

How Title Underwriters Protect Themselves Against Escrow Theft: A Review of 2017 Agency Appointment and Defalcation Prevention Study

Douglas A Powell | Senior Financial Analyst, Demotech, Inc.

Escrow Theft – What is it?

Escrow theft can be a serious problem for consumers, the Title insurance industry, and the broader real estate community. Title insurance agents play an important role in real estate transactions and are often entrusted with significant funds that are intended to be applied on behalf of the parties to the transaction. A major problem can arise when fiduciaries betray their obligations and embezzle the money entrusted to them.

Escrow theft was described by Joseph Petrelli in *Escrow Theft: Today's Challenge in Title Insurance* as follows. Parties to a real estate transaction often entrust Title agents or other settlement professionals with the transaction. Problems can arise when these professionals violate that trust and breach their duties. Most alarming is when this violation of trust comes in the form of escrow theft, which occurs when someone misappropriates funds held in a fiduciary capacity.

The most common form of escrow theft occurs when a settlement agent receives funds to apply to a real estate transaction, but rather than disbursing the funds properly, the agent misappropriates the funds for his or her own benefit. The agent may continue making payments to the previous lender, which keeps the loan current and covers the fraudulent activity for a time.

Escrow theft is a serious problem

for the Title insurance industry, not because of its frequency, but rather because of the egregious breach of trust, the amount of money lost, and the damage to the industry's reputation. This is of significant consequence for an industry that is already plagued by a negative public perception as well as limited appreciation for its role in facilitating real estate transfers.

2017 Agency Appointment and Defalcation Prevention Data Request

For more than 30 years, Demotech, Inc. has observed and reported on the impact of escrow theft on the Title industry. As part of its ongoing monitoring and review process, Demotech annually requires all Title underwriters assigned a Financial Stability Rating® to submit information pertaining to how they protect against defalcations and escrow theft.

Title underwriters provide information regarding their current reinsurance, agent review process, defalcation prevention procedures, and any mediation procedures. The information requested by Demotech consists of a questionnaire and detailed summary for each Title underwriter as well as any additional information or documentation they wish to provide. The information Demotech receives as part of this data request is confidential and will not be shared at an individual



underwriter level. The information contained in this study reflects the aggregate results of 34 regional underwriters as it applies to their agency appointment policies and defalcation prevention measures.

Summary of Results

Below is the summary of responses to Demotech's 2017 Agency Appointment and Defalcation Prevention Data Request. The results are as of June 30, 2017.

Agency Application Process – 30 underwriters indicated that they have a formal or distinct process for reviewing agencies.

Probability Review – 20 indicated they conduct a probability review of its agency base.

Verification of Licensing – 29 indicated they require an independent verification of an individual agent's license. 28 indicated they require an independent verification of an individual agency's license.

Committee Review of Appointment – 25 indicated they conduct a committee review of the potential agent.

Background and Credit Checks – 26 indicated they conduct a background check of potential agents. 21 indicated they conduct a Google search of potential agents, while 23 indicated they conduct a credit check of potential agents.

Agent Review – 15 indicated they conduct an agent review on a monthly basis. 31 indicated they conduct an agent review on an annual or bi-annual basis. 17 indicated they conduct agent reviews with a committee.

Bonds and E&O Coverage – 18 indicated they currently have a crime bond to protect policyholders in the event criminal activity (such as agent theft, computer fraud, forgery, burglary, etc.) is discovered. 22 indicated they currently have a fidelity bond to protect policyholders in the event fraudulent acts are discovered. 18 indicated they currently have a surety bond. 26 indicated they currently have Errors and Omissions coverage on agents to protect policyholders in the event errors or omissions are discovered.

Cyber Security Investigated – 21 indicated they have conducted an independent investigation of actual or potential cyber security risks within the last year.

Software Corporate Policy Issuance – 20 indicated they use proprietary software or third party software to monitor agency activity.

Escrow Review – 28 indicated they examine the agent's latest escrow reconciliation. 24 indicated they check the balance of escrow accounts at least quarterly.

Sample Transactions – 27 indicated they ask agents for a sample of their work, such as a commitment and a policy, and then complete an

independent review of the agent's work.

Mediation Procedures – 14 indicated they have a specific corporate policy on mediation procedures. 16 indicated they conduct mediation procedures with a committee.

Interpretation of Results

While not all Title underwriters have formalized and documented procedures and practices related to each of the various activities listed above, many of them have multiple procedures in place to monitor agencies and prevent defalcations. 88 percent of regional Title underwriters have a formal application process for vetting potential agencies to write business. Demotech would recommend that those regional Title underwriters that have not written a formal application process for agency reviews to do so. Regardless of the personal relationship an underwriter may have with a potential agent, it makes good business sense to conduct a thorough investigation into their background and credit history.

91 percent of regional Title underwriters conduct agent reviews on at least a bi-annual basis, 82 percent conduct a periodic reconciliation of escrow, and 59 percent conduct a probability review of their agency base. Demotech would recommend that those regional Title underwriters that have not conducted these reviews to do so as part of their Enterprise Risk Management process as they are viewed as important components for an underwriter to make informed decisions on its agency base.

Overall, the aggregate results of regional Title underwriters seem satisfactory. For the period July 1, 2016 to June 30, 2017, only one defalcation was discovered by a

regional Title underwriter. While no system may be completely effective in every instance, it seems the processes and procedures currently in place are mitigating defalcation activity. Keep in mind, this is not an indication that systems should remain stagnant or that processes and procedures should not be reviewed periodically and updated accordingly. In fact, robust enhancements are necessary to remain ahead of the curve.

For further context, this annual study of Agency Appointment and Defalcation Prevention information is a part of the overall monitoring Demotech conducts on each rated Title underwriter as a part of the Financial Stability Rating® process. Demotech reviews and evaluates quantitative and qualitative data. Regarding supplemental information, every entry, whether related to financial data (footnotes, etc.) in any quarterly financial statement, annual statement, reinsurance treaty, independent audit, examination report by a department of insurance, or business plan as well as information in the public domain or otherwise submitted, is reviewed and interpreted. The information submitted for this study has been reviewed in conjunction with other efforts that Demotech utilizes in its review process to garner an overall determination to the financial stability of each rated Title underwriter. 🌐

Douglas Powell supports the formulation and assignment of Financial Stability Ratings® by providing analysis of statutory financial statements and business information.

Email your questions or comments to dpowell@demotech.com.

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