The Weekly Walk of Shame: Even More Banking Scumminess

By Matt Koppenheffer | More Articles November 11, 2010 | Comments (14)

This Motley Fool series examines things that just aren't right in the world of finance and investing. Here's what's got us riled up this week. If something's bugging you, too, go ahead and unload in the comments section below.

Today's subject I'll admit it, though I keep an eye on the banking industry, I don't have copies of *American Banker* as part of my bathroom reading. But an article from that source has stirred up a bit of a brouhaha in a dark corner of the banking business.

Because a house is collateral behind any mortgage loan, banks have good reason to want to keep that collateral in good shape. As a result, most mortgages require that homeowners keep the house insured. "Force-placed" or "client-placed" homeowners insurance is insurance that a bank or servicer puts in place when a voluntary policy through State Farm, **Allstate** (NYSE: ALL), or another traditional home insurer lapses. As any mortgage-loan investor would tell you, this force-placed insurance is essential because if an insurance policy lapses and, say, a hurricane levels the house, the creditor is, for lack of a better word, screwed.

But according to *American Banker*, the business may have developed a pretty ugly underbelly.

As we've become all too aware, the mortgage lending business isn't what it used to be, and part of that means that loans are packaged up and sold off to investors. As part of this, the loans are looked after by servicers -- a group that includes **Bank of America** (NYSE: BAC), **JPMorgan Chase** (NYSE: JPM), **Wells Fargo** (NYSE: WFC), **Citigroup** (NYSE: C), and **Goldman Sachs** (NYSE: GS),

as well as private companies like OneWest Bank and Select Portfolio Servicing. It seems as if these servicers may have gotten a little too chummy with force-placed insurers -- which include **Assurant** (NYSE: AIZ) and QBE Insurance -- and that's allowed both sides to snag profits while sticking it to homeowners and mortgage-loan investors.

Why you should be indignant So here's what *American Banker* says is going on. The servicers are letting the insurers come in on these accounts with lapsed insurance and charge outrageous prices that a homeowner would never pay if buying the insurance voluntarily. Why would the servicers do this? For one, they're not the ones paying the insurance. If the homeowner is still around, they're going to have to shoulder this burden. If not, the mortgage-loan investors will have to eat the cost of the insurance, which typically gets settled *first* when a foreclosed house is sold.

Better still, most of the time the servicer is getting a commission (kickback?) from the insurer for giving it the business. In other cases the loan servicer may actually reinsure the force-placed insurance. This means that the servicer takes on some of the risk and pockets some of the profits from the insurance contract. That may be an even bigger problem than the kickbacks because when you're a servicer that has no stake in the property except the fees that you collect, you've got a heck of a lot less incentive to file claims when the money from those claims could come out of your pocket.

Don't worry, if your head is spinning, that's to be expected. If *American Banker*'s claims represent widespread industry practices, this could be a serious mess. And exactly how bad has it gotten? From the *American Banker* article:

... EverBank Financial Corp's servicing arm had allegedly allowed a borrower's $4,000 escrowed insurance to lapse in error and then replaced it with a policy costing more than $33,000. In response to written questions, a subsidiary of Assurant, one of the country's biggest specialty insurers, revealed that it hadn't

kept all the money that EverBank's servicing operation had paid it. Instead it immediately paid EverInsurance, the servicer's subsidiary, a $7,100 "commission" and left the door open to further compensation.
If that sounds insane, consider further that the $7,100 "commission" absolutely dwarfs the $51 that servicers typically earned per loan in 2009. Obviously, this is most likely one of the worst cases out there, but multiply out many cases where the shady conduct wasn't nearly as egregious and you've still got big profits for both sides.

What now? After watching its stock drop as much as 17% yesterday, Assurant was quick to set up a conference call to try and quell the outrage. Not only would continued concern over this issue likely impact Assurant's stock, but if lawmakers and regulators start getting riled up it could be a very big deal for the company. *American Banker* noted that $811 million of Assurant's $879 million in total profits over the past two years came from the force-placed insurance business.

I can't say that the conference call was terribly convincing. Much of the time the CEO hid behind current rules and regulations, saying that the company is in compliance. While this may suggest that the company hasn't done anything *legally* wrong, it may mean that regulations are not what they should be and that it's high time for lawmakers to tighten the screws.

He also cited the fact that there are significant risks facing the properties that they are insuring, including catastrophe risks from storms on their covered properties in Florida. This seems to miss the point completely. Of course there are risks; that's not the question. The question is whether the transaction with the servicer is at arm's length and if the insurance is being competitively priced. I've never taken a single actuarial course, but I'm pretty darn sure that if my customers are price insensitive, I can make a tidy profit selling insurance.

But while Assurant would certainly be hard hit if misconduct on a broad scale is

uncovered, it's important to keep in mind that -- as noted above -- there are a lot of players involved in this mess. Bank of America, for example, has its own captive force-placed insurance business, which may have even more trouble passing the smell test.

In the end, the *American Banker* article *seems* to have hit on some pretty disgusting practices, but now the onus is on regulators to pick up the thread and see if it actually leads anywhere.

As for me? I need some Pepto-Bismol.

The reputation of the financial services industry has been pretty tarnished over the past few years, but there may still be companies that have kept themselves clean. Better still, my fellow Fools think that three companies in particular are ready to profit from the resurgence of individual investors. To see this free report, click here *and enter your email address.*