Mortgage Bankers Association

White Paper

Commercial

Due Diligence for Force Placed Insurance

Commercial Real Estate/Multifamily Finance Board of Governors
Servicing Committee Executive Insurance Council

MORTGAGE BANKERS ASSOCIATION®
Investing in communities

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White Paper

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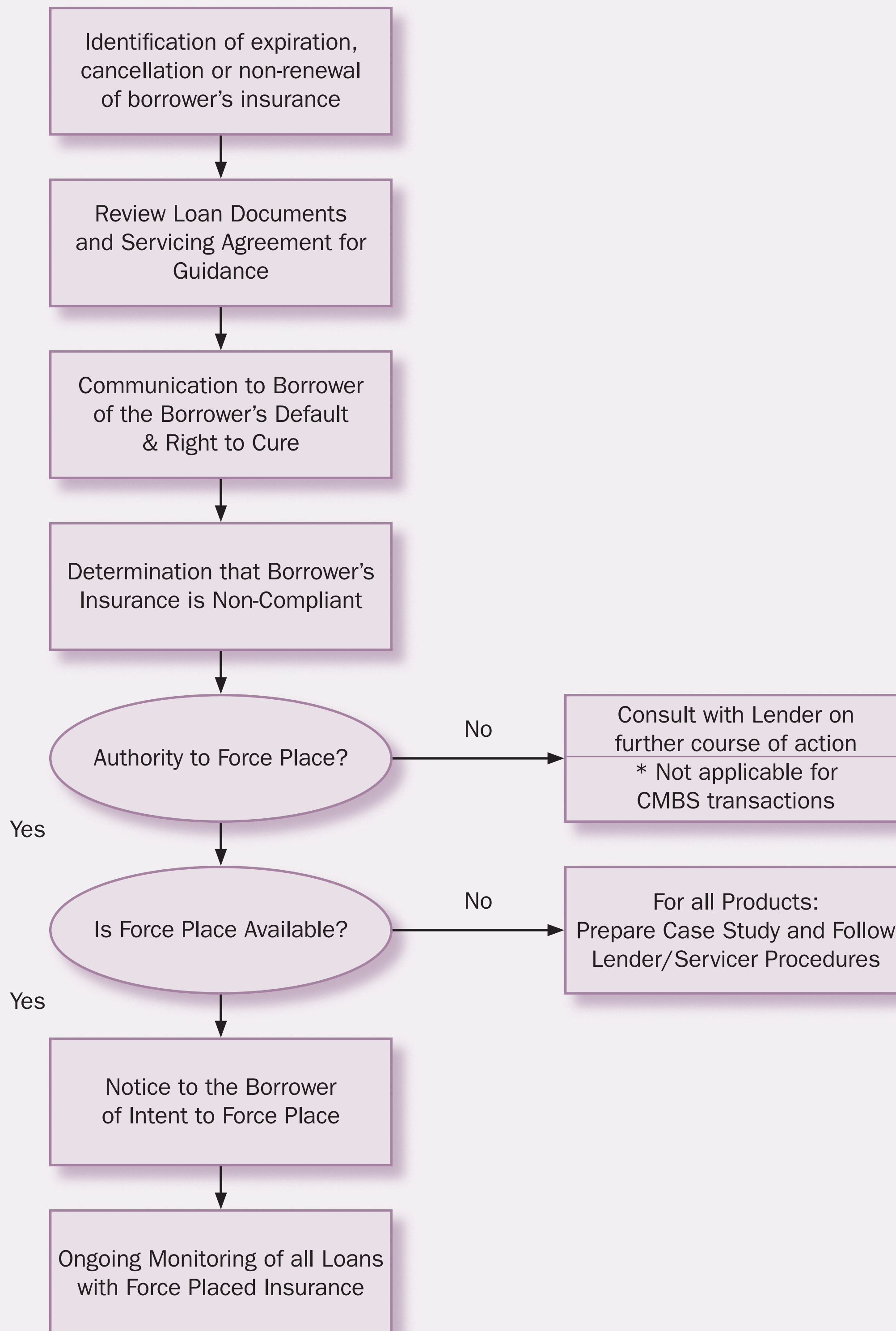
Servicer's Decision Chart: Due Diligence on Force Placed Insurance



PREFACE

The issues surrounding insurance availability and affordability have necessitated the commercial servicers to take a new look at the requirements and enforceability of insurance coverage in commercial real estate transactions.

While ensuring the underlying real estate supporting commercial real estate finance transactions have insurance coverage remains the top priority for servicers, the lack of availability in some markets has created a pressure on the industry to utilize force placed insurance as a backstop. The use of force placed insurance has a significant impact on both the borrower and the loan transaction. Because of the impact of force placed insurance, the commercial real estate finance industry has developed this guideline to help servicers navigate through the decision making process of when force placed insurance may be appropriate.

The purpose of this document is to provide the reader with an informative look at the process to determine whether to force place insurance. The paper is to serve as a guidance document for the servicing industry and use of this guidance is purely voluntary.

The document does not make any conclusions or recommendations as to the final outcome of the due diligence review. The outcome and final conclusion of such a review should be determined on a case by case basis, taking into account, among other things, the specific property, the loan documents, any transaction or servicing agreements, insurance information, the market, the company profile and the lender or trust associated with the transaction.

Also as a note, the White Paper necessarily must be something of a snapshot, because even during the period of its preparation, there may have been developments in the market that are certain to have an impact on knowledge of these areas in both the short-term and long-term.

Executive Insurance Council

Mortgage Bankers Association
Commercial Real Estate/Multifamily Finance
Board of Governors' Servicing Committee

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I. What is Force Placed Insurance?

Force placed insurance coverage is defined as insurance "coverage obtained by a lender to protect its security interest in a property where the borrower has failed to renew existing coverage."[1]

A. What is the Purpose of this Insurance Coverage and Who is Covered?

Force placed insurance is designed by nature to be an insurance of last resort for the lender or servicer. It protects the property with insurance coverage(s) as required by the mortgage loan documents or the security agreement. The insurance coverage could range from property, business income and building ordinance to liability insurance coverage.

Since force placed insurance is written to protect the interest of the lender, a common misconception of borrowers is that force placed insurance covers their interest in the property. As part of any force placement process, it is suggested that the lender or servicer notify the borrower that they are not afforded any coverage through the force placed policy. Specifically, borrowers should be advised that they are not entitled to any proceeds under a force placed policy if there were a loss at the property. Additionally, if coverage is force placed for liability, no proceeds are disbursed until a legal court determines who is liable. This does not preclude the servicer from collecting their legal defense costs if they are named in the lawsuit.

The decision to obtain a force placed insurance policy is a corporate decision. For companies that do participate in force placed insurance coverage, force placed insurance is a critical part of the lender's or servicer's insurance portfolio. It provides a backstop for the collateral securing mortgages in their portfolio in cases where the appropriate insurance coverage is not provided by the borrower.

B. What is the Typical Force Placed Policy Structure?

The lender's or servicer's force placed policy is renewed on an annual basis by the insurance carrier. The lender or servicer adds and deletes properties as necessary on a monthly basis. Premiums are then charged monthly, with pro-rata premiums for properties added or deleted mid-month. In some instances where a servicer is an infrequent user or has lower volumes, the servicers may be charged a minimum up-front premium.

C. Who Writes the Coverage and How to Purchase It?

Force placed insurance is written by a limited number of insurance carriers and is written through insurance agents. The insurance agent works with the insurance carriers and underwriters to construct a force placed insurance policy that meets the lender's or servicer's specific needs. Lenders and servicers are advised to review annually their current force placed insurance policy and their insurance coverages.

D. How does Force Placement Work?

The due diligence process includes the lender or servicer working with the borrower and its insurance agent to either obtain proof of adequate insurance coverage and/or clarify insurance coverage requirements,

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1 *Mortgage Banking Terms,* 10th Edition, Mortgage Bankers Association, Washington, DC, 2002.

endorsements, etc. Therefore, this due diligence process often goes beyond the expiration date. The insurance market recognizes this issue and most force placed carriers offer an automatic coverage period. Typical automatic coverage periods range from 30 to 90 days. To the extent that the lender or servicer does not have proof from the borrower of viable insurance for a particular property on the insurance expiration date, coverage is automatically bound through the force placement insurance carrier according to their insurance contract.

During the due diligence period, there is no earned premium charged so long as the borrower can provide proof of no lapse in insurance coverage. If after the automatic coverage period, the borrower still does not provide adequate insurance coverage, the lender or servicer will instruct the force placed agent to issue the appropriate insurance coverage(s) and charge the premiums accordingly, retro-active back to the date of the original expiration date and/or lapse in insurance coverage.

Should the lender or servicer become aware of a cancellation or non-renewal of an insurance policy via notification from the insurance carrier, force placement insurance coverage should be issued immediately as of the effective date of cancellation.

All costs associated with a force placed insurance policy are typically at the borrower's expense. The lender or servicer should check the borrower's loan documents. The costs associated with force placed insurance policies are usually above other insurance market rates and are therefore a more expensive alternative for insurance.

E. What Insurance Coverage is Available?

Coverage's that are typically provided under the basic force placed policy including, but not limited to:

- Building Coverage
- Loss of Rents including Extra Expense
- Terrorism
- Windstorm
- Personal Property
- Ordinance and Law
- Boiler & Machinery
- Earthquake
- Flood
- General Liability

Standalone[2] policies typically available including, but are not limited to:

- Terrorism
- Fungus Cleanup & Removal
- Flood (National Flood Insurance and/or excess coverage)
- Boiler & Machinery

Highlights of the typical insurance coverage available, including but no limited to:

- Agreed Amount
- 60 or 90 Day Notice of Cancellation
- Coverage for Building, Terrorism, Windstorm, Boiler & Machinery, Earthquake and Flood can be written for properties with a total insurable value (TIV) up to the $25Million
- General Liability Coverage options: $1 Million per occurrence, with $2 Million aggregate; $2 Million per occurrence, $4 Million aggregate, $3 Million per occurrence, with $6 Million aggregate
- Deductibles range from $5,000 to $25,000, with higher deductibles for catastrophic losses (Earthquake, Flood and Windstorm)
- Over $25MM coverage and Standalone Terrorism upon request and with at least 30 days advanced notice to the insurance agent
- Coverage can be written on Replacement Cost basis or to cover the unpaid principal balance (UPB)
- Coverage can be written on real estate owned properties (REOs)
- Monthly Premium Installments
- Automatic Coverage Period

Coverage's that typically are not provided under the force placed policy including, but not limited to:

- Umbrella Liability (can reach the loan document requirements by force placing additional General Liability insurance coverage)
- Professional Liability
- Directors and Officers Liability
- Liquor Liability
- Fidelity Bond
- Extended Period of Indemnity
- Automobile Liability
- Work Compensation

2 A standalone policy is a self-contained policy covering a specific peril or perils independently.

II. How to Evaluate When to Force Place

A. When is Force Placement Initiated?

Force placed insurance starts when a borrower defaults on an insurance requirement in the loan documents. There are typically three instances where the borrower may encounter insurance issues that may rise to a force placement event. The three most likely instances are:

- Borrower neglects to offer proof or evidence of insurance at renewal time or any other time as requested from the lender or servicer based on the loan documents;
- Borrower has no insurance — either the borrower has cancelled an insurance policy or the borrower's insurance company has notified the borrower that all or a portion of the borrower's policy will not be renewed and the borrower has neglected to find a replacement insurance policy;
- Borrower has insurance, but the amount, coverage, deductible or insurance carrier itself does not meet the loan document requirements and therefore is deemed inadequate insurance coverage.

The three instances are not mutually exclusive; the borrower may have multiple insurance issues arise. The lender or service will be required to review all instances of potential non-compliance with the loan documents to make a determination whether force placement is required.

B. What do the Documents State?

A careful review of the loan documents and servicing agreements is necessary to determine if any specific language is incorporated to instruct the lender or servicer on when to force place. First we need to understand the different language within the loan documents, the whole loan servicing agreements and the CMBS pooling and servicing agreements.

Loan Documents

- The language in the loan documents may state: "if at any time Lender is not in receipt of written evidence that all insurance required hereunder is in full force and effect, Lender shall have the right, to take such action as Lender deems necessary to protect its interest in the Property, including, without limitation, obtaining such insurance coverage as Lender in its sole discretion deems appropriate. All premiums incurred by Lender in connection with such action or in obtaining such insurance and keeping it in effect shall be paid by Borrower to Lender upon demand."
- Other language may read very broadly that, "the borrower must make all efforts to obtain and maintain the specific insurance coverage requirements satisfactory to Lender in its sole discretion, and evidence of the payment of all premiums payable for the existing policy period"
- Some loan documents may not address force placed insurance coverage specifically or any remedy in the event that the borrower does not comply with the insurance requirements of the loan documents.

Portfolio Servicing Agreements for Whole Loans

The Servicing Agreement between the lender and the correspondent will address the correspondent servicer's role concerning insurance coverage and enforcement. The language may include:

- Specific instructions on whether to force place insurance or not, including whether the servicer should use its own force placed policy or use the lender's policy. Language may require the servicer to force place insurance at the borrower's expense.
- Some use broader language that if the servicer can't get insurance coverage (either from the borrower or from its own force placed policy) that the lender will obtain the insurance coverage.
- There may be general language stating that the servicer should use "every effort," "best efforts" or "due diligence" to ensure full insurance compliance, as required in the loan documents.
- Typically the lender will continue to have a role in the decision making and determination of whether to force place. Some lenders want a recommendation from the servicer on whether to force place, but still ultimately reserve the final decision and approval for themselves.

CMBS Pooling and Servicing Agreements

The Pooling and Servicing Agreement (PSA) may identify the requirements for the master servicer's and/or the special servicer's force placed policy, such requirements may include:

- Force placed insurance is obtained from an insurance company with a financial strength rating or claims paying ability that meets specified requirements (typically a carrier rating).
- That the force placed policy will provide an equivalent amount of insurance protection as is required in the individual documents.
- The PSA may also specify insurance requirements regarding nonperforming loans, loan workouts and REO properties.
- However, the PSA language may also be vague and open to interpretation on performing loans, for example, it may instruct the servicer to use "reasonable efforts" and/or to follow the "Servicing Standard."
- Terrorism insurance has highlighted the different interpretive questions that may arise. Language in the loan documents and PSAs may stipulate that terrorism insurance is required if "available at commercially reasonable rates within the same geographic area." Some questions may arise based on this language that the servicer will have to interpret:
    - What is the definition of "reasonable rates"?
    - What is reasonable for properties within the "same geographic area"?
    - Some documents will permit the servicer to use discretion in a manner consistent with the "servicing standard," what does that mean?

C. Does the Action Trigger a Default?

Generally, loan documents spell out what constitutes an event of default. The loan documents should be reviewed based on the type of insurance issue the borrower is experiencing. The White Paper looks at the impact of three insurance issues: 1) lack of evidence of insurance, 2) no insurance policy in place and 3) when insurance is inadequate or incomplete. The lender or servicer may take a different course of action based on the insurance issue.

Lack of Evidence of Insurance

Many loan documents include a lack of proof of coverage as an event of default. This type of default may have a varied level of impact on the property. The borrower has neglected to provide the lender or servicer with the proof of coverage, but this does not automatically mean that the borrower does not in fact have insurance coverage. In these instances, the lender or servicer should communicate with the borrower to ascertain if the borrower has insurance coverage. The lender or servicer needs to know if the property is protected, but does not want to force place insurance if the borrower has insurance already; that would lead to potentially having double coverage on the property. Most lenders and servicers will work with the borrower and the agent or broker to get satisfactory evidence of insurance.

No Insurance Policy in Place

Most loan documents consider a lapse in an insurance policy, where there has been a cancellation or a non-renewal determination by an insurance company, as an event of default under the loan documents. Typically the borrower is not permitted under the loan documents to cancel an insurance policy that was required at closing. Any cancellation of an insurance policy will leave the investor exposed to potential additional risk and is specifically prohibited. Likewise, if the borrower is informed that its insurance coverage is being cancelled by its insurance company, the borrower is expected to inform the lender or servicer and then find alternative insurance coverage, based on the loan document requirements (of equal or greater coverage). As stated above, if at any time the lender or servicer becomes aware of a lapse in insurance coverage, the lender or servicer should force place insurance immediately.

Insurance is Inadequate or Incomplete

When the actual insurance coverage is obtained by either the borrower or its insurance agent, the loan requirements are compared to the insurance coverage/limits provided. If the loan document language does not match the renewal insurance coverage information, then the lender or servicer will make a determination if the inadequate or incomplete insurance difference(s) have an impact in the level of property protection.

If it is determined that the insurance coverage is not compliant with the loan requirements and that it impacts the lender's or investor's interest then force placement should be considered. If proof of adequate insurance coverage has not been provide, then insurance coverage that protects the lender's interest should be force placed to the extent of the replacement costs or the unpaid principal balance (UPB) of the mortgage debt outstanding. This will safeguard the lenders interest in the property as well as allow for basic compliance with the loan requirements. The force placed insurance shall be maintained at the borrower's expense.

In some instances inadequate insurance coverage may not have an impact on the lender's or investor's interest. In this instance, the servicer may argue that the noncompliance is more of a "technical default," with no substantial impact to the property. A technical default is typically when the borrower is not compliant with the specific requirements of the loan documents that do not relate to the payment of the mortgage. If the servicer makes such a determination, then this should be communicated to the lender or special servicer in the transaction for discussion and approval.

A final point to consider is the application of default interest when there is determination of insurance default. The rate of default interest is stipulated in the loan documents, which should also outline what constitutes a borrower breach or nonperformance and when to assess default interest.

D. How to Communicate Default(s) and the Right to Cure

Upon determining that a loan is non-compliant with regards to the required insurance coverages, notification should be sent to the borrower advising them of such default. The letter should indicate what insurance deficiencies exist, a drop dead date for resolution and the next course of action (force placed insurance, notify the investor, etc.).

- Depending on the situation, the letter can be general[3] in terms of endorsements (replacement cost, agreed amount, etc.) or it can be specific[4] to a particular insurance coverage (Terrorism, windstorm, flood, etc.).
- In most instances, prior communication with the borrower and/or insurance agent has been established and this prior contact should be reiterated within the context of the letter.
- In closing the letter, reserve your rights and remedies that may be available.

View Sample Letters on the next page for a general letter or a specific letter.

3 View *Sample Letter — General*
4 View *Sample Letter — Specific*

SAMPLE LETTER – GENERAL

[INSERT DATE]

[BORROWER NAME]
[ADDRESS 1]
[ADDRESS 2]
[ADDRESS 3]
[CITY, STATE ZIP]

Re: Loan Number: [INSERT LOAN NUMBER]
Policy Number: [INSERT INSURANCE POLICY NUMBER]
Property: [INSERT PROPERTY ADDRESS, CITY, STAT, ZIP]

Dear Sir/Madam:

We are the servicer with respect to the above-referenced Loan for the [Investment Trust or Lender's Name]. Please be advised that you are currently in default of your mortgage documents as it pertains to your insurance coverage(s).

We have contacted your agent with regard to your evidence of property and/or certificate of liability insurance. As of this date, your coverage is non-compliant and the following items are outstanding and must be addressed immediately.

List of Outstanding Items:

- Replacement Cost Endorsement
- Deductible is greater than $25,000
- Umbrella Liability coverage for $3MM

Please contact your agent and have them send the information directly to me within (15) days of this letter to clarify your coverage and comply with all outstanding requirements as outlined in this letter.

If we do not receive a response, we may force place all missing coverage(s) and/or notify the investor of your default on the terms and conditions of your loan agreement without further notice. If we decide to force place, please be advised that the insurance will only protect the lender's interest.

Nothing herein shall be considered a waiver of any or our rights or remedies under the loan documents. We reserve all rights and remedies available to us.

Your immediate attention to this matter is greatly appreciated.

Very truly yours,

SAMPLE LETTER – SPECIFIC

[INSERT DATE]

Express or Certified Mail

[BORROWER NAME]
[ADDRESS 1]
[ADDRESS 2]
[ADDRESS 3]
[CITY, STATE ZIP]

Re: Loan Number: [INSERT LOAN NUMBER] (the "Loan")
Property: [INSERT PROPERTY ADDRESS] (the "Mortgaged Property")

Dear [INSERT CONTACT NAME]:

We are the servicer with respect to the above-referenced Loan for the [Investment Trust or Lender's Name]. Despite various attempts to communicate with either yourself or your agent, we have been unable to determine that the Mortgaged Properties that secure the Loan are insured against <type of coverage>.

We call your attention to Section [INSERT SECTION #] of the [INSERT NAME OF SECURITY DOCUMENT] (the "Mortgage") which contains the requirements for insurance coverage. The lack of coverage for <type of coverage> brings the insurance out of compliance with the Mortgage.

Please provide to us, no later than [INSERT DROP DEAD DATE — 10 BUSINESS DAYS FROM DATE OF LETTER], written evidence of insurance coverage for terrorist acts in the amounts required for insurance coverage under the Mortgage. If you do not have such coverage, you are hereby instructed to obtain such coverage. If you fail to respond by [INSERT DROP DEAD DATE — 10 BUSINESS DAYS FROM DATE OF LETTER] we will assume the property is uninsured against <type of coverage> and we will consider this a default under the terms of the Mortgage. Furthermore, we may choose to exercise one or more of the remedies available to us under the terms of the Mortgage, including the right to purchase insurance against <type of coverage> on the Borrower's behalf, and to require that you reimburse us for the cost of such insurance.

Nothing herein shall be considered a waiver of any or our rights or remedies under the loan documents. We reserve all rights and remedies available to us.

If you have any questions, please contact me.

Very truly yours,

III. How to Evaluate What to Force Place

A. Is Force Placed Coverage Available?

It is the lender or servicer's responsibility to enforce the insurance requirements of the loan documents or the servicing agreement. Force placed coverage is a remedy to the extent that coverage is available.

Force placed programs vary between the various insurance providers. Some of the insurance coverages required in commercial real estate finance transactions may not be available from a force placed company, depending on the specific insurance provider. Since the force placed policy is broad and nonspecific to any property, there are some risks that the insurance carrier is unwilling to insure, for example, insurance coverage such as Workers Compensation or Professional Liability. Likewise, force placed programs have maximum TIV limits for insurance coverages and that can vary by program. This needs to be taken into consideration when looking to force place insurance.

If insurance coverage is not available, lenders, master servicers or special services can consider other alternatives, such as carve outs, letters of credit (LOC), or may actually consider the lack of coverage a transfer event.

B. What about Duplicate Insurance Coverage?

Another factor to consider is that some insurance carriers that write force placed coverage do not offer coverage for some perils on a stand-alone basis. Wind coverage is a good example of this. Because the cost of wind coverage alone is the same as force placing the all risk[5] building coverage, some insurance carriers do not offer it on a stand-alone basis. Therefore, when wind is force placed, all other property coverage is also force placed, even if the borrower already has building coverage on their own property insurance policy.

C. What to do if the Loan Documents are Silent

If the loan documents are silent, or if they offer minimal direction on insurance coverage requirements and/or limits of insurance coverage, the lender or servicer can:

- Look back to the insurance coverage amounts required at closing
- For Whole or Portfolio loans, work directly with the lender who originated the loan to determine their minimum insurance coverage requirements
- For CMBS loans, work directly with the special servicer and/or rating agency to determine the minimum insurance coverage requirements
- Develop an internal set of lender or servicer minimum required insurance coverages, similar to the coverages as outlined below.

5 All Risk coverage is defined as coverage for all perils except for those specifically excluded. In this example, wind would be specifically excluded and would not be covered under the all risk policy.

If the borrower does not maintain at least the minimum insurance coverages, then lender or servicer can, and in some instances may be required to, force place.

Property

Cause of Loss Form	Special
Replacement Cost or Actual Cash Value	Replacement Cost
Coinsurance	Acceptable at 80% or 90%
Deductibles Property Earthquake Wind	$25,000 10% of the Total Insurable Value (TIV) 3%–5% of the Total Insurable Value (TIV)
Law & Ordinance	Required
Business Interruption	Required at a minimum of 12 months with a 90 day extended period of indemnity
Flood when in a SFHA (Zones A & V)	Replacement Cost or the maximum amount available from the National Flood Insurance Program (NFIP)
Boiler & Machinery/Equipment Breakdown	Required if exposure exists to Replacement Cost
Wind	Required if property is located in a hazardous wind county – refer to Wind chart (Exhibit A) If coverage is secured through a state residual market gap/wrap, coverage must also be purchased for those coverages not offered through the pool
Earthquake	Required to Replacement Cost if high or moderate hazard – refer to Earthquake chart (Exhibit B)
Builders Risk	Required if the property is under construction
Environmental	Required if ASTM Phase I/Phase II indicates a pollution exposure
Terrorism	Required
Mold	Not required

Liability

General Liability Limits	$1,000,000 per occurrence; $2,000,000 aggregate
Multiple Properties Insured	Coverage must apply per location
Liability Deductible	Not allowed
Excess/Umbrella	Apartment $5 Million Retail $10 Million Office $5 Million Hotel $10 Million Industrial $3 Million
Automobile Insurance	$1,000,000/occurrence; $2,000,000/aggregate – required only if exposures exists
Professional Liability	Required for Healthcare Facilities $3,000,000
Work Comp	Required if exposure exists

Other Requirements

Carrier Rating	AM Best A X S&P A
Cancellation Requirement	10 days non-pay; 30 days all other
Form of Proof	Certificate Property: ACORD 28 Liability: ACORD 25
Policy Term	1 Year
Blanket Policy	City and State of all locations must be listed Total TIV must be listed
Property Address	Must be listed on the Certificate
Named Insured	Must be the Borrower

D. How to Evaluate Risk Tolerance

A risk tolerance matrix can be used to assist lenders and servicers in determining the action to be taken for each insurance requirement within the loan document or security agreement. This tool can also be used to chart out the lender requirements if those are to be followed in lieu of the loan document or security agreement.

- The first column specifies the actual insurance requirement (standard in most loan documents).
- The second column outlines the potential risk if the requirement is not met.
- The third column is designated for the action the lender or servicer will take. The action taken should be based on the lender's or servicer's corporate policies and procedures for how to handle issues that may arise surrounding insurance. The actions may range from a letter campaign, calls to the borrower, or a determination that no further action is necessary.

Requirement	Risk if Requirement is Not Met	Action Taken
All Risk or Special Cause of Loss Form	Only a limited number of perils would be covered	
100% Full Replacement Cost	Not enough money to repair or replace; settlement would be Actual Cash Value and would take into consideration depreciation	
Earthquake (if applicable)	There would be no coverage for Earthquake	
Wind (if applicable)	There would be no coverage for Wind	
Flood (if applicable)	There would be no coverage for Flood	
Builders Risk (if applicable)	There is no coverage while the property is under construction	
Terrorism	There would be no coverage for Terrorism	
Boiler & Machinery or Equipment Breakdown	There would be no coverage for mechanical breakdown or electrical arcing	
Ordinance & Law	There would be no coverage to restore the property to code	
Such Other Insurance	There would be no coverage for exposures such as mine subsidence, environmental, etc.	
No Coinsurance/Agreed Amount	There would be a penalty at the time of the loss if coverage is not to value	
Deductible	The insured will have to pay a greater amount	
Blanket Policy	There would not be enough money to repair or replace	
Lender Loss Payee	The lender would not receive insurance proceeds	
Mortgagee	Mortgagee wouldn't have any additional rights under the policy and wouldn't receive insurance proceeds	
Additional Insured	The lender would not have any coverage or defense costs under the policy	
General Liability	Could affect the borrower's cash flow	
Excess Liability/Umbrella	Could affect the borrower's cash flow	
Business Interruption	No coverage, or not enough coverage to compensate for the loss of business	
Extended Period of Indemnity	No coverage for loss of business after the location opens	
Workers Comp	This is statutory and does not extend	
30 Day Notice of Cancellation	Would not receive advance notice of cancellation	
Waiver of Subrogation	Eliminates the right of the insurer to collect from the responsible party — takes the lender out of the process	
Carrier Rating	If the carrier is not properly rated, they could go insolvent and not be able to meet their obligations	
Other exception issues		

E. How to Evaluate the Insurance Carrier Ratings

The loan documents and servicing agreements require the lender or servicer to monitor not only the amount of insurance coverage on the property, but also the individual insurance company rating. The rating is an indication of the insurance companies' financial strength and ability to pay out on insurance policies when there are losses.

Interestingly, if an insurance carrier's company rating is not compliant with the loan documents, then force placing insurance coverage could actually result in the property having double insurance coverage. The best solution for when an insurance company's carrier rating is not compliant is for the borrower to replace the insurance carrier with one that is compliant (meets the required rating). If the borrower can not obtain insurance coverage from a compliant carrier, and the carrier rating is still within a superior or excellent rating category, then a case study should be drafted to submit to the lender, master servicer and/or special servicer to waive the requirement for the current insurance term. If the non-compliant carrier is outside of the superior or excellent rating category, then the lender or servicer should consider force placing after advising the borrower that they will be potentially paying for insurance coverage twice.

There are times when the loan documents require a carrier rating from a specific rating agency and it turns out that the specified rating agency does not rate that particular insurance carrier. The International Risk Management Institute, Inc. (IRMI) has published a Comparison of Ratings Distribution by Agency, which can be used to determine the adequacy of a carrier that is not rated by the specific rating agency, by comparing the insurance companies by "grade" level to the comparable ratings of the other rating agencies.

Example. To use the IRMI comparison, if the loan documents require an AA level S&P rating for an insurance carrier and S&P does not rate the carrier the borrower chooses, then to figure out a comparable level rating from another rating agency (for example AM Best), handle the situation as follows:

- Go to secure ratings for S&P on the chart
- Note that a AA is a level two
- Determine the rating agencies that do rate the carrier in question (for example AM Best)
- Go to the secure rating for AM Best on the chart and look across at level two to determine the comparable rating , here it is A, A-
- Ensure that the carrier in question meets the AM Best level two rating

The chart has four columns, they represent:

- Level — this is the category given by the International Risk Management Institute to enable the comparison.
- Rating — this is the actual rating assigned by the respective rating agency.
- # — this represents the number of insurance carriers that each respective rating agency rates in that level.
- % — this represents the percentage of insurance carriers that are within that level for each of the respective rating agencies.

Comparison of Ratings Distribution by Agency[6]

Specific comparisons between rating agencies are difficult to assess because rating scales and descriptions vary by agency. Also, some rating agencies typically rate a higher percentage of insurers than others.

To view the comparison chart, visit IRMI's comparison at ***www.irmi.com.***

F. How to Evaluate the Deductibles

A deductible is defined as "the amount of an insured loss for which the insured is financially responsible before an insurance policy provides coverage."[7]

Loan documents are based on a viewpoint at a moment in time, which tries to anticipate future events, while the insurance marketplace is fluid and dynamic. Because of this inherent difference, lenders and servicers run into situations where the insurance market does not bear what the loan documents require. This situation happens with deductibles. Sometimes the required deductible amounts are much less than what the borrower can actually get in the insurance market.

Currently, the typical market deductible amount the borrower pays for a commercial property is $25,000. Loan documents typically specify a requirement of a $10,000 deductible. The difference between the actual deductible and the loan document requirements is very small and most likely will not cause any material impact on the property, and thus force placing is often not the best option in this situation.

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6 Provided by International Risk Management Institute, Inc. and available on their website at *http://www.irmi.com*.

7 As defined by Rupp's Insurance & Risk Management Glossary, 2nd Edition.

In addition, acceptable deductible amounts can vary by property type and cash flow. When a borrower initiates a request for some insurance relief and the loan documents have a low deductible requirement and the property can support a larger deductible, a case study should be drafted and submitted to the lender, master servicer and/or the special servicer for approval of the higher deductible amount. As a note, the approval will probably only be acceptable for the current insurance term, and any changes in the market or changes at the property, could result in a future enforcement of the lower deductible amount. At each renewal, a case study should be submitted to the lender, master servicer and/or special servicer for review and approval. Where it may be possible to buy down the deductible amount using the force placed vehicle, this is typically not an insurance exposure to the property that would warrant that action.

Lastly, there are times when the external environment causes deductibles to increase. Lenders and servicers see this situation in areas prone to catastrophes, for example, the coastal states with hurricane exposure; and California with earthquake exposure. Some loan documents recognize this and have different deductible requirements for these specific exposures. In this instance when it is clear the loan documents have already contemplated the scenario and its risk, the deductibles should be strictly enforced and failure to comply should lead to force placed insurance. Other loan documents may include these exposures under the "all risk" language, and therefore the deductible requirements are generally unattainable. In these situations, the lender or servicer should consider what the realistic standard deductibles are for these exposures in the insurance marketplace. If the property can not support the higher deductible, then force placing may be an option to buy down that deductible amount.

IV. What are the Next Steps?

A. Has a Transfer Event Occurred?

In the CMBS environment, in conjunction with the decision to force place insurance coverage, some PSAs will require that the loan be transferred to the special servicer. The servicer will need to develop a process for requesting approval from the special servicer for such things as contacting the borrower, the disbursement of premiums, the direct billing of the borrower, the recoverability of advances and the delivery of any escrow analysis reflecting changes in monthly payment constants.

If the decision to force place insurance is not defined as a transfer event in the applicable PSA, at a minimum, it is an event that requires placement on the servicer's monthly Investor Reporting Package (IRP) Watchlist report to the investors. The Watchlist code number "1B" indicates that any loan having force placed insurance (excluding terrorism, general liability, or excess liability coverages) should be added to the Watchlist during the reporting period that the force placement occurs. The loan should remain on the Watchlist report until force placed insurance is replaced with compliant insurance coverage secured by the borrower.

In Whole or Portfolio Loan servicing, the decision to force place insurance coverage is usually determined by the lender. For those correspondents servicing loans for third parties, prior to force placing insurance coverage, the servicer will need to consult with the lender to ensure they agree with the servicer's assessment and suggestion for further action. Some lenders may want to use their own force placed policy. Other lenders may, as a corporate rule not force place insurance, allowing a period where the property is uninsured or underinsured; and will instruct the servicer to take no further action. Still other lenders may want to begin dealing directly with the borrower in order to find a workable solution or to apply additional leverage that the servicer does not have, such as their additional financial relationships or another loans pending with the borrower.

If the servicer manages insurance for its company's book of loans (portfolio loans), the servicer may find it necessary to create and implement its own guidelines around the force placement of insurance. The policy should contemplate a variety of borrower and market situations, and may even be specific to coverage type, property type, location, loan size, property value, property operating information, borrower profile, etc. Remember, if one's company makes the decision to not force place required insurance coverages, that decision will likely transfer additional risk to the organization. Each individual company's appetite for such risk should help drive the creation of its force placed insurance procedures.

For multifamily portfolios with the Government Sponsored Enterprises (GSEs), Fannie Mae, Freddie Mac and Ginnie Mae, there are specific written guidelines for how to handle servicing issues. The lender or servicer is required to enforce the insurance coverage requirements as spelled out in their respective servicing handbooks. In the event that coverage is not compliant with the agency guidelines, the lender or servicer can force place to meet the requirements. However, if the lender or servicer in discussions with the

borrower, agree that insurance coverage should be waived, a waiver request is prepared and sent to the respective agency for approval. If you force place in the interim wihle awaiting approval, the servicer may incur costs tha are not recoverable.

All decisions to force place insurance should be properly documented on the lender's or servicer's system of record and communication made to the borrower that a force placed policy is in effect. The costs associated, which the borrower is required to pay, should be spelled out in the written communication.

B. How to Conduct On-Going Monitoring

Once the decision to force place insurance coverage is made, it is important to monitor the borrower's progress in obtaining its own insurance coverage to replace the force placed insurance. Because of certain policy limitations and the higher expense, the lender or servicer should begin encouraging the borrower to immediately take action in securing insurance coverage through the facultative market. Written correspondence by the lender or servicer that addresses the borrower's need for immediate action is a good start. The letter should contain the policy premium amount and effective date of the force placement. Then follow up with phone calls or additional letters to the borrower to restate the purpose of force placed insurance and the benefits of directly securing insurance coverage on their own. The lender or servicer should document their efforts and keep copies of all correspondence with the borrower.

After force placement, if the borrower later provides proof of compliant insurance coverage which shows no lapse between the expiration of his previous policy and start date of his current policy, it may be possible to recover a complete refund from the force placed insurance carrier, depending on the terms of the lender's or servicer's force placed policy. If the borrower's replacement insurance policy does indicate a lapse and the lender's or servicer's force placed policy allows flexibility, it may be prudent to cancel the force placed policy only back to the effective date of the borrower's replacement insurance coverage. Doing this ensures that there is no lapse period where the certificateholders (investors) or lender were unprotected, should an insurance claim arise later. The lender or servicer should review the applicable loan documents and the servicing agreements to determine if there is a provision that mandates continuous insurance coverage.

In some instances, such as a lapse in insurance coverage, foreclosure or a lack of availability in the facultative market, force placed insurance may be the only alternative for the lender, servicer and/or borrower.

Given the unique aspects of many force placed insurance policies, all parties should be clear on the insurance coverages afforded, and the limits. As a process, the lender or servicer should perform a periodic review of all the loans that have force placed insurance coverage and the length of time the coverage has been force placed. Remember, the best time to inform a borrower or the lender/investor of insurance coverage details and potential limitations, is prior to a loss, not after one.

V. What to Expect in Volatile Market Conditions

A. Price

During volatile market conditions, insurance carriers that write force placed insurance react in a similar manner as those writing voluntary insurance coverage in those markets; prices go up and the capacity is reduced. Rate adjustments can be made at renewal or during the term of the contract with advance notice. Some carriers may increase the premium during hurricane season and then reduce it once the season is over. During volatile times rate increases can be as high as 400%.

For the borrower with an insurance policy, their biggest concern often is the change in pricing in the market. Price increases can be so high that it has an impact on the borrower's net cash flow and thereby a negative effect on the property's debt service coverage ratio (DSCR). If this is the case, the loan will need to be reviewed for placement on the Watchlist and/or a determination of a transfer event.

B. Availability

Even worse than rate increases is the issue of insurance availability. If the market conditions are such that insurance carriers start issuing moratoriums, caps or cease writing force placed insurance coverage all together, it would leave the lender or servicer with no alternatives to cover potential insurance losses. In that scenario, the servicer would have to work with the lender on portfolio loans, and for CMBS loans would have to transfer the loan under a technical default to the special servicer. Failure to do so would leave the servicer potentially with the total UPB liability, should the property be destroyed.

C. Self Insurance

On the other side of this issue is when the borrower self insures either because insurance prices are cost prohibitive or insurance coverage is not available. Self insurance is the borrowers "planned assumption of risk instead of purchasing insurance."[8] Self insurance can be handled through a variety of ways, including setting up a LOC, adding a personal guarantor, adding a reserve account, or setting up a captive in their own company

Allowing the borrower the ability to self insure based solely on their financial capacity would not be prudent. The borrower should provide a structured program that incorporates the following three elements:

1. Actuarial Review — there needs to be evidence that an actuarial review was completed to ascertain the amount of funding necessary into an account to handle future losses. An actuarial review will consist of an independent analysis and statistical calculation of the funding amounts needed to self insure.

8 As defined by Rupp's Insurance & Risk Management Glossary, 2nd Edition.

2. Casualty Account — there needs to be evidence that an account is set up solely for the purpose of paying claims for losses at or on the property. This account can not be commingled and withdraws can only be for losses.
3. Claims Adjustment – there needs to be evidence that losses are settled by a knowledgeable claims adjuster.

There are third party independent companies that specialize in setting up and managing self insurance captives, which is preferable to a borrower managed self insurance structure.

D. Rating Agency Viewpoint

The rating agencies in commercial real estate mortgage have also been monitoring the issues that servicers face during volatile market conditions and the due diligence process that should be followed in dealing with issues that may arise.

In the event that commercial mortgage servicers can not force place insurance due to restrictions on their force placed policy, the rating agencies expressed that this would necessitate a transfer event, or at a minimum, consultation with the special servicer and/or the CCR advisor. From the perspective of insurance coverage being cost prohibitive, again it is suggested that servicers should consult with the special servicer and/or the Controlling Class Representative (CCR) advisor, and perhaps handle the situation the same as recoverability. Servicers are expected to use their best judgment in protecting the interests of all the investors, and must find insurance coverage for all properties even if it means going outside of their force placed policy.

However, in the instance that the situation affected a large portion or the entire deal, suddenly the risk would go beyond the CCR advisor to incorporate potential risk to the investment grade investors (AAA, AA, A or BBB securities). In this type of scenario the rating agencies, and perhaps even the issuer, would need to be involved. Should any situation reach this magnitude, the servicer should seek additional guidance and should not be completely burdened with the responsibility of making any determination of next steps. The industry should continue discussions on how this type of situation might get handled.

The rating agencies recognize that in volatile market times borrowers look for creative ways to meet the insurance requirements of their loan documents and may look outside of the traditional insurance mechanisms. Borrowers may suggest other options, like self insurance to meet their insurance requirements. The rating agencies expressed that most conduit loans do not have the financial strength to self insure, but that it might be a viable option for some of the larger, investment grade assets. For self insurance to be considered, the rating agencies explained that the borrower must present a solid, structured program that, at a minimum, consisted of: an actuarial review for funding, a secure account to house the funds to be used only for losses, and some type of claims adjustment expertise. Likewise, this type of option would need to be discussed with, and approved by, the special servicer.

As far as force placing triggering default under the loan and PSA documents, the rating agencies expressed that force placing alone will most likely not trigger a default, but it does cause them to look at other underlying issues that may have lead to the force placement. Having force placed insurance coverage does not necessarily indicate that the borrower has weak credit. However, the due diligence review would include understanding why the insurance was force placed, the monetary impact on the property (change in DSCR or LTV), if it is a long term or a short term issue, the diversified holdings of the borrower and the associated risks. As a note, a loan with force placed insurance may trigger a requirement to place the loan on the Watchlist, which is a technical default. In some instances, a rating agency could decide to inhibit upgrades or may contribute to downgrades, but it would not be the sole factor upon which they would base their decision.

VI. Conclusions

It is important for lenders and servicers to understand the force placed insurance product and how it can help them protect their security interest in a property. Force placed insurance provides a remedy for a potential borrower breach or nonperformance of the loan documents or servicing agreement. Lenders and servicers should work closely with their insurance agent in developing a force placed program that provides them with the necessary insurance coverages needed to protect the property. Policies and procedures, communication and education help the real estate finance industry effectively utilize and understand these insurance policies, their structure and how they work.

Due diligence is necessary to make sure that all of the proper steps have been taken before placing a property on the force placed program. There are several tools that the lender or servicer can use to make sure that they are consistent in their decisions on when to force place, or when to take other actions, as deemed necessary. On going monitoring is critical to ensure that the program is being used effectively for its intended purposes. Lastly, this insurance coverage, like all other insurance coverages, can be affected by external forces. During these times, lenders and servicers must also battle drastic market fluctuations, including rate increases and a potential lack of availability.

Armed with the best information, an outlined process and insurance knowledge, lenders and servicers will be best equipped to safeguard the interest of all parties concerned by protecting the property.

Exhibit A: Servicer Minimum Insurance Requirements: Windstorm Chart

State:	**Coastal Wind and Hail Zone Within the State:**
Alabama	Baldwin and Mobile counties
Florida	Entire State
Georgia	Brantley, Bryan, Camden, Charlton, Chatham, Effingham, Glynn, Liberty, Long, McIntosh and Wayne counties
Hawaii	Entire State
Louisiana	Parishes of: Acadia, Ascension, Assumption, Calcasieu, Cameron, East Baton Rouge, Iberia, Iberville, Jefferson, Jefferson Davis, Lafayette, Lafourche, Livingston, Orleans, Plaquemines, Pointe Coupee, St. Bernard, St. Charles, St. Helena, St. James, St. John the Baptist, St. Martin, St. Mary, St. Tammany, Tangipahoa, Terrebonne, Vermilion, Washington, West Baton Rouge and West Feliciana
Mississippi	George, Hancock, Harrison, Jackson, Pearl River and Stone counties
North Carolina	Beaufort, Bertie, Brunswick, Camden, Carteret, Chowan, Craven, Currituck, Dare, Hyde, Jones, New Hanover, Onslow, Pamlico, Pasquotank, Pender, Perquimans, Tyrrell and Washington counties
South Carolina	Beaufort, Berkeley, Charleston, Colleton, Dorchester, Georgetown, Horry and Jasper counties
Texas	Aransas, Bee, Brazoria, Brooks, Calhoun, Cameron, Chambers, Fort Bend, Galveston, Goliad, Hardin, Harris, Hidalgo, Jackson, Jefferson, Jim Wells, Kennedy, Kleberg, Liberty, Live Oak, Matagorda, Nueces, Orange, Refugio, San Patricio, Victoria, Wharton and Willacy counties
Virginia	Accomack, Charles City, Gloucester, Isle of Wight, James City, Lancaster, Mathews, Middlesex, New Kent, Northampton, Northumberland, Prince George, Southampton, Surry, Sussex, York counties and the following independent cities: Chesapeake, Hampton, Newport News, Poquoson, Portsmouth, Suffolk, Virginia Beach and Williamsburg counties
Territories	Puerto Rico, U.S. Virgin Islands, Guam, American Samoa and Saipan

Exhibit B: Servicer Minimum Insurance Requirements: Earthquake Chart

State	High Hazard		Moderate Hazard			
Alaska	All Counties					
Arkansas	Clay		Arkansas	Lawrence	White	
	Crittendon		Chicot	Lincoln	Woodruff	
	Cross		Craighead	Lonoke		
	Jackson		Desha	Monroe		
	Lee		Drew	Praire		
	Mississippi		Grant	Pulaski		
	Phillips		Greene	Randolph		
	Poinsett		Independence	Saline		
	St. Francis		Jefferson	VanBuren		
California	All Counties					
Hawaii	All Counties					
Illinois	Alexander		Bond	Franklin	Marion	Shelby
	Jackson		Clay	Gallatin	Monroe	St. Clair
	Johnson		Crawford	Hardin	Montgomery	Wabash
	Pulaski		Cumberland	Jasper	Washington	Perry
	Union		Effingham	Lawrence	Randolph	Wayne
	Williamson		Fayette	Madison	Saline	White
Kentucky	Ballard		Bullitt	Carroll	Hancock	McLean
	Fulton		Butler	Crittendon	Hardin	Ohio
	Hickman		Calloway	Davies	Henderson	Union
	Livingston		Campbell	Graves	Hopkins	Webster
	McCracken		Carlisle	Greenup	Marshall	
Mississippi	DeSoto		Tallahatchie	Bolivar	Holmes	Panola
	Tunica		Humphreys	Carroll	Quitman	Tate
			Washington	Coahoma	Issaguena	Sharkey
			Grenada	Leflore	Sunflower	Yazoo
Missouri	Bollinger	Pemiscot	Callaway	St. Clair	Cape Girardeau	
	Butler	Ripley	Jefferson	Warren	Marion	
	Dunklin	Scott	St. Genevie	Clark	St. Charles	
	Mississippi	Stoddard	St. Louis	Franklin	Pike	
	New Madrid		St. Louis City	Perry	Wayne	
Nevada			Carson City	Mineral	Washoe	
Ohio			Allen	Darke	Mercer	Shelby
Oregon			Auglaize	Hardin	Van Wert	Linn
			Champaign	Logan	Putnam	
			Clackamas	Marion	Multnomah	
			Washington	Polk	Miami	
Tennessee	Dyer	Obion	Carroll	Crockett	Fayette	Henry
	Gibson	Shelby	Hardin	Haywood	Henderson	Madison
	Lake	Tipton	Weakley			
	Lauderdale					
South Carolina			Beaufort	Charleston	Georgetown	Jasper
			Berkeley	Colleton	Hampton	
Utah			Box Elder	Salt Lake	Weber	Davis
Washington	Clallam	Lewis				
	Clark	Mason				
	Cowlitz	Pacific				
	Grays Harbor	Pierce				
	Island	San Juan				
	Jefferson	Skagit				
	King	Snohomish				
	Kitsap	Thurston				
	Kittias	Whatcom				

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