National Association of Independent Land Title Agents

The Premium-to-Surplus Ratio Rule: Helping Title Underwriters Maintain Solvency and Prevent Escrow Theft

The National Association of Insurance Commissioners (NAIC) is in the process of publishing a white paper entitled, “Title Escrow Theft and Title Insurance Fraud Whitepaper”. The purpose of this document is to give regulators a tool to research methods for combating and preventing escrow theft, title insurance theft and other forms of fraud associated with title insurance and closing services. The paper exposes several specific escrow fraud solution methodologies from across the United States which includes:

- Addressing escrow theft at the licensing stage
- Addressing escrow theft during active business operations
- Mitigating escrow theft once a theft has occurred

The proposed solutions range from the extended use of closing protection letters to the creation of robust escrow account review programs implemented by the regulators themselves. Many of these solutions require the inter-connected involvement of insurers and regulators to enforce or use without, what appears to be, meaningful input from title insurance agents.

Recently, draft language has been circulated suggesting that the NAIC and those from the title insurance underwriter trade organizations are also considering the creation of escrow theft reserves at the title underwriter level. Proposed language on this point dictates the following:

> “Although all states have statutory or unearned premium reserve requirements, these reserves are only available to pay losses when an insurer ceases to conduct business, becomes insolvent or is placed into receivership. As a result, existing SPR requirements are not responsive to covering large escrow losses suffered by an on-going entity. Accordingly, consideration should be given to requiring a separate reserve specifically established to pay escrow theft losses in lieu of increased capital and surplus requirements. Such a reserve could be funded by a CPL fee, as discussed above, or by having a portion of the existing premium set aside solely for payment to the insurer before calculation of commissions. The funds in reserve would then be available for withdraw to pay escrow theft losses as they occur or as the funds are released over

> time pursuant to a withdraw schedule. To ensure that the reserve remains adequate to respond to escrow losses, a minimum amount of reserve should be considered that, once reached by the insurer, cannot be released other than to pay escrow losses. By paying for escrow theft losses through a reserve, a company is less likely to drop below state-mandated capital and surplus requirements thus enabling it to continue as a going company and be in a better position to cover losses. Finally, because the nation's four largest publicly traded insurers generally have sufficient funds to meet their escrow theft losses, consideration should be given to waiving the reserve requirement for companies that maintain a specified amount of surplus as regards policyholders."

The statutory premium reserve is a reserve that all title insurance underwriters must maintain in order to comply with statutory requirements in their domiciliary state. The SPR is designed to prevent private insurers from liquidating their assets in the event of a material financial crisis. It attempts to provide a system for policyholders to recover in the event of claims, even if the insurer becomes insolvent. However, because escrow account defalcations often times come unexpectedly and in large amounts that many times exhaust the reserve, many believe that the SPR alone is insufficient to provide recourse for policyholder recovery. Thus, the NAIC is considering the establishment of a separate reserve to account directly for escrow defalcations as suggested by the proposed draft language above.

The preliminary idea from NAIC is to require insurers to contribute revenues to a separate escrow defalcation reserve account apart from ordinary capital and SPR requirements. The funding mechanism for the reserve would come either from CPL income or by premium set-asides. The reserve would be used solely for the payment of defalcation related losses. Although unclear from the paper, the cost to consumers is likely to increase in order to pay for the reserve. These issues and more are currently being determined by the affected title insurance underwriters, the American Land Title Association and the NAIC.

Will an Escrow Theft Reserve Maintain Title Insurer Solvency?

The NAIC's proposition to create a requirement for separate escrow theft reserves illustrates the regulators' concern that title insurance underwriters, especially those from within the regional ranks, have certain systemic risks and heightened solvency concerns relating to material financial defaults. Defalcation losses and high claims ratios have ravaged the title insurance industry over the past five years. The NAIC believes that separate reserves for losses relating to defalcations may help insurers hedge against the attendant risks and maintain capital in their respective companies. In theory, this may be true. In actual practice, the proposal has several significant shortcomings.

Additional risk reserves for defalcation-related events do not address the market differences between title insurers. These differences often times mask the efforts the underwriter uses to limit or prevent risk. Unique differences between title insurance underwriter market practices are one of the primary reasons some insurers can absorb defalcation risk and others cannot. In the title insurance industry, there are four companies that comprise approximately 90% of the overall national title insurance market. The remaining forty title insurers compete for the last 10% of the national market. The largest four companies have succeeded to capture large swaths of the national title insurance market by concentrating on gaining market share. Seeing the perceived success of market share capture rates from the national underwriters, certain larger regional title insurance underwriters have predictably tried to emulate those results, despite not having the capital resources or reserve resources to do so. This leads to a dangerous risk of insolvency for the underwriters who are undercapitalized to engage in large market share acquisitions. This is the "aim-big, miss-big" theory of title market growth. National underwriters can take larger risks because, in most cases, they are capitalized to do so. Smaller regional underwriters, in most cases, cannot. Those that attempt to do so with insufficient capital and reserve resources risk insolvency and liquidation.

Having smaller insurers who engage in market share acquisitions reserve for escrow theft issues will enable the insurer to collect monies for those losses, which is appropriate, but the fact of creating a reserve does not impact the real "elephant in the room" – the market share dynamics that cause insolvency concerns in the first place. In recent history, the smaller regional title insurance underwriters that chase market share without regard for balancing premiums to the risk have predictably suffered financial failure or sit on the very precipice of same.

What About Other Ways to Preserve Solvency and Prevent Escrow Theft?

The National Association of Independent Land Title Agents (NAILTA) is proud of its association with title insurance underwriters, both regional and national. In conjunction with those partners, NAILTA has researched ways to protect policyholders and solvency concerns at the same time and recommends the NAIC to consider the adoption of important objective criteria that regulators can use to broadly assist the title insurance marketplace avoid escrow theft and also maintain the solvency and stability of the title insurers themselves. It is NAILTA's belief that these risks are related concepts. One such objective criterion is the "Premium-to-Surplus Rule," which is part of NAILTA's newly created Blue Ribbon Title Insurance Underwriter Certification criteria.

The Premium-to-Surplus Rule is an objective measure of the health and solvency of a title insurance underwriter based upon a simple ratio of the insurer's annual gross title insurance premiums versus the insurer's policyholder surplus. Those title insurers with ratios greater than 5:1 are at a heightened and predicable risk of insolvency due to a material financial event, such as defalcations or high claims.

The Premium-to-Surplus Rule can be illustrated by looking at the recent history of the title insurance marketplace. Over the past five years, annual aggregate gross premiums written for the title insurance industry are as follows:[1]

[1] Demotech, Inc. "Performance of Title Insurance Companies, 2012," p. 257-259.

Year	Total ($billions)
2011	$9.249
2010	$9.369
2009	$7.905
2008	$7.707
2007	$10.732

Over that same period, aggregate policyholder surplus figures for the title insurance industry are as follows:[2]

Year	Total ($billions)
2011	$2.638
2010	$1.738
2009	$1.831
2008	$1.488
2007	$1.613

Historically, the gross premium-to-policyholder surplus ratio for the title insurance industry has ranged as follows:

Year	Ratio
2011	3.5:1
2010	5.5:1
2009	4.4:1
2008	5.1:1
2007	6.7:1

As an industry, title insurance underwriters have consistently held gross premium-to-policyholder surplus ratios (PSR ratios) within an approximate range of 5:1. In fact, the five year aggregate average for the title insurance industry is 5.04:1.

The Premium-to-Surplus Rule (PSR) is an important indicator of financial risk and stability for title insurance underwriters. In 2011, there were two significant defalcation matters that ended in the insolvencies and/or subsequent liquidations of two larger regional title insurance underwriters – Southern Title Insurance Corporation (STIC) and New Jersey Title Insurance Company (NJTIC). These failures highlight the prediction quality of the PSR ratio.

In the case of NJTIC, that company held a premium-to-surplus ratio of greater than 12:1 at the end of 2010, just prior to its collapse. Befallen by a major defalcation in 2011, NJTIC was placed into state receivership. In addition to the defalcation, NJTIC was simply not capable of managing the rapid growth it experienced in its authorized jurisdictions. From a PSR

[2] *Id. supra*.

perspective, the NJTIC was too big for its own reserve and the PSR ratio clearly identified this risk.

NJTIC (2008-2010)[3]

Year	PSR ratio
2010	12:1
2009	7:1
2008	3:1

As for Southern Title Insurance Corporation (STIC), the story was slightly different. It appears as though STIC was attempting to rectify a prior PTS ratio imbalance, after becoming aware in 2008 of a major defalcation involving a STIC agent in Texas.[4] In 2010, STIC had a respectable premium-to-surplus ratio of 4:1 on the eve of its receivership. However, if the research goes back to 2008, STIC carried a 7:1 ratio in the run-up to its demise. More importantly, the defalcation event that ultimately imperiled STIC occurred in a time frame of 2004-2006, meaning that the mortal financial wound inflicted on the company had already been inflicted and was irreparable without significant capital infusion. In other words, while STIC was trending in the right direction towards the end of its business life cycle, the results of having a higher-than-average industry ratio helped lay the groundwork to the collapse.

STIC (2008-2010)[5]

Year	PSR ratio
2010	4:1
2009	4:1
2008	7:1

NAILTA's adoption of the PSR ratio rule as a measurable criteria for professional performance was recommended not only because of the predictive quality for determining which title insurance underwriters were solvent, but also because the PSR ratio rule helps interested industry stakeholders gauge the strength of audit and fraud protection measures utilized by the title insurance industry players involved.

Until the Great Recession of 2008, many title insurance underwriters did not have adequate quality controls for their title insurance agents such as mandatory monthly escrow trust account reconciliations or annual agency audit programs for each licensed agency. The size and volume of individual title insurance agencies with a title insurance underwriter's stable of title agents made it difficult for each company to manage and audit their own title agents. Often times, this meant that title insurance agencies could go months and even years without receiving an escrow account audit from their respective title insurance underwriter, thereby disguising and delaying

[3] Demotech, Inc., "Performance of Title Insurance Companies 2008-2010"

[4] http://www.richmondbizsense.com/2011/09/19/embezzlement-investigation-hits-firm-hard/

[5] *Id. supra*

the discovery of defalcation losses and putting policyholders at greater risk. This deficiency was exacerbated by the fact that smaller regional title insurance underwriters that emulated the larger national title insurance underwriters in the quest for greater market share would often times add the appointments of hundreds of new title insurance agents without regard for how those agents would be monitored to ensure policyholder safety. Sadly, although many new requirements have helped to lessen the likelihood of such defalcations and escrow thefts, title insurance underwriters remain under-equipped to monitor the escrow practices and daily underwriting procedures of their appointed title insurance agents. By concentrating on escrow theft reserves at the underwriter level, the concern is that more must be done by regulators to protect the industry from itself. The PSR ratio rule, properly implemented and enforced, will help the title insurance industry maintain better stewardship of its agents.

NAILTA recommends the institution and use of the PSR ratio rule as a predictive measure of title company solvency and suitability because historical data shows that those entities whose PSR ratio is greater than the historic norm of 5:1 are far more likely to experience a material financial default and to compromise audit and risk management procedures with regard to their title insurance agency family than those whose PSR ratio is at or below the same figure. In addition to some of the other proposals that NAIC is considering to address fraud and solvency, including CPL fees, escrow account reviews, and reserve computations, the PSR ratio rule should be a definitive part of the discussion and NAILTA is prepared to provide data to help substantiate the need to incorporate this predictive measure into the final model rule.

About NAILTA:

The National Association of Independent Land Title Agents (NAILTA) is a non-profit trade association that represents the interests of independent title insurance agents and independent real estate settlement professionals from across the United States. It was created by independent real estate settlement professionals to further the agenda of small business owners from within the title insurance, abstracting, surveying, and real estate community who lack representation at local, state and national levels.

To contact NAILTA, please visit our website at www.nailta.org.