Demotech, Inc.

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Affiliated Business Arrangements, Captive Reinsurance Not Problematic to Financial Stability

Regulatory Reform Should Include Prior Approval of Title Insurance Rates

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Recently, prominent Title underwriters have settled investigations related to alleged kickbacks through captive reinsurance arrangements. Demotech, Inc., the first company to review and rate the financial stability of Title underwriters, will not revise any Financial Stability Ratings® (FSRs) based upon affiliated business arrangements or captive reinsurance arrangements.

Our rationale is straightforward. In calendar year 2004, all reinsurance cessions – premium paid for reinsurance – totaled approximately $70 million. Given that the aggregate calendar year 2004 premium for the Title industry was approximately $16 billion, all reinsurance cessions accounted for less than one-half of one percent of premium. Accordingly, affiliated business arrangements and captive reinsurance arrangements were a small portion of less than one-half of one percent of premium.

From an economic perspective, the financial impact of the arrangements is the proverbial tempest in a teapot. However, in the long-term, Demotech is hopeful that the departments of insurance will focus on the unique regulatory constraints of Title underwriters. Specifically, Demotech believes that prior approval of Title insurance rates is consistent with the needs of consumers as well as the needs of Title underwriters. We hope the recent activity will re-focus attention on the need for prior approval of Title insurance rates.

In Federal Trade Commission v. Ticor Title Insurance Company, et. al., initiated in 1985 and decided by the United States Supreme Court in 1992, the Supreme Court established a two-pronged test for establishing the antitrust immunity of collective title insurance activities.

The Court concluded that the insurance industry's antitrust exemption under the McCarran-Ferguson Act required active state regulation. Active state regulation was necessary "to determine whether the State has exercised sufficient independent judgment and control so that the details of the rates or prices have been established as a product of deliberate state intervention, not simply by agreement among private parties." In addition, the Court concluded that for antitrust immunity to be available to Title insurance rates, the State's position must be "clearly articulated and affirmatively expressed as state policy." In sum, the two-pronged test required active supervision and clear and affirmative articulation of policy.

Given this Supreme Court decision, it is somewhat ironic that since 1985 the regulatory approach of most departments of insurance has been toward the deregulation of rates. Although the movement toward file and use or use and file regulatory systems was applicable to a Property and Casualty insurance industry converting from rate filings to loss cost filings, these same regulatory changes placed the Title insurance industry in the cross-hairs of antitrust liability.

With the Title insurance industry needing clear articulation and active supervision to form a rating bureau and present proposed rates for the review and consideration of a department of insurance, anything less than prior approval became problematic. Some departments of insurance, Virginia and Indiana for example, have statutory prohibitions against the regulation of Title insurance rates.

Compounding the Title insurance industry's dilemma, some Property and Casualty insurance companies introduced Title insurance products purporting to be casualty insurance. As Title insurance is a monoline product, these Property and Casualty insurers disguised rate, rule and form filings so state insurance departments were unable to isolate that the products were Title insurance or otherwise included Title insurance. Based upon anecdotal evidence, we believe that once the departments of insurance were alerted to the issue, most withdrew approval of the disguised products.

Demotech views the current situation as an opportunity for regulatory reform. Title underwriters deserve and desire a regulatory environment that stresses a clear and affirmative articulation of policy. Consumers expect Title insurance rates to be actively supervised. The immaterial, albeit embarrassing, bumps in the road were, in part, the result of the change in the regulatory paradigm created by the FTC v. Ticor decision, and the concurrent transition from prior approval of rates to statutory provisions that anticipated Property and Casualty loss costs, but not necessarily Title insurance rates.

In summary, Demotech, Inc. has concluded that the existence of captive reinsurance arrangements and affiliated business arrangements is immaterial with respect to the financial stability of the specific Title underwriters involved. However, we view prior approval of Title insurance rates, consistent with the FTC v. Ticor decision, as part of the longer-term solution. Recognizing that Title insurance is not the same as Property and Casualty insurance is the other part of the solution.

About Demotech, Inc.

Joseph L. Petrelli is the Founder and President of Demotech, Inc.

Since 1985, Demotech, Inc., a Columbus, Ohio based financial analysis and actuarial services firm, has been providing a wide range of services including pricing analysis, state filings assistance, Financial Stability Ratings® and support for other required regulatory reporting. Demotech was the first rating service to have its rating process formally reviewed and accepted by the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac) and the United States Department of Housing and Urban Development (HUD).

In 1992, Demotech became the first company to review the financial stability of the Title Insurance industry and publish an independent opinion of underwriters' financial stability. Since 1992, Demotech has presented Financial Stability Ratings® for virtually all Title underwriters. No other organization reviews more underwriters or has been providing Financial Stability Ratings® longer.

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