



INSIGHT

LENDERS' FINANCE ARRANGEMENTS

Since the demise of the BBA/ABI Bank Agreement in 2012, we have seen a sharp increase in the number of requests for bespoke amendments to policies at the request of lenders. These are creating challenges for insurers and brokers, due to their complexity and nature of the requests. This article explains what is being requested by lenders and looks at the implications from both the insurers' and policyholders' point of view.

WHY DO LENDERS ASK FOR CHANGES TO BORROWERS' INSURANCE POLICIES?

When a property or business owner approaches a financial institution for finance or re-finance, the lender will often require a method to secure their interest in the individual property or business. Part of the finance agreement for the loan will include how the lender requires their interest to be secured in the borrower's insurances. They use this as a way of securitising their financial interest under the loan. The request from the lender usually takes the form of a letter which sets out various obligations and requirements including confirmation that the insurances are set up in line with

the facilities agreement. It is the facilities agreement which contains the detail about how the borrower's insurances should be arranged.

It's very unlikely that a standard insurance policy will comply, therefore, in order to receive the loan money the borrower's insurers have to make amendments to policy coverage.

WHAT ARE THE LENDERS ASKING FOR?

There are various methods for the lender to securitise their loan. Some are more invasive than others in terms of the structure and operation of the insurance policy.

NOTING OF INTEREST

This is the least invasive, and is a simple request for the lender's interest to be noted on the borrower's policy document. It achieves little for the lender as it has no specific legal effect. The lender does not become party to the insurance. This request is seen mainly in the domestic insurance market.

FIRST LOSS PAYEE/ ASSIGNMENT OF POLICY PROCEEDS

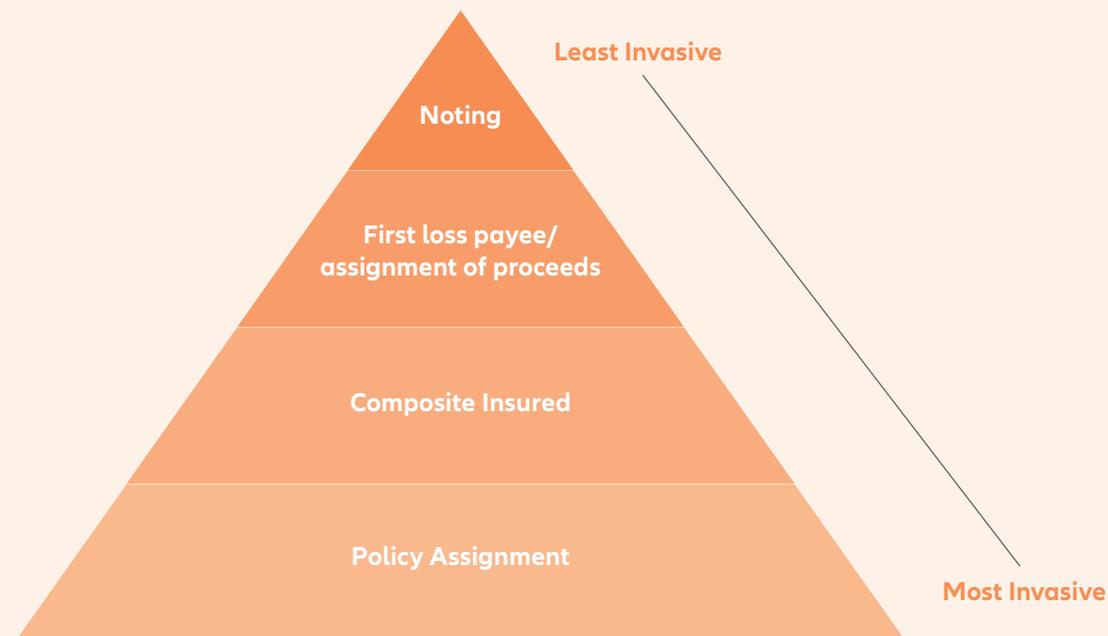
These designate a third party to accept insurance claims money rather than the insured, so before claims payments are made, the first loss payee/ assigned party must be consulted to establish who the money is to be paid to. There is often (but not always) a monetary limit included in order that small claims can be paid directly to the borrower without consultation.

This has implications for the insured as the claims money may be used to pay down the loan, rather than reinstate or repair following the loss. It also has



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MAIN METHOD OF PROTECTING THEIR SECURITY



implications for insurers as a business interruption claim may continue to run if claims money is not used to reinstate the business. It is worth noting though, that the first loss payee/assigned party has no rights under the policy to claim independently and the insurer retains all their rights under the policy (i.e. they can rely on the standard policy wording). This, however, weakens the lender's position under the policy, since if a borrower does not comply with policy conditions, the insurers may refuse to pay a claim. Lenders overcome this issue by asking for non-invalidation or non-vitiation clauses to be added to the policy.

NON-INVALIDATION / NON-VITIATION

These ensure the policy remains operative even if a borrower contravenes a condition of their insurance policy. This has significant implications for insurers as they can no longer rely on their policy terms, and may pay claims they would otherwise not have paid. It's not unusual to see requests for claims to be paid to the first loss payee/assigned party for wilful or criminal acts by the borrower.

POLICY ASSIGNMENT

This is the most invasive of the requested changes, and entails the policy, in its entirety, to be assigned to a third party. The insured retains no rights under the policy, but may still be responsible for the premium. It's possible for the insurance policy to be "sold on" with the loan. Most insurance policies contain a standard condition stating that the policy cannot be assigned to other parties, and it is very unusual for an insurer to agree to this request.

NB, the term "Policy Assignment" is often misused, when what is actually required is "Assignment of Policy Proceeds".

The implications for both borrowers and insurers are many and varied. An important question to consider is whether borrowers fully appreciate what they are asking their insurers to do to their insurance arrangements.

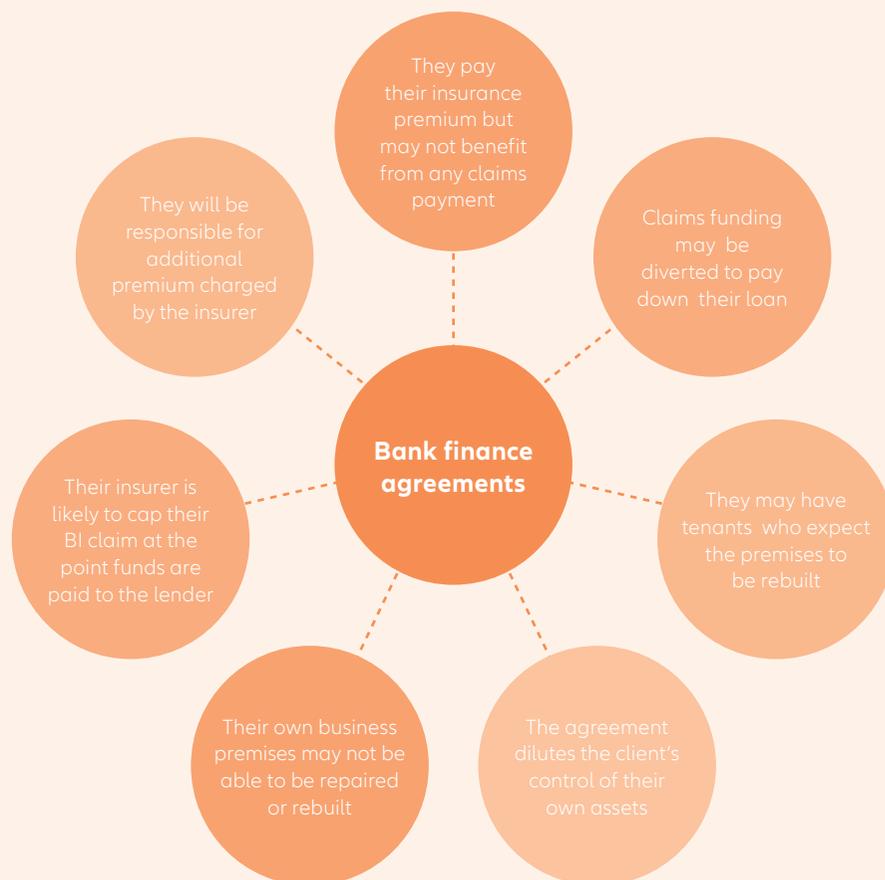
THE MARKET SITUATION

Undoubtedly some lender's letters have been signed by either brokers or insurers without a full understanding of the implications, but market understanding is now improving and this should be happening less frequently. Some insurers have formed expert teams which attempt to understand exactly what each lender's request is trying to achieve, and have taken legal counsel regarding the best way to respond. Insurers are attempting to charge some additional premium where appropriate and may try to limit their ongoing obligations due to concerns that they may not be able to comply.

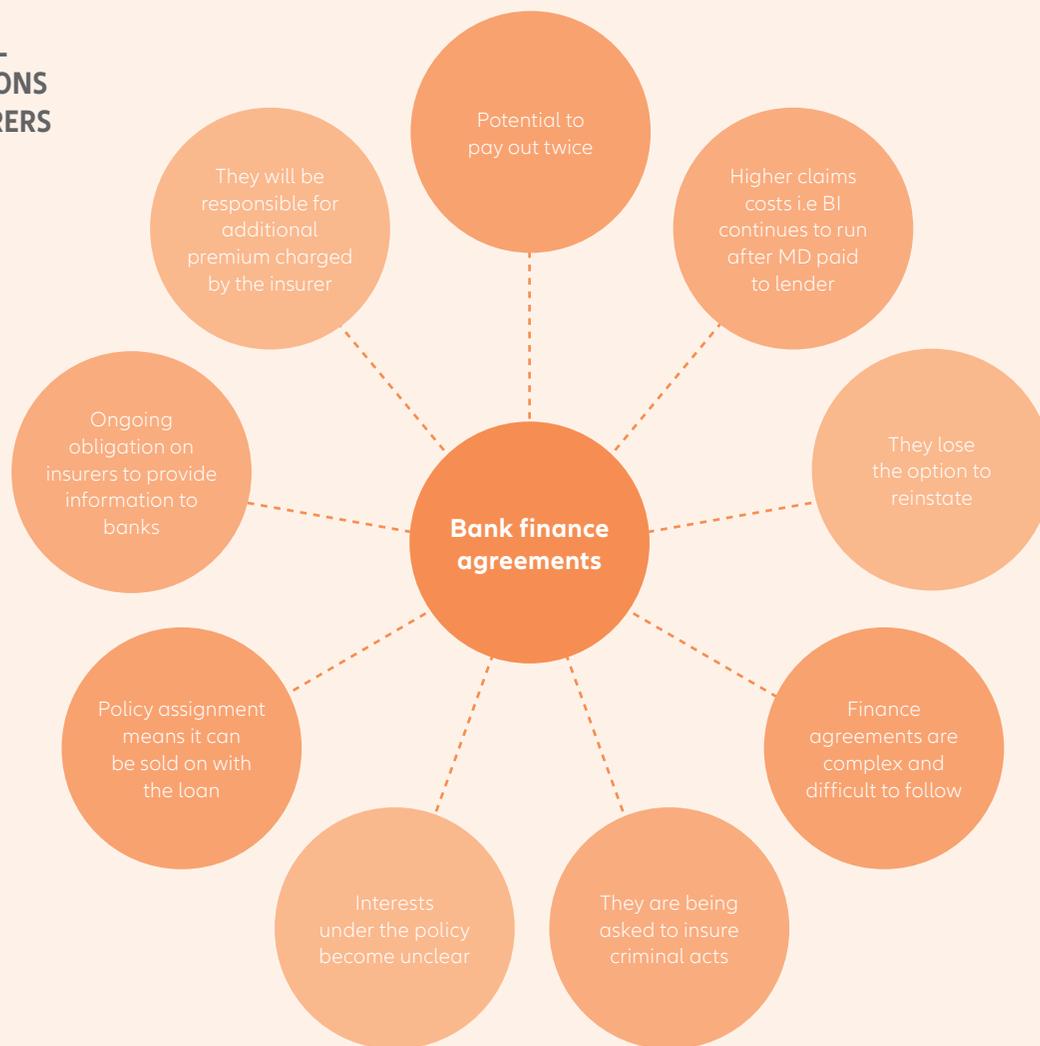
Many insurers have realised that there are some basic principles of their policy contract that they are not prepared to change or set aside; examples being the right to enforce reinstatement and the need for disclosure by the lender of any information that materially alters the risk. Insurers are also ensuring that they limit the possibility of paying out twice by stating that where payment is made to one party, it is deemed payment to all parties. Confidence is growing by insurers to suggest alternative wordings and there is some evidence to suggest lenders are becoming more flexible. The question of a borrower's understanding still remains a concern.

The ABI has been liaising with lenders and the Loan Markets Association to raise concerns regarding complex and varying requests and policyholders not understanding the implications of the changes to their policy.

POTENTIAL IMPLICATIONS FOR OUR CLIENTS



POTENTIAL IMPLICATIONS FOR INSURERS



WHAT'S NEXT?

Some brokers are pre-empting issues by ensuring their client's lenders are advised upfront of what their insurers will/won't accept.

However, there are still some questions worth considering:

- What happens when multiple lenders start to layer requests onto a single policy?
- Will the addition of lender's requests be remembered by brokers and clients at the point of a policy moving to a different insurer?
- Will the situation change if, in the event of a large claim where the money is diverted to the lender, media interest leads to negative publicity?

For now, the situation continues to evolve. Increased understanding in the market is vital to ensure all parties to the contract fully understand the implications and brokers give the best advice possible to their clients.

WHAT CAN BROKERS DO TO HELP?

- ✓ Ensure you and your colleagues are as well informed as possible
- ✓ Be able to hold an informed conversation with your client about what their lender may be asking them to do with their insurance covers
- ✓ Prepare your client for the fact that their insurer may not simply agree to all that is being asked for
- ✓ Do not sign the lender's letter! Your client's policy is unlikely to be compliant. The implications of wrong information sits with you
- ✓ Flag the complexity of the situation and ensure insurers are given as much notice as possible. Because all finance agreements are different, they have to be considered individually
- ✓ Explain that there may be an additional charge as the insurer is widening cover at their lender's request



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