

Defalcations: Today's Challenge in Title Insurance
And Our Thoughts On Addressing This Challenge

Prepared by:

Demotech, Inc.
2941 Donnylane Blvd.
Columbus, Ohio 43235

614 761-8602

www.demotech.com

2003

Defalcations: Today's Challenge in Title Insurance

Introduction to Title Insurance

We begin with what might strike many readers as Rudimentary. We include this information as background for some – those less familiar with the subject – and, for all, for purposes of clarity and consistency of terminology, in order that we may better frame the debate over how to solve one of the more vexing problems plaguing the field of title insurance.

“Insuring the title to land” is as succinct and precise a definition of title insurance as one might find. We can also state with precision that it was on March 28, 1876, Commonwealth Title wrote the first coverage, a loan policy. Since that time, the title insurance business has evolved into an industry with nearly ten billion dollars a year in direct written premium. This growth was fanned especially when a guaranteed title became a requirement as insurance companies began investing in mortgages and the sale of securities backed by real estate became popular.

A title insurance policy responds like this:

Subject to certain stated exclusions, exceptions, and conditions and stipulations, a title underwriter insures as of the date of the policy against loss or damage, not exceeding a stated limit of liability. Additionally, there may be costs, attorneys' fees and expenses that the title underwriter may become obligated to pay if these are insured by the insured for these reasons:

1. Title to the estate or interest in Schedule A being vested otherwise than as stated;
2. Any defect in or lien or encumbrance on such title;
3. Lack of a right of access to and from the land; or
4. Unmarketability of such title.

The exceptions to a title insurance policy are specific and known claims, liens or judgments against the parcel of real estate for which a title insurance policy is requested. The exceptions are set forth in Schedule B of the policy.

Prior to issuing a title insurance policy a title insurance company issues a “Commitment for Title Insurance,” also called a “binder”. The commitment binds the insurer to issue a title insurance policy subject to the requirements and exceptions set forth in the insurer's commitment.

The American Land Title Association (ALTA) has promulgated standard text for commitments. A typical issuing clause may read as follows:

The title underwriter commits to issue its policy or policies of title insurance ... in favor of the proposed named in Schedule A, as owner or mortgagee of the estate or interest covered in the land described or referred to in Schedule A, upon payment of the premium and charges therefore; all subject to provisions of Schedules A and B and to the Conditions and Stipulations hereof.

This Commitment shall be effective only when the identity of the proposed Insured and the amount of the policy or policies committed for have been inserted in Schedule A hereof by the Company, either at the time of the issuance of the commitment or by subsequent endorsement.

Coverage against hidden defects is a valuable additional impetus to secure title insurance rather than an alternative. Examples of hidden defects include forged will or deed, fraudulent representations, undisclosed heirs, invalid divorces, undiscovered wills, non-delivery of deeds, inadequate surveys, improperly probated wills, clerical errors, deeds executed under expired or false powers of attorneys and birth of an heir subsequent to date of a will.

The Influence of the Secondary Mortgage Marketplace

By providing an insured title to real property that is marketable in the event of foreclosure and guaranteed against all defects not enumerated in Schedule B, lender's title insurance has facilitated the development of the secondary mortgage market. Lenders are able to allocate resources to the purchase of mortgages on real estate located in areas of the country that may be outside the lender's operating area.

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) specifically require that a paid-up mortgage title insurance policy exist on each mortgage it purchases. The assurance of a marketable title is a dormant asset until the real property is conveyed to another. The owner/seller is protected from unexpected problems.

The Problem

The transfer of title is the culmination of the real property sales effort. This generally occurs at 'the closing'. Traditionally, the mortgage lenders required a closing protection letter from the title underwriter when an issuing agent prepared the property. Over time, the title underwriter's issuance of a closing protection letter has been expanded to include any closing processor, whether the closer is an issuing agent of the title underwriter or not.

Consumers tend to walk away from their closings thinking that everything is done and they now have a marketable title to their home. However, there are several duties subsequent to a real estate closing. For example, the lending institution must examine the title, public records must be updated, proceeds must be properly disbursed, and the final title policy must be issued.

Defalcations occur when the proper disbursement of proceeds is not accomplished. It's an archaic term used to describe the act of a person taking money that does not belong to them, an embezzlement, though it's generally applied to a misappropriation from a trust account.

Simply stated, defalcations are embezzlement by individuals who are serving as the closers of a real estate transaction. It is white-collar crime. Defalcation is as illegal as fraud, forgery, counterfeiting, purse snatching or any other variation of theft.

When funds associated with a closing are misappropriated, if a closing protection letter is in place, the title underwriter that issued the closing protection letter generally is responsible for properly financing the closing and generating the appropriate public information related to the public records and the title insurance policy. However, from a consumer's perspective there are gaps in coverage and protection that can exist.

The Underwriters' Perspective

The title insurance industry's approach to the defalcation issue is multi-faceted. Some title underwriters have required blanket fidelity policies on agents and employees. Other title underwriters require their agents to procure individual fidelity coverage before they can be appointed as agents. Background checks are commonplace, either as a title underwriter requirement or as a department of insurance agent licensing requirement.

All of the national and major regional title underwriters and most other title underwriters employ internal auditors or contract auditors to review the finances of their agents. These field audit efforts reconcile checking account information, premium remittances related to specific insurance policies, and closings that have been coordinated on behalf of the title underwriter. But they are expensive to coordinate and administer. They are beset by the underwriters' inability to audit all agents simultaneously and spontaneously, conditions which add to cost and, because they are scheduled in advance, warn and give lead-time to the dishonest and provide them with the time to cover their tracks.

And there is another issue, arising from the hard fact that audits, of their nature, are confrontational. An audit is designed to detect fraud or irregularities may be misconstrued as a lack of trust. As a result, agents may move business from a more restrictive title underwriter to a less restrictive title underwriter. In any competitive marketplace, historically honest and profitable producers with large books of business should be treated professionally and courteously.

The Regulatory Effort

All states and the District of Columbia have department of insurance or other regulatory agencies that license or otherwise authorize individuals to be title insurance agents. The state departments of insurance created the National Association of Insurance Commissioners (NAIC) to address the need to coordinate the regulation of multistate insurance companies. The NAIC provides a forum for the development of uniform procedures and practices when uniformity seems appropriate.

One of the NAIC's areas of support is the development of model laws. The model law applicable to defalcations is the Title Insurance Agent Model Act, Model #230. The latest published version of this model act was copyrighted by the NAIC in 1995, would provide:

- A licensing requirement (must be licensed to act as a title insurance agent).
- An examination requirement (the right to examine accounting records on demand).
- Fidelity coverage (similar to a bond for agents who handle escrow or securities funds).
- Required contractual language for contracts between underwriters and agents.
- Account conditions (conditions for providing escrow, closing, or security services; and maintaining escrow and security deposit accounts).
- Penalties for violating the law, which can range from monetary damages to revocation or suspension of the agent's license.

Can the NAIC Title Insurance Agent Model Law Impact Defalcations?

Demotech, Inc. analyzed the impact of this model law. We made assumptions regarding the statutory, statewide Schedule T loss ratios over the latest available five years – 1997 through 2001. Essentially we assumed that variations in Schedule T loss ratios from state to state were due to defalcations. Limitations in the readily available public information on the title industry preclude the verification of this assumption.

We acknowledge that there are rate adequacy assumptions implicit in our analysis. However, Demotech, Inc. believes that virtually all jurisdictions have laws or regulations that require a title insurance company to make an exhaustive search of the public record. Further, if the individuals making the search of the public record have expertise with the quality of public information in the county or counties that they operate in, then it is a reasonable assumption to believe that variations in loss experience from state to state will be based upon dynamic rather than static occurrences.

We reviewed the applicable statutes and public information related to the licensing of title insurance agents in each state and the District of Columbia. We then established our own internal scale to estimate the perceived degree of difficulty associated with becoming a licensed title insurance agent in that jurisdiction. The most rigorous jurisdictions were assigned a ten (10) on our internal scale and the least rigorous jurisdictions were assigned a one (1). The NAIC Model Act as regards title insurance agent licensing was assigned a seven (7). The results of our internal assignment process are presented as Exhibit 1. Our internal and admittedly arbitrary criteria for the internal assignment process are presented as Exhibit 2.

Conclusions and Recommendations

We consider the loss ratio of the states that adopted the NAIC Model Law, or a law that we perceive to be equivalent to the NAIC Model Law, as our base line. The five-year average loss ratio for this base line group was 4.49%. States that we assigned to a category with less restrictive licensing requirements had a higher loss ratio, 7.23%. States with an agent licensing law that we assigned to a category with a more restrictive licensing requirement had a lower loss ratio, 3.78%.

While we acknowledge the need for additional statistical information to segregate losses between true title losses and losses resulting from defalcation, we respectfully submit that the differences in loss ratio observed in this study could reasonably be assumed to be due to the emergence of defalcation losses. In other words, we attribute the savings associated with the most restrictive agent licensing, a loss ratio of 3.78%, below the average loss ratio of the grouping of NAIC Model Law states, to a reduction in defalcations. Similarly, we attribute the higher loss ratio in the less restrictive group, 7.23%, to additional defalcation exposure created by agent licensing standards below the requirements outlined in the NAIC Title Insurance Agent Model Act.

We acknowledge the need for additional information including more sophisticated analysis of loss ratios and operating experience. However, based on the preliminary analytical evidence, it seems to us that an integral component of a comprehensive solution to the defalcation problem should include the adoption of the NAIC Title Insurance Agent Model Act or an equivalent agent licensing requirement.

The defalcation problem occurs when the title insurance process is all but over and the closing, settlement or escrow process begins. The NAIC Title Insurance Agent Model Act addresses this critical area of the process. By instituting objective requirements and uniform licensing prerequisites on applicants, this NAIC Model Act institutes a level of discipline, professionalism and regulation at the initiation of the agent licensing process that the title insurance industry cannot impose subsequent to an agent receiving a license

If title underwriters want to avail themselves of this part of the solution, they should present each state legislature that has not adopted this model act or a similar act with a copy of NAIC Model Act #230 – The Title Insurance Agent Model Act.

Beyond this, in terms of financial reporting and data analysis, Demotech, Inc. believes that the NAIC should consider expanding the financial reporting requirements associated with Schedule P of the Form 9 to include an additional disclosure to identify and segregate defalcation losses vis a vis other title insurance losses.

In sum, tighter title insurance agency appointment and agency auditing standards and procedures in conjunction with the NAIC Title Insurance Agent Model Act would go a long way toward mitigating the risk and exposure associated with defalcations

Notes and Acknowledgements

The foregoing is solely the effort of Demotech, Inc. The opinions presented are Demotech, Inc.'s and our alone. They do not represent the opinions of our clients, service providers or any other title insurance underwriters, title insurance agents or regulators.

Demotech, Inc. is indebted to Angela M. Vitale, a senior at Capital University Law School, Columbus, Ohio, for her exceptional research, analysis and assistance in the preparation of this paper.

A GLOSSARY OF COMMON TITLE INSURANCE TERMS

ABSTRACT OF TITLE

A summarization of the title to land consisting of a synopsis of all recorded deeds, mortgages, liens, encumbrances and court proceedings which have affected the title to real estate. The abstract includes all liens, charges or liabilities to which the real estate may be subject.

ABSTRACT SEARCH

A title examination based upon an abstract of title rather than a review of public records.

AMERICAN LAND TITLE ASSOCIATION

ALTA is a national association of title insurance companies and title abstract organizations. As part of its function, ALTA promulgates standard policy forms.

APPROVED ABTRACTOR

An individual (layman, attorney, company, etc.) who has been deemed qualified to prepare complete, accurate abstracts of title and upon whose abstracts title company examiners and approved attorneys rely in determining the status of a title.

APPROVED ATTORNEY

An attorney who has been deemed qualified to examine and render an opinion on real estate titles and on whose opinion title policies may be issued.

BACK TITLE LETTER (also BACK TITLE CERTIFICATE)

A letter or certificate furnished to an attorney authorizing him to base his title opinion concerning a particular parcel of real estate on an examination of title beginning with a specific date or a specified deed. The back title letter (certificate) provides the status of the title as of the specific date or specified deed.

BINDER (also COMMITMENT)

An agreement that upon satisfaction of the requirements set forth in the binder the insurer will issue the specified title insurance policy subject only to the exceptions stated in the binder. The binder contains the title status on a particular date.

CLOSING (also SETTLEMENT)

The process by which parties to a real estate transaction agree to and conclude the details of a sale / mortgage including the execution of documents relating thereto and the distribution of the appropriate funds.

COLLATERAL

Marketable real or personal property that a borrower pledges as security for a loan. In mortgage situations, specific parcels of land usually constitute collateral.

DEED (also GENERAL WARRANTY)

A written conveyance of realty whereby title is transferred from one entity to another and in which the grantor obligates himself, his heirs, etc. to forever defend the grantee, his heirs, etc, against all lawful claims against the title.

DEED REFERENCE

The number of the book and page in the public deed records where a particular deed may be found.

DEFALCATION

The term is generally used to identify a misappropriation associated with a trust account.

DEFECT IN TITLE

A deficiency or impropriety in title to real estate.

EASEMENT

A privilege, right of use or enjoyment which one entity may have in the land of another.

EMINENT DOMAIN

The right of a government to take private property for public use. The owner of the private property must be compensated.

ENCUMBRANCE

Any right or interest in land held by other than the owner that may decrease the lands value. Examples include mortgage liens, tax liens, etc.

ESCHEAT

The transfer of title of property to the state if the owner dies intestate and without heirs.

ESCROW

Money, securities, funds, documents or other property deposited with a third party to be held by that third party (known as an escrow agent) until the happening of a future event. Upon the happening of the future event, the property deposited is delivered to the designated party.

ESTATE

The degree, quantity, nature and extent of interest that a person has in land.

EVIDENCE OF TITLE

Deed, abstract of title, attorneys opinion, title insurance, etc. A document that demonstrates the status or quality of a real estate title.

EXCLUSION

General matters affecting title to real property excluded from coverage of a title insurance policy.

FHA (also FEDERAL HOUSING ADMINISTRATION)

An agency of the federal government which insures private loans for financing of new and existing housing and for home repairs under government approved programs.

FEDERAL HOME MORTGAGE CORPORATION or FREDDIE MAC

A federally sponsored private corporation which provides a secondary market for housing mortgages.

FEDERAL NATIONAL MORTGAGE ASSOCIATION or FANNIE MAE

A federally sponsored private corporation which provides a secondary market for housing mortgages.

FEE SIMPLE

The highest estate one may have in real property. An absolute or fee simple estate is entitled to the entire property, with unconditional power of disposition during his life, and descending to his heirs and legal representatives upon his death intestate.

FORECLOSURE

The process through which a mortgager of real property is deprived of his interest in that property because of the mortgagor's failure to comply with the terms and conditions of the mortgage.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION or GINNIE MAE

A government association which provides a secondary market for housing mortgages and special assistance to mortgagee financing housing under special FHA mortgage insurance programs.

GOOD TITLE

Marketable or merchantable title. Such a title as a court of equity would adopt as a sufficient ground for compelling specific performance of a contract to purchase.

GRANTEE

Buyer of a real estate title

GRANTOR

Seller of a real estate title.

GUARANTY POLICY

A title insurance policy which insures against defects of title appearing in the public records. (Note: Title insurance policies insure against defects whether or not they appear in public records.)

HEIR

An entity that succeeds to an estate in lands, upon the death of his ancestor by descent and right of relationship.

TITLE PLANT

A compilation of records of transactions affecting particular parcels of real property. The information contained therein is otherwise available only from an examination of public records.

TORRENS SYSTEM

A governmental title registration system wherein title to land is evidenced by a certificate of title issued by a public official.

UNDISCLOSED DEFECTS

Imperfections in a title that cannot be determined by an examination of public records.

UNMARKETABLE TITLE

A title which cannot be sold for a fair market value because of defects or limitations.

WARRANTY

A promise by a grantor of real estate title, for himself and his heirs, to warrant and defend the title and possession of the estate granted, to the grantee and his heirs forever.

Exhibit 1 – Demotech's Internal Criteria for the Assessment of Title Insurance Agent Licensing Requirements

Group	1	2	3	4	5
Brief Description	No Direct Regulation Identified	Agency or Title Plant Regulated	Minimal Agent Regulation	Some Agent Regulation	Moderate Agent Regulation
Elements	<ul style="list-style-type: none"> No regulation identified 	<ul style="list-style-type: none"> Only a title agency is regulated or licensed or <ul style="list-style-type: none"> The title plant is regulated to insure accurate searches or <ul style="list-style-type: none"> Must be an attorney 	<ul style="list-style-type: none"> Licensing or certificate requirement 	<ul style="list-style-type: none"> Application Licensing requirement May have an examination (test) requirement 	<ul style="list-style-type: none"> Application Licensing requirement Account conditions or good reputation May have an examination (test) requirement
States	District of Columbia	Connecticut Washington	Alabama	Georgia Hawaii Missouri Oregon Wyoming	Illinois Minnesota Nevada New Hampshire Rhode Island West Virginia

Exhibit 1 – Demotech's Internal Criteria for the Assessment of Title Insurance Agent Licensing Requirements

Group	6	7	8	9	10
Brief Description	Less Regulation than NAIC Model Act	NAIC Title Insurance Agent Model Act or equivalent	NAIC Model Act and something more	NAIC Model Act and moderately more	NAIC Model Act and substantially more
Elements	<ul style="list-style-type: none"> • Application • Licensing Requirement • Good Reputation • Account Conditions • May have an examination (test) requirement 	<ul style="list-style-type: none"> • Application • Licensing requirement • Examination of books and records allowed • Required contractual language • Escrow and security deposit account conditions • Record retention policy • Penalties • May have an examination (test) requirement 	<ul style="list-style-type: none"> • All NAIC criteria • Evidence of good character through letters of recommendation • Examination (test) requirement • May have background check • May have pre-licensing requirements 	<ul style="list-style-type: none"> • All NAIC criteria • Letters of recommendation and character evidence • Examination (test) requirement • Bond • Pre-licensing course • Background check • Audits 	<ul style="list-style-type: none"> • All NAIC criteria • Letters of recommendation and character evidence • Examination (test) requirement • Bond • Strictest penalties • Pre-licensing course • Background check (including fingerprint analysis) • Continuing education • Yearly audits and surprise audits
States	Idaho Indiana Massachusetts North Carolina Vermont	Arizona Arkansas Delaware Florida Iowa Mississippi Oklahoma Ohio	California Colorado Kansas Kentucky Louisiana Maine Maryland Michigan Montana New York North Dakota Pennsylvania South Carolina Tennessee	New Jersey New Mexico South Dakota Texas Utah Virginia Wisconsin	Alaska Nebraska

Account conditions may include bonding, escrow account usage limitations, or required accounting practices.

These criteria have been generalized. There may be states that do not fall exactly within our groupings. An example would be a state that has a licensing requirement (Group 3) and a bond (Group 9). For example, if a state’s requirements include a bond, that state may not be assigned to Group 9, if, in our opinion, that state has none of the other elements required of Group 9 states.

Exhibit 2 - Five Year Schedule T Loss Ratios

Group based on Demotech's Agent Licensing Assignment	State	1997 - 2001 Direct Premium Earned	1997 - 2001 Direct Losses Incurred	Five Year Incurred Loss Ratio for Group
1	DC	\$ 66,270,464	\$ 5,992,001	
2	WA	\$ 933,249,026	\$ 56,661,828	
2	CT	\$ 429,510,227	\$ 19,812,411	
3	AL	\$ 212,510,531	\$ 20,050,176	
4	GA	\$ 580,504,337	\$ 44,383,019	
4	HI	\$ 174,812,762	\$ 16,150,062	
4	MO	\$ 184,541,411	\$ 30,881,129	
4	OR	\$ 765,159,172	\$ 25,244,440	
4	WY	\$ 65,962,472	\$ 1,549,550	
5	RI	\$ 62,986,084	\$ 3,317,342	
5	IL	\$ 748,774,892	\$ 95,358,507	
5	MN	\$ 328,336,535	\$ 23,600,390	
5	NH	\$ 109,338,390	\$ 6,330,736	
5	NV	\$ 438,561,929	\$ 28,195,921	
5	WV	\$ 43,957,207	\$ 1,762,547	
6	ID	\$ 291,330,556	\$ 14,341,662	
6	IN	\$ 336,610,441	\$ 16,050,769	
6	MA	\$ 677,962,422	\$ 41,538,150	
6	NC	\$ 327,850,810	\$ 38,906,141	
6	VT	\$ 31,640,565	\$ 2,246,403	
Groups 6 and lower		\$ 6,809,870,233	\$ 492,373,184	7.23%
7	AR	\$ 119,512,725	\$ 7,537,291	
7	AZ	\$ 1,163,948,426	\$ 43,254,579	
7	DE	\$ 70,749,675	\$ 2,670,484	
7	FL	\$ 3,599,180,605	\$ 174,431,937	
7	IA	\$ 4,051,038	\$ 400,902	
7	MS	\$ 104,666,411	\$ 7,259,199	
7	OH	\$ 1,068,080,425	\$ 38,311,498	
7	OK	\$ 131,970,429	\$ 5,312,047	
Group 7		\$ 6,262,159,733	\$ 279,177,937	4.46%
8	CA	\$ 6,864,777,131	\$ 312,077,098	
8	CO	\$ 1,213,836,185	\$ 38,964,963	
8	KS	\$ 137,657,505	\$ 4,725,112	
8	KY	\$ 155,991,374	\$ 4,024,185	
8	LA	\$ 249,403,110	\$ 12,552,914	
8	MD	\$ 549,312,760	\$ 29,837,433	
8	ME	\$ 93,366,135	\$ 5,395,770	
8	MI	\$ 1,287,281,727	\$ 53,930,313	
8	MT	\$ 149,127,596	\$ 7,221,818	
8	ND	\$ 15,440,699	\$ (63,706)	
8	NY	\$ 2,512,589,527	\$ 116,605,700	
8	PA	\$ 1,511,554,861	\$ 43,543,583	
8	SC	\$ 261,553,098	\$ 13,021,103	
8	TN	\$ 382,471,626	\$ 32,354,228	
9	NJ	\$ 1,132,367,159	\$ 69,276,388	
9	NM	\$ 344,816,994	\$ 19,777,716	
9	SD	\$ 40,471,577	\$ 406,537	
9	TX	\$ 4,560,588,074	\$ 85,051,666	
9	UT	\$ 562,094,875	\$ 29,187,236	
9	VA	\$ 713,604,641	\$ 35,979,699	
9	WI	\$ 421,567,963	\$ 18,335,967	
10	AK	\$ 116,116,710	\$ 3,160,698	
10	NE	\$ 135,694,764	\$ 1,734,794	
Groups 8 and higher		\$ 23,411,686,092	\$ 937,101,215	4.00%

Source: 1997 through 2001 Schedule T as per the Form 9 of title underwriters reporting data. Compiled but not audited by Demotech, Inc.