SCOTSMAN GUIDE

The Price is Right — Is the Policy?

Find out how to avoid the pitfalls of E&O and fidelity insurance

By **Lee Brodsky,** president of Mortgage Banking Insurance Group, JMB Insurance

On the surface, the news seems good. The insurance market continues to be in a "soft" mode. That means there is plenty of capacity, and insurance rates for mortgage brokers and bankers throughout the industry are stable or somewhat decreasing. But just because rates are low doesn't mean you should drop your guard.

Many insurance pitfalls exist. Consider that insurance carriers are trying to increase cash flow, expanding into loan-origination coverage as a new area and offering hard-to-refuse rates. Insurance, however, is cyclical. When rates increase, these same carriers might exit the mortgage-broker-insurance market. If you've filed a claim, you now have a mark on your record — and you're looking for a new carrier at a time when rates are going up. In other words, your thriftiness today could be costly down the road.

Here are ways to sidestep that and other major traps as you find an insurance broker, choose a carrier and purchase fidelity/employee dishonesty coverage, mortgagees' errors-and-omissions insurance (E&O) and professional-liability insurance. We'll take a closer look at how to compare quotes, determine limits and meet requirements of warehouse lenders and government-sponsored entities (GSE).

For more than 30 years, **Lee Brodsky** has specialized in operational insurance for the mortgage-banking and financial-services industry. In May 2004, Brodsky established the Mortgage Banking Insurance Group at JMB Insurance. As an independent brokerage with no ties to specific carriers, his group helps mortgage bankers and brokers procure operational insurance that meets client goals and satisfies investor requirements. Visit www.mortgagebankinginsurance.com, e-mail lbrodsky@jmbins.com or call (312) 915-2383.

Visit a specialist

Several factors help determine your limits and insurance requirements. These factors include warehouse-lender and GSE requirements, trends, the loans you originate and service, policy language and more. Without an insurance broker who understands the details of mortgage origination, you could end up underinsured or with the wrong insurance.

A specialist also will know how to work with carriers to get coverage that meets your risk-management needs and complies to requirements. For example, because the mortgage-broker/banker-insurance market is small, carriers can try to sell "standard" forms, such as a Finance Company Blanket Bond. Without a knowledgeable broker and proper amendments, though, this form won't comply with warehouse-lender or GSE requirements.

In addition, some carriers only do business with an insurance broker or firm that is writing with them above a certain premium volume. A generalist insurance broker might have a limited ability to seek quotes. A specialist focused on mortgage-broker-related insurance usually will have more options.

Choose the right carrier

The best way to avoid carriers jumping out of the market is to find one with a stable track record. Rather than picking a new carrier based on rates alone, choose one with a solid history and experience in mortgage-related insurance.

When in doubt, ask your insurance broker to help select a carrier with a high rating. Ratings, as determined by AM Best Co., assess an insurer's financial strength and ability to meet ongoing obligations to policyholders. Most warehouse lenders and GSEs require a carrier rated A-minus or better.

Go beyond fidelity rules

Many people think fidelity covers any type of dishonesty. Actually, fidelity/employee dishonesty can be defined in a policy to be "improper personal, financial gain by an employee with the intent of causing a loss to the employer."

If left as is, this definition exposes you to uncovered losses. For example, if employees didn't intend to cause the loss to the employer because they were temporarily borrowing funds, it might not be covered. Another scenario occurs when an employee steals money and gives it to someone else; this case doesn't meet the definition because the employee didn't profit personally. To protect your firm, your broker should ask for a "Robin Hood" clause and several other additions.

When setting policy limits, meeting lender or GSE requirements should not be the only determinant. For example, warehouse lenders that follow Fannie Mae's requirements in setting their own coverage amounts determine the limit solely on servicing volume and do not consider originations. Most mortgage brokers do not service loans, so you could be underinsured even when you meet the requirement. Experience shows there's a much greater risk of dishonesty in the origination process. Therefore, it's important to go beyond the requirements and determine your firm's risk-management needs. An experienced broker will advise you.

In addition, be sure to consider the

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type of loans in your portfolio and the risks inherent in that type of business. For example, nonprime loans are a greater risk than conventional residential loans. High loan-to-value loans as well as interest-only loans also are riskier. If your portfolio is weighed heavily in these areas, you might want to increase your limits and ensure that you are not underinsured.

When considering requirements, note that standard fidelity bonds don't extend to your firm's partners or owners. The reason is that if you're an owner who's stealing from your own business, there's no reason to reimburse you for the money you stole from yourself. Some requirements, however, mandate that you carry fidelity coverage to protect from "theft of investor's money or collateral by owner, principal, major shareholder or partner." When comparing coverage plans, be sure this investor-required protection is included. Keep in mind, too, that each warehouse lender could have unique requirements. You must comply in all areas in which you do business.

Ensure enough E&O coverage

While you're probably not servicing loans, you still might need mortgagees' E&O for your exposure during the short-term origination and warehousing period. E&O covers your mortgagee interest plus your liability to mortgagors and investors, in case you make errors that leave their property underinsured, uninsured or with unpaid taxes.

When comparing policies, make sure the coverage doesn't limit its scope. Residential lenders must have fire coverage, flood coverage and extended-coverage perils, plus liability and more. Additionally, commercial lenders should extend their coverage to include business interruption, loss of rent and more. Warehouse lenders and GSEs usually require this coverage.

Once again, these market requirements shouldn't be the only determining factor when you set your coverage limits. Look at your business. What kinds of loans do you handle? What's your largest loan? Where are properties located? Could one natural disaster affect multiple properties? If you only rely on lender or GSE requirements, your limit may be too low. Again, a specialist can help you with this decision.

Go for both E&Os

Many people think that if they have required mortgagees' E&O coverage, they already have professional-liability coverage. This is not the case.

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Mortgagees' E&O covers specific losses.These can stem from failing to obtain or maintain the following: specific types of insurance, flood-zone certification, private mortgage insurance and Federal Housing Administration Insurance or a Veterans Administration guaranty — as well as failing to pay real estate taxes. A professional-liability policy is written broader. Think of it as business-malpractice insurance that protects you from lawsuits that may arise from professional services you render as a mortgage broker or banker. Common suits addressed by professional-liability policies can include bait-and-switch loan offerings, ARM or interest miscalculations and failure to provide proper disclosures under the Truth in Lending Act and Real Estate Settlement Procedures Act.

Generally, professional liability covers a variety of errors, negligent acts and omissions for which you are legally liable when you conduct professional services as a mortgage broker or banker. Carriers then add their own exclusions. In some cases, as in loan repurchases, they'll take the coverage away but may allow you to add it back for a lower limit by charging you an additional premium. Read the fine print, particularly the exclusions. Or get your insurance broker to compare exclusions and the cost to include them. Keep in mind that if the carrier wants to exclude a risk, it is likely designed to protect your firm's financial stability.

Also, check to see if policies are written on a "pay on behalf of" or on an indemnification basis. "Pay on behalf" means the carrier pays the claim directly, in addition to your deductible. Your out-of-pocket costs are limited. Indemnification, which is less desirable, means the carrier reimburses you after you've paid the claim. Suits can take years, so this difference can make a sizeable dent in your cash flow. Additionally, some policies are written on a "duty to defend" basis so the carrier takes on your defense in a lawsuit; beyond the deductible, you don't incur defense costs in a long legal battle.

Although most warehouse lenders and GSEs don't require professional liability insurance, a few lenders now require a minimal amount — $150,000 to $300,000. As in every other case, look beyond the requirements and beyond the premiums to determine the correct type and amount of coverage you should carry to protect your firm from an expensive loss.

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