is a fundamental precept of real property collateral risk that the risk of loss is sufficiently transferred to a third party. That third party could be a mortgage or title insurer, or in the case of the topic of this discussion, a property and casualty insurer.

Failure of the lender to ensure that improvements on a loan are insured to replacement cost value commensurate to the loan requirements is an impact that affects equity protection, operational risk management, the integrity of certifications and warranties made to investors by the originating lender, potential loan buy backs, risk of loss from catastrophic and every day events, consumer problems, fines and compliance issues. In short, the quality of securitization and collateral risk are the result.

### D. Maintaining Proper Insurance through the Life of the Loan

While funding a loan with adequate hazard insurance at inception is critical, maintaining proper replacement coverage during the life of the loan is of equal importance. Whether a loan is retained in the originating entities portfolio, or sold into the secondary market for securitization, mitigating risk of loss to collateral is vital and required by the servicing lender. The cost to replace a home changes with increases in commodities prices like petroleum, copper and lumber.

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[46] This is not to say that every appraiser does this. There are appraisers that will take the time to perform the cost approach independent of the market value, so as to garner a true indicated value by this approach. It is just not the mainstream practice by the average appraiser.
[47] One general comment by the Survey participants was: *Underwriters are not always willing to accept explanations as to why there is a substantial difference between the cost and market approaches so appraisers have adopted the attitude that it is just easier to back into the numbers and make the approaches match.* Cost Approach Industry Survey, pg. 2 (09/06)
[48] Cost Approach Industry Survey, supra.
[49] Michael Corkery, Wall Street Journal (09/26/06)



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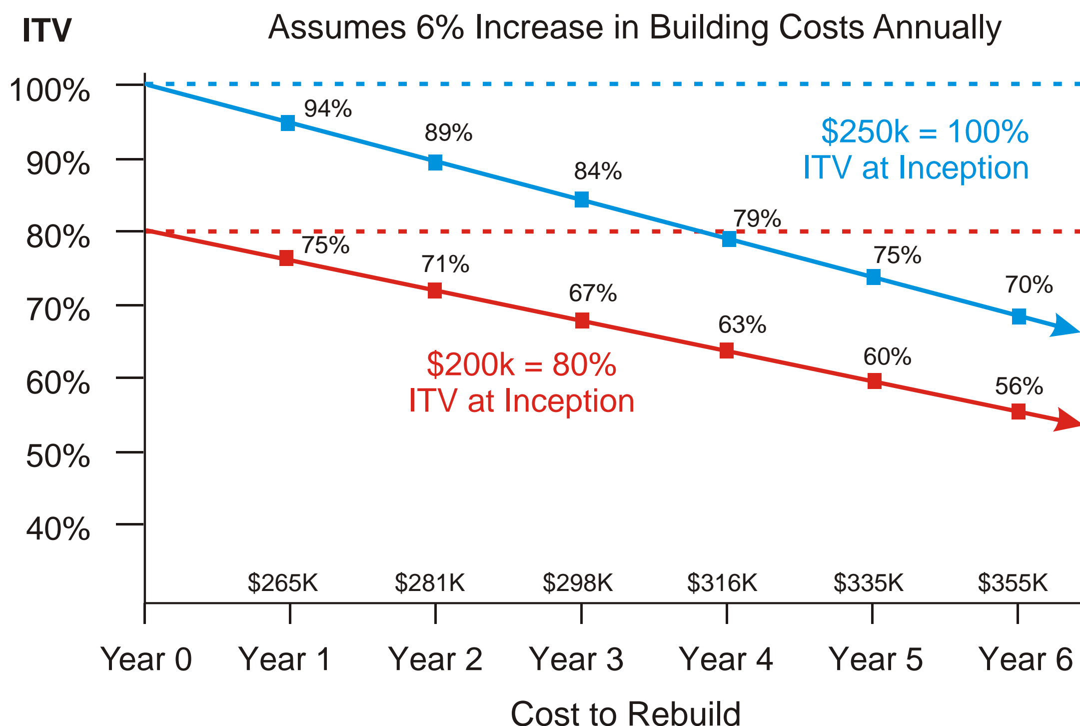
Since 1991 the cost of construction has increased between 6 and 7 percent annually. This means that the cost to rebuild a home in the year 2006 has increased between 36 and 42 percent since the year 2000. Additionally, remodeling and home improvements have increased 27 percent in the last two years to an estimated $155 billion.[50] Yet despite the remodeling boom, only 37 percent of homeowners who remodeled notified their insurance carrier that their homeowners' insurance needs may have changed according to J.D. Powers. Out of the 9040 homeowners who owned their homes for an average of sixteen years, only half had their coverage updated during their entire sixteen year ownership.[51] Because increases in construction costs continue to rise, failure to ensure sufficient replacement cost insurance during the life of the loan will leave collateral underinsured and out of guideline compliance. Fannie Mae requires that the lender must make sure that the required insurance is maintained so long as it services the mortgage.[52]




The graph above represents a six year loan life of 123 Main Street, USA. The improvements on this property cost $250k to replace at loan inception. The blue arrow illustrates the coverage amount at 100 percent full replacement cost of the insurable value (ITV), while the red arrow shows 80 percent full replacement cost of the insurable value (ITV) at loan inception. Assuming a 6% increase in building costs annually, the cost to replace the improvements increases from $250k to $355k between loan inception and year six. This graph does not assume any home improvements, post disaster spikes in rebuilding costs after a disaster which can drastically skew the insured to value percentage downward even further than represented. depending on the amount of improvements made to the mortgaged dwelling. The graph demonstrates that the percentage of coverage decreases as building costs increase posing extreme risk early on in the loan. In the example illustrated by the red arrow, the collateral is only insured for 75% of the cost to replace the insurable improvements 12 months into the loan. In the example illustrated by the blue arrow, adequate insurance coverage at loan inception mitigates the gravity of underinsurance risk, but without continued maintenance of sufficient coverage consistent with loan requirements during the life of the loan, even when the property is adequately insured to value from the onset is at risk.

What is of significant note is that many hazard insurance policies will not pay replacement cost coverage if the coverage drops below 80 percent of the replacement cost value of improvements. In this scenario, the homeowner and mortgagee would only be entitled to payment on an actual cash value basis (replacement cost, less depreciation). Additionally, many extended replacement cost endorsements that provide an additional percentage of coverage

[50] M.P. McQueen, Wall Street Journal (09/15/06)
[51] J.D. Powers and Associates Reports (11/01/05)
[52] Fannie Mae, Ch. IV, A: Specific Warranties, No. 16. (07/05)



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beyond replacement cost limits would not trigger unless the home was insured to value to begin with.[53] Some carriers offer policies that provide for annual coverage increases tied to an index, which can help to offset the risk of underinsurance. It is important to note that annual index adjustments are not offered by all insurance carriers or in all policies, nor are the increases guaranteed to be sufficient to keep the collateral safe from underinsurance risks.

Even the best case scenario, the servicing lender must continue to ensure that the insurable value of improvements is monitored and the coverage required by the loan maintained through the life of the loan.

## CONCLUSION

### V. Technological Innovation Offers a New Solution to an Old Problem

Some originators and appraisers have discovered an easy and inexpensive solution for reliable collateral replacement cost information by utilizing a tool new to the mortgage market called InsureBASE™ developed by Bluebook International of Lake Forest, California. InsureBASE offers a Replacement Cost (RC) Report and an Appraiser Assisted Residential Cost Analysis Report (AARCA) which assists appraisers in determining accurate cost approach cost calculations. RC provides a reliable estimate of the cost to rebuild a home of like kind and quality in the area the home is located, and includes customary charges like contractor overhead, profit, architect fees, and debris removal. AARCA provides cost details on improvements as required in the URAR cost approach, and gives lenders and appraisers who require a more detailed picture of the components of the subject property risks a reliable report. A lender or appraiser at the request of a lender can utilize either of these reports to determine or validate hazard insurance sufficiency.

Unlike other cost-data solutions which are difficult to use because they require intense training and are accompanied by lengthy user manuals, InsureBASE does the heavy lifting whether the user is an appraiser, a lender, or a loan servicer and is based on 42 years of experience reconstruction cost-data. .

### VI. A Win-Win-Win-Win for Everyone

Ascertaining at loan inception, and maintaining sufficient limits of insurance throughout the life of the loan from the mortgage and servicing side will achieve equity of risk distribution, and provide a win for everyone touched or concerned by issues today surrounding insufficient and inadequate homeowners insurance. 1) Insurers will compete for business based on a proper replacement cost coverage amount required by the lender, and not be subject to consumer price shopping which can motivate the insurer to reduce coverage amounts to lower premiums and garner the business. This will result in more premiums for insurer, and less litigation for allegations of underinsurance. 2) A borrower's equity will be preserved from risk of loss due to insufficient insurance coverage in the face of the loss of a home. 3) Lenders will fund loans that have adequate insurance in place at the onset, thereby reducing risk of loss to collateral, meeting compliance obligations and providing supporting documentation in the loan file that an independent insurance sufficiency check was performed during origination. 4) Reliance on appraisal cost approach figures or an insurer's deference to a homeowner will be eliminated, thereby ensuring reliability is not exchanged for habit or convenience. 5) Loans will be in compliance with insurance guidelines whether retained in the portfolio of the originating lender or sold to the secondary market and securitized. 6) The appraiser will be able to perform a cost approach in accordance with USPAP guidelines, and not risk having his calculations relied upon for purposes outside of its utility. 7) The lender can rely either on its own staff to determine hazard insurance sufficiency or rely on a skilled appraiser to provide a replacement cost report specifically for insurance purposes.

Collateral replacement cost, what is the lender's responsibility? In the mortgage finance transaction, many things can go wrong. Reliance on replacement cost calculations that are not intended for insurable purposes, backed into, or the product of consumer price shopping does not represent the best case for lender due diligence or fiduciary responsibility. It creates unnecessary exposure for the appraiser, places the consumer at risk, and squarely puts the collateral in jeopardy in the event of loss. Finding new and innovative solutions to issues requires the industry as a whole to take notice of not only why a problem exists, but the nature of that problem and the confluence of behaviors across an industry that touch and affect the appraiser, the consumer, the insurer, the lender and investors. In the case of collateral replacement cost, an ounce of prevention may truly be a pound of cure.

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[53] Policies vary on the required insured to value minimum percentage before limiting conditions apply. Some require that the coverage A dwelling limits are at least 80% insured to value for extended coverage endorsements to trigger, while others require a higher insured to value percentage. Some policies will only pay actual cash value if not insured to value by a minimum percentage dictated by the carrier and policy type.

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**More About Bluebook and InsureBASE**

The InsureBASE solution is web based on (XML or HTML), and is built on Microsoft.NET technology. It is easy to use and the reports take minutes to complete.

Bluebook International has been researching and reporting "cost" data on residential structures for over forty-two years. Its research is founded on the analysis of actual property claims audits, insurance and construction estimates, in addition to current materials, labor and equipment costs. Bluebook does not base its cost data on construction costs from large track developments, where economies of scale issues significantly skew pricing downward. Cost and labor data is continually updated and collected across the United States, and pricing fluctuations on labor, materials and equipment are closely monitored. The engine behind the data is based on Bluebook's experience in what it takes to rebuild an individual house, start to finish, including, among others, debris removal and architect fees, delivery of the materials to the property address for profit and overhead and other localized costs.

InsureBASE is different than any other cost data software solution in that the calculations drill down to the neighborhood level, with information on homes in over 70,000 neighborhoods across the United States covering approximately 2800 counties. Other cost-data providers compile zip code average costs to rebuild, whereby square foot costs of homes in varying neighborhoods are averaged across an entire zip code producing one "per sq. foot cost" for every home.

Bluebook's cost data and analytics have been relied upon by the judicial system, adjusters, contractors, contractors' schools, disaster repair industry, fire departments, government agencies, hazardous waste companies, home owners, home inspectors, insurance companies, landlords, maintenance companies, repair industry, reconstruction industry, realtors, remodeling industries, restoration industries and more, to provide those costs attendant in replacing a dwelling and/or its contents. Most recently, InsureBASE has been utilized by appraisers and lenders. The reports are complimented with accurate depreciation and normal useful life figures for age and condition of individual structural attributes known as component based depreciation. Bluebook's data also includes depreciation values by trade across 680 categories and 84 trades. The tables are utilized today industry-wide.

InsureBASE is equally distinguishable by its ease of use. InsureBASE algorithms and data perform the intricate math, making it a tool that any one in the mortgage finance transaction can utilize effectively by simply entering a few pieces of key property characteristic information. Training takes about twenty minutes, and there are no cumbersome codes, complicated manuals or lengthy classes required to use the tool effectively. The results are delivered direct to the user's desktop, either one property at a time, or thousands per hour in portfolio review.

InsureBASE can be used by anyone at anytime during the origination & (validation) process, and is currently available through Bluebook directly and its reseller partners.

While the costs differ depending on the provider and volume expectations, the report costs a user under $8 for purchases of one at a time with additional discounts applying for quantity purchases.



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