Comments of the Center for Economic Justice

Regarding Action Items in 2007 for the NAIC Title Insurance Working Group

February 16, 2007

The Center for Economic Justice (CEJ) submits the following comments regarding the activities of the Title Insurance Working Group (TIWG). Our comments are grouped into four categories.

1. In 2006, several industry-sponsored consultants commented on the Birnbaum Report on Competition in the California Title Insurance and Escrow Markets. Mr. Birnbaum was never afforded an opportunity to respond to those extensive comments. ***CEJ therefore requests that the attached responses, prepared by the California Insurance Commissioner in connection with his title insurance regulation, be included in the official record of the NAIC TIWG.***

2. The evidence is clear that market failures pervade title insurance and escrow markets and that reverse competition in these markets cause consumers to pay rates far in excess of the reasonable costs of providing those services. A market-based response to reverse competition is "lender pays" – a requirement that the lender pay for title insurance and escrow and be prohibited from passing along these costs separate from the interest rate charge for loan.

   "Lender pays" aligns the interests of consumers with lenders and creates a market dynamic in which lenders have an incentive and market power to discipline title insurers and escrow providers on price. "Lender pays" is typically not a solution available to states because lenders and mortgage lending are generally regulated by federal laws and federal regulatory agencies. Consequently, any effort by a state to require a lender to pay for title insurance and escrow services would likely be pre-empted by federal financial regulators. ***Since "lender pays" likely requires federal action to help states address state-based title insurance and escrow market failures, we recommend and request that the TIWG recommend to the Government Accountability Office (GAO) the "lender pays" solution for inclusion in the GAO's upcoming report on title insurance.***

3. Title agents and title insurers often attempt to justify their high prices by arguing that they are in the "loss prevention" business and that the high price of title insurance results from the activities required to assure clean title and avoid title insurance claims. There is, however, considerable and growing evidence that title agents and title insurers do little to avoid title losses and do not incur significant costs for "loss prevention." This evidence includes dramatically fluctuating loss provisions by title insurers and automated title underwriting and commitment. With automated title underwriting and commitment – including products like First American's TitleSmart and NextAce's TitleEDGE – the providers promise a title commitment within 60 seconds. There has been significant criticism by some within the title industry of the

underwriting and loss prevention practices – or absence thereof – of title insurers and agents. ***We ask that the TIWG investigate the underwriting, loss prevention and loss reserving practices of title agents and title insurers, with particular attention to automated underwriting and commitment, the reasonableness of title agent and title insurer expenses and to methods of loss reserving.***

4. As a preface to our detailed discussion of the above three items, we ask that the TIWG recognize that there are serious structural problems in title insurance and escrow markets, as evidenced by routine illegal rebates, affiliated business arrangements that provide no benefit to consumers but add unreasonable costs to the system, dramatically excessive price, reverse competition and market failures that prevent market forces from protecting title insurance and escrow consumers. We ask that the TIWG recognize that significant actions are necessary to change the current market dynamics of title insurance and escrow markets and to protect consumers from the damages of reverse competition. ***We ask that the TIWG consider and take the necessary significant actions and not confine itself to tinkering with existing NAIC models which have failed and will continue to fail to address the core market failures of title insurance and escrow markets. We ask that the TIWG "think outside the box" and consider alternative approaches to title, including the approach taken with a new product for auto title that consists of two items – a report on the auto title history and an insurance policy that the auto title history report is correct. The cost for this product is currently about $100 and it is unclear why this approach could not be used for real estate title.***

Response to Comments on the Birnbaum Report on Competition in California Title Insurance and Escrow Markets

Attached (as Appendix 1) please find responses to comments submitted – including a summary of the submitted comments – to the California Department of Insurance (CDI) by Gregory Vistnes, Bruce Strombom and Bruce Stangle, Nelson Lipshutz and Jared Hazleton regarding the Birnbaum Report on Competition in California Title Insurance Markets. These commenters also presented their views on the Birnbaum Report to the Title Insurance Working Group (TIWG) in 2006. Mr. Birnbaum has never had an opportunity to respond to the comments before the TIWG and CEJ requests that California Insurance Commissioner's response to the comments be included in the official NAIC record. The Commissioner disagreed with comments of Vistnes, Strombom and Stangel, Lipshutz and Hazleton and identified a number of factual errors in their analyses, which included analyses of title insurance markets outside of California as well as in California. The Commissioner concluded that California title insurance and escrow markets do not possess a reasonable degree of price competition.

Recommend a "Lender Pays" Solution to the GAO for Inclusion in its Upcoming Report

The Birnbaum Report and the California Insurance Commissioner's analysis and rejection of industry arguments regarding competition in title insurance markets confirms that title insurance markets are dysfunctional. Title insurance markets are characterized by reverse competition in which the sellers of title and escrow products compete by showering inducements on the real estate professionals – real estate agents, mortgage lenders, mortgage brokers, real estate attorneys and homebuilders – who are in a position to steer business to title agents and title insurers. There are dozens of examples of illegal rebates, including the captive reinsurance agreements in which almost half of the premium was directed to homebuilders by national title insurers as a kickback for referring business. There are also numerous examples of legal rebates that increase the cost of providing title insurance and the price of title insurance to consumers. The most glaring of these legal rebates take the form of affiliated business arrangements in which a title insurer sets up a title agency in joint ownership with a real estate agent or homebuilder, who receives the title insurance rebate in the form of profit from the affiliated business enterprise. Many of these are "sham" business arrangements, as evidenced by the recent enforcement actions in Colorado. But even those that are not "sham" arrangements, as described by HUD RESPA regulations, typically do not provide lower costs to consumers and add expenses to the title insurance system.

Title insurance markets are dysfunctional because the party with the market power – the real estate professional in the position to steer business – does not pay for the title insurance products or escrow services. Consequently, market forces demand that title agents and title insurers compete for the business of these referrers. Consumers who actually pay for title insurance are not in a position to discipline title agents and title insurers on prices because the consumers have little or no market power – they are in the market for title insurance infrequently, they have little ability to shop around for title and escrow services and the title and escrow services – while costly – are a small part of a much larger transaction. The problem is exacerbated by the fact that lenders typically determine what type of lender's title policy and endorsements are required – even though the lenders do not pay for the products they require. Given the reverse competitive market structure of title insurance and escrow markets, there is no market-based solution to protect consumers from excessive title insurance rates and escrow fees. Further, the market imperative to compete for the referrals of real estate professionals means that anti-rebate laws are ultimately ineffective at either stopping the rebates or controlling unreasonable expenses associated with reverse competition. In the absence of a market-based solution, rate regulation – as contained in the recent California regulation – is the only way to protect consumers from excessive title insurance rates and escrow prices.

There is, however, a market-based solution to the market failures of title insurance and escrow markets. The market-based solution must change the reverse-competitive dynamic of title insurance and escrow markets by aligning the interests of the referrers of business with the consumers who actually pay for title insurance and escrow services.

This solution has been proposed several times over the years and is known as "lender pays."

Under "lender pays," the mortgage lender is required to pay for title insurance and escrow and is prohibited from passing these costs on to the consumer as a separate charge. Rather, the lender must incorporate the costs of title insurance and escrow into the interest rate charge (including points). With this approach, the lender now has an incentive to seek the lowest cost title insurance and escrow services and to only purchase those title insurance policies and endorsements absolutely necessary from the lender's perspective. Since the lender is constantly in the market for title and escrow services, the lender is knowledgeable about the products, services and prices and is in a position to discipline title agents, escrow providers and title insurers on price. Under lender pays, there is no longer a rationale for affiliated business arrangements that do not lead to lower costs. The bottom line is that "lender pays" aligns the interests of lenders with those of consumers in terms of title insurance and escrow products and prices.

It should be noted that "lender pays" is predicated upon – and assumes – that mortgage markets are price-competitive and that lenders will be forced by price competition to pass along lower costs of title insurance and escrow to consumers. In fact, there are some parts of the mortgage market – the subprime market, for example – which may not be price-competitive and for which "lender pays" may not fully protect consumers. However, "lender pays" is clearly a market-based approach to addressing the current market failure of title insurance and escrow markets.

"Lender pays" is typically not a solution available to states because lenders and mortgage lending are generally regulated by federal laws and federal regulatory agencies. Consequently, any effort by a state to require a lender to pay for title insurance and escrow services would likely be pre-empted by federal financial regulators. ***Since "lender pays" likely requires federal action to help states address state-based title insurance and escrow market failures, we recommend and request that the TIWG recommend to the Government Accountability Office (GAO) the "lender pays" solution for inclusion in the GAO's upcoming report on title insurance.***

Investigate the Underwriting, Loss Prevention and Loss Reserving Practices of Title Agents and Title Insurers, with Particular Attention to Automated Underwriting and Commitment, the Reasonableness of Title Agent and Title Insurer Expenses and to Methods Of Loss Reserving.

Title insurers, title agents and their defenders typically justify the very low loss ratios for title insurance by claiming that title agents and title insurers are in the "loss prevention" business and that the high expenses of title agents and title insurers are directed at discovering and eliminating title problems and avoiding title claims. There is, however, considerable and growing evidence that title agents and title insurers do relatively little to prevent title losses and, consequently, this justification for high title insurance expenses is not justified.

Dramatically Fluctuating Title Loss Provisions

In its November 2, 2006 release discussing third quarter 2006 results, First American reported large increases in provisions for losses – an increase of almost 100% as a percentage of premium:

> *For the Title Insurance segment, the claims provision as a percentage of title insurance operating revenues was 8.8 percent for the current nine-month period and 4.5 percent for the same period of the prior year. This increase reflects the $155.0 million adjustment recorded in the second quarter 2006 to reflect adverse claims development (see discussion under Adjustments to Second Quarter Preliminary Financial Results below), as well as an increase in the loss provision rate to 5.5 percent in the third quarter 2006 from 5.0 percent in the same period of the prior year.*
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> *The company is adjusting preliminarily its second quarter 2006 financial results, which were released and furnished to the Securities and Exchange Commission on July 26, 2006, to reflect an increase in the provision for incurred but not reported (IBNR) reserves of $155.0 million . ... The increase in the IBNR reserve is due primarily to adverse claims development. . . .*
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> *The company provides for Title Insurance losses by a charge to expense when the related premium revenue is recognized. The amount charged to expense is generally determined by applying a rate (the loss provision rate) to total Title Insurance operating revenues. The company's management estimates the loss provision rate at the beginning of each year and reassesses the rate quarterly to ensure that the resulting IBNR reserve included in the company's consolidated balance sheets reflects management's best estimate of the total costs required to settle all IBNR claims.*

> *To estimate and reassess the loss provision rate and the resulting IBNR reserve, the company's management analyzes historical claims experience and considers current trends that impact future claims development but are not fully reflected in historical claims experience. To help analyze historical claims experience, the company uses an independent third-party actuary. The actuary provides to the company a report, generally twice a year, which identifies a range of reserve estimates for IBNR, as well as loss rates that reflect the total expected ultimate loss by policy year as a percentage of that year's title insurance operating revenues, based on the assumptions included in the actuarial models. The report prepared by the actuary is primarily historical claim payment patterns and incurred loss patterns. Therefore, the report principally projects expected future claims patterns or development based on historical claims frequency, severity and payment patterns. It does not fully reflect current trends that impact future claims development. These trends include, among others, changes in technology (primarily impacting title searching), changes in the average revenue generated per title policy issued, changes in the types of policies issued, changes in the types of real estate transactions, changes in the average life of a mortgage, and changes in the frequency of turnover of properties. The company's management analyzes and estimates the impact of current trends primarily by consulting with in-house claims and operations personnel, consulting with the independent third-party actuary and by applying its extensive knowledge of the title insurance business. The company's management combines the results of its analysis of the impact of current trends with the results obtained from the actuary to determine what it considers to be management's best estimate of the total costs required to settle all claims incurred but not reported to the company.*
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> *For the second quarter of 2006, the company increased its IBNR reserve by a total of $176.9 million (vs. $21.9 million originally reported in July 2006). The company has experienced adverse claim development this year, primarily for policy years 2000, 2001, 2002, 2003, 2004 and 2005. Given that recent actual claim experience has exceeded previous expectations of claim experience, management placed a greater weight on the estimated likely loss exposure determined by the independent actuary, which is based on historical claim payment patterns and incurred loss patterns, and less weight on the current trends (listed above) that are expected to impact future claims development, in establishing the IBNR reserve for the quarter ended June 30, 2006.*

In its October 25, 2006 release discussing third quarter 2006 results, LandAmerica announced it had increased its provisions for title losses by 51% from 5.3% to 8.0% of premium:

> *The claims provision as a percent of operating revenue for the Title Operations segment was 8.0% in third quarter 2006 compared to 5.3% in third quarter 2005 and 6.3% in the first nine months of 2006 compared to 5.3% in the first nine months of 2005. The increase in the claims provision ratio was primarily due to upward development in the 2001 through 2005 policy years.*

Given the argument that high title insurance expenses are a result of loss prevention activities by title agents and title insurers – careful search, analysis and underwriting of chain of title – it is unclear why title losses should fluctuate significantly from one period to the next and certainly why title loss provision should increase by 50% or 100% over a one year period. In fact, title losses should be declining over time as the title on more and more properties becomes perfected with additional sales and refinancing transactions on that property. A report by A. M. Best and the American Land Title Association describes this effect:

> *Although faster claims development might be one byproduct of a higher turnover rate, a property becomes a better title insurance risk the more it is bought and sold, because a property's title and tax records are searched each time it is sold. Frequent examination of a property's title records increases the odds of perfecting the property's title. The benefit, of course, comes from the fact that the new policy not only supersedes and effectively terminates the old policy but also generates new revenue. The term "perfecting" is the removal of any discovered potential defects in the title to real property prior to closing.*[1]

In addition, greater automation of title documents and title search should improve the ability to analyze and underwrite the title of real property.

The radical increases in title insurance loss provisions are inconsistent with the arguments and alleged practices of title insurers regarding expenses incurred for title search, examination and underwriting. In addition, the radical increases in title insurance loss provisions calls into question the reserving practices of title insurers and warrants new investigation by insurance regulators.

No Impact on Mortgage Fraud

During the real estate boom from 2000 to 2006, there was a similar boom in mortgage fraud. These increases in mortgage-related fraud recall the types of fraud experienced in the 1980's in the so-called savings and loan crisis. In both periods, title agents and title insurers appear to have had little effect on dampening this mortgage fraud and preventing increased title losses resulting from such fraud. Again, these results are inconsistent with the industry claim that its high expenses are directed at loss prevention activities.

[1] A.M. Best Special Report, *Title Industry Running on All Cylinders*, October 4, 2004, page 15.

Automated Underwriting and Title Commitment

In recent weeks, two organizations have announced automated title search, underwriting and commitment. In a January 16, 2007 release, First American announced TitleSmart – "a new technology that delivers title commitments in less than 60 seconds."[2] Vice President of Strategic Marketing for First American, Laura Roedel, is quoted in a new article:

> *Roedel said they have worked closely with First American's corporate underwriting group and performed an initial analysis test to examine actual risk. She agreed there is additional risk by bringing in automated sources of data, but First American found it to be acceptable. She said there are some obscure things such as ingress and egress to the property where it's difficult to find a data source that has that information.*[3]

In a February 7, 2007 release NextAce announced it was "expanding its automated title software and services offering, Title EDGE(R), to deliver full resale and long-form commitments. By automating the resale process, the consumer can benefit from a faster settlement, title insurers can deliver a faster and more consistent product while reducing their associated production costs, and lenders realize process improvement and faster application-to-close turn time."[4]

Some within the title insurance industry are concerned about the impact of automated title underwriting and commitments on the quality of the title loss prevention function:

> ***Diane Cipa****, general manager of The Closing Specialists in Pennsylvania, has been outspoken against automated technology such as TitleSmart. She said on her blog that "less than adequate search products, like TitleSmart, has a high likelihood of producing any number of title flaws that would hamper the ability of a mortgage lender to foreclose without delay or sell the property once it's acquired at sheriff sale."*
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> *Problems could arise from lack of access to and from a public roadway, mortgage lien placed on the wrong property, unpaid taxes or municipal liens, easements or restrictions that interfere with use of the property, mortgage instrument not signed by all vested owners, mortgage not in first position and an unresolved estate or bankruptcy or income tax or judgment issues. "*

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[2] See Appendix 2.
[3] "Title in 60 Seconds? First American Out to Prove It's Possible," *Title Insurance Report*, January 22, 2007.
[4] See Appendix 3.

> *I hope security analysts and A.M. Best are all considering the impact to the bottom line of the lenders who participate in TitleSmart and the increased risk FATIC is taking on," Cipa said. "I hope regulators are considering the increased reserves these companies might need to set aside to cover the increased risks they are assuming. God forbid this product becomes available for the unsuspecting purchaser, who does not set aside reserves and doesn't understand increased risk. Can a layman be expected to understand that the 'instant' title product even when backed by title insurance carries more risk than title insurance backed by a traditional full 'real' title search."*[5]

Ms. Cipa is so concerned about the impact of automated title search, examination, underwriting and commitment that she has started a petition to ask "the Board of Governors of the Federal Reserve to consider the economic impact of the degradation of quality underwriting standards and controls in the title insurance industry and the impact automated search and examination products will have on the integrity of land records." In the petition and in other posts on title insurance blogs, Ms. Cipa and others discuss the conflicts of interest in real estate transactions emanating from controlled business arrangements and other market structures.[6]

We would add that automated title commitments bring title insurance essentially into the same realm as credit reports and credit scores. Both involve the maintenance of a database, the production of reports from the database and the application of expert rules to that information in the report. Yet, while a credit report and credit score costs in the tens of dollars, the title abstract and title commitment cost in the hundreds or thousands of dollars. Again, this calls into question the reasonableness of the high expenses incurred by title agents and title insurers.

Given the issues described above, we ask that the TIWG investigate the underwriting, loss prevention and loss reserving practices of title agents and title insurers, with particular attention to automated underwriting and commitment, the reasonableness of title agent and title insurer expenses and to methods of loss reserving.

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[5] "NextAce Automates Title for Resales," *The Title Report*, February 9, 2007.
[6] See Appendix 4 for petition. See http://coalitionpetition.blogspot.com/ and http://radicaltitletalk.blogspot.com/ and http://title-opoly.squarespace.com/ for blogs discussing problems in the title insurance industry.

Think Outside the Box and Move Beyond Tinkering With Existing Models

We ask that the TIWG recognize that there are serious structural problems in title insurance and escrow markets, as evidenced by routine illegal rebates, affiliated business arrangements that provide no benefit to consumers but add unreasonable costs to the system, dramatically excessive price, reverse competition and market failures that prevent market forces from protecting title insurance and escrow consumers. We ask that the TIWG recognize that significant actions are necessary to change the current market dynamics of title insurance and escrow markets and to protect consumers from the damages of reverse competition. ***We ask that the TIWG consider and take the necessary significant actions and not confine itself to tinkering with existing NAIC models which have failed and will continue to fail to address the core market failures of title insurance and escrow markets. We ask that the TIWG "think outside the box" and consider alternative approaches to title, including "lender pays" and the approach taken with a new product for auto title.***

First American provides an auto title insurance product in combination with the credit bureau Experian. Experian provides a report of auto title for a fee and First American provides an insurance policy that guarantees the accuracy of the auto title information. The TitleGuard policy also provides coverage against losses due to title fraud, impersonation, forgery and prior theft. The cost of the two products are about $50 a piece or $100 in total.[7]

We ask that the TIWG examine the approach take with auto title insurance to determine if such an approach might be used with title insurance for real property.

[7] See Appendix 5 and https://www.autotitleguard.com/VTI/Secure/000-Home.asp.