



Lenders' finance arrangements

Since the demise of the British Bankers Association/Association of British Insurers 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 is 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 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

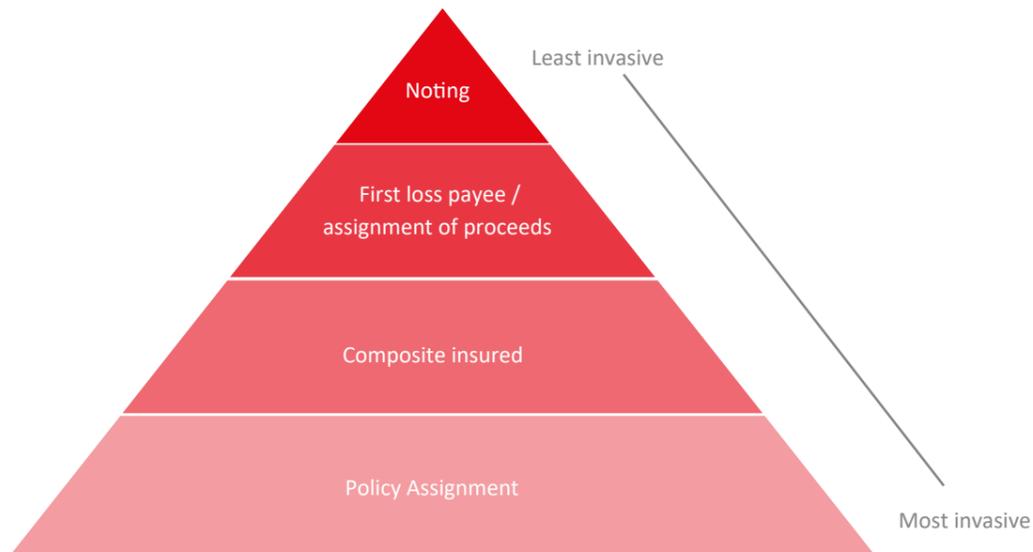
These designate a third party to accept insurance claims money rather than the insured, so before claims payments are made, the first loss payee/assigned party must be consulted to establish who the money is to be paid to. There is often (but not always) a monetary limit included in order that small claims can be paid direct 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 implications for insurers as a business interruption claim may continue to run if claims money is not used to reinstate the business.

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Main method of protecting their security



It is worth noting though, that the first loss payee/ assigned party have 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, as 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.

Composite Insured

The policy is divided into two, to cover both the borrower and the lender for their respective interests. This enables both parties to make an independent claim under the policy to the extent of their own loss, and in basic terms means that the insurer can pay out twice

from the same event. This does mean that the lender picks up the obligations under the policy, but, of the few they could ever contravene (duty of disclosure for example), they usually ask for these to be waived. This is a significant change to the policy structure and must not be underestimated.

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 is 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.

What's Next?

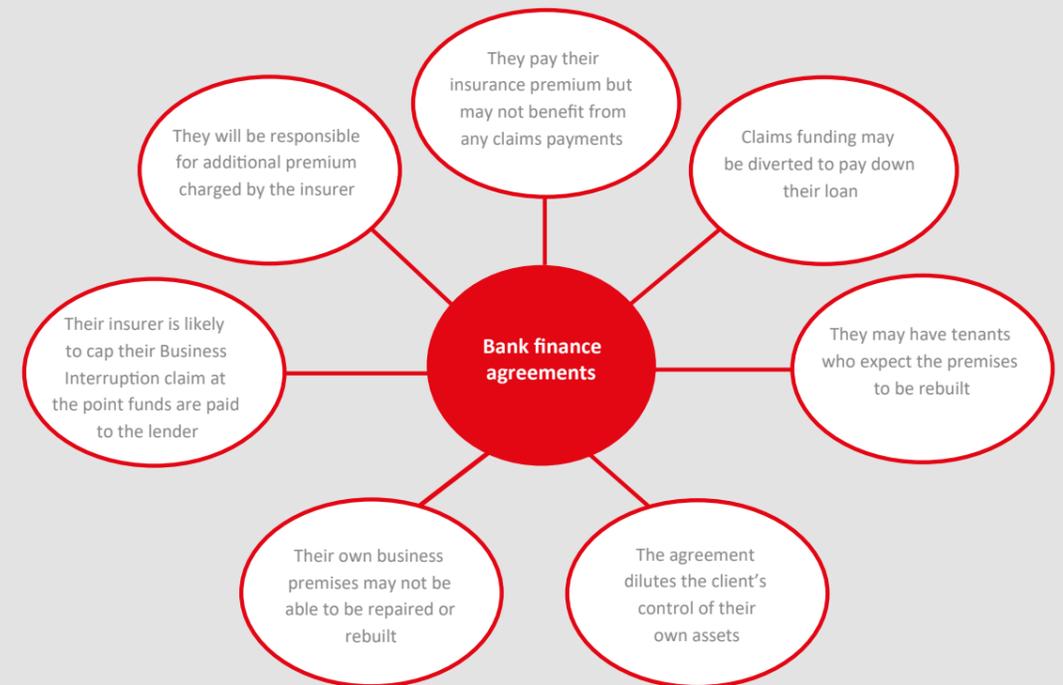
Some insurers are working with chosen lenders to agree wordings but it seems unlikely that a market wide approach will be re-established. Some brokers are pre-empting issues by ensuring their client's lenders are advised upfront of what their insurers will/won't accept. However, there are still some 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?



For more information please contact us.

Potential implications for our policy holders



Our real estate and property team have strong experience in negotiating terms with a variety of insurers and balancing the needs of the lender with those of the chosen insurer.

If you are faced with difficulty in resolving a lender request or feel you need some experience or expertise in this area, then we would welcome a discussion with you to find a suitable way forward.

**Please contact Greg Edwards in our Real Estate/Property team;
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