September 25, 2025

Best's
Methodology and Criteria

Rating Title Insurance Companies

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Our Insight, Your Advantage™

Rating Title Insurance Companies

Outline

The following criteria procedure should be read in conjunction with *Best's Credit Rating Methodology (BCRM)* and all other related BCRM-associated criteria procedures. The BCRM provides a comprehensive explanation of AM Best's rating process.

A. Market Overview

The title industry plays a critical role in the US economy by facilitating the growth of the mortgage market, as the process of insuring the proper transfer of real estate title from seller to buyer is critical to the real estate transfer process. At any real estate closing, the parties involved must be assured that the title of the subject real property is as represented.

The underwriting process for title insurers involves the search and examination of any legal interests affecting the title to real property. Typically, this includes identifying (and curing, if possible) defects to title in order to indemnify an owner's (or lender's) financial interest in real property for any covered loss caused by a defect in title existing as of the policy's effective date. Identifying defects can require the search of numerous public documents including tax documents, court judgments, bankruptcies, deeds, and encumbrances. Despite increasing automation, the process is often quite labor intensive.

Title insurance generally involves coverage of past transactional events and can be in effect for a long period of time. Lender's coverage terminates on repayment of the loan, and owner's (or borrower's) coverage lasts as long as the insured owns an interest in the property.

AM Best's Rating Process

AM Best's rating process involves evaluating key building blocks—balance sheet strength, operating performance, business profile, and enterprise risk management (ERM), as shown in **Exhibit A.1**. This criteria procedure outlines the factors within the various building blocks that are specific to title insurers including distinct balance sheet strength, operating performance, and business profile considerations.

Exhibit A.1: AM Best's Rating Process

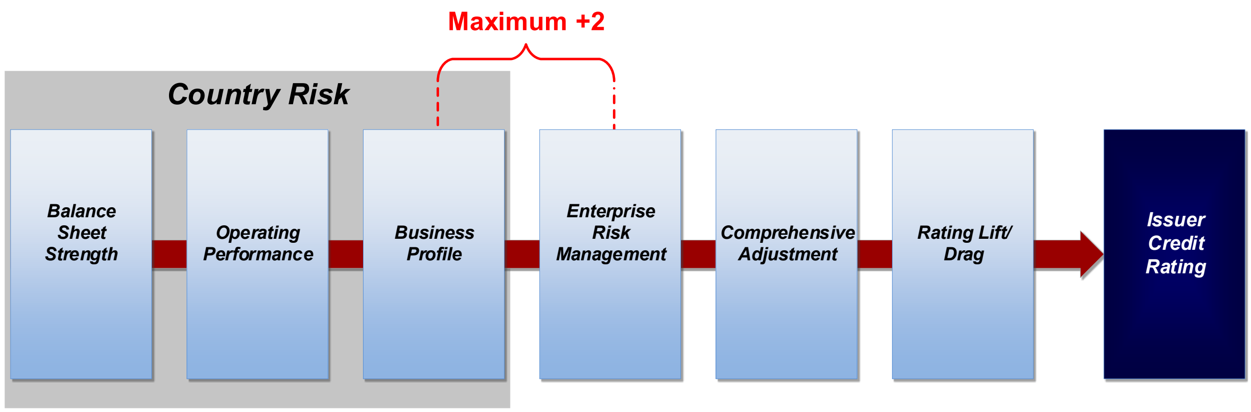

Exhibit A.2 details the possible assessment descriptors for each building block as described within the BCRM.

Exhibit A.2: BCRM Building Block Assessments

Balance Sheet Strength	Operating Performance	Business Profile	Enterprise Risk Management
Strongest	Very Strong	Very Favorable	Very Strong
Very Strong	Strong	Favorable	Appropriate
Strong	Adequate	Neutral	Marginal
Adequate	Marginal	Limited	Weak
Weak	Weak	Very Limited	Very Weak
Very Weak	Very Weak		

B. Balance Sheet Strength

BCAR for Title Insurers

Best's Capital Adequacy Ratio (BCAR) depicts the quantitative relationship between a rating unit's balance sheet strength and key financial risks that could impact such strength. Calculating a rating unit's BCAR requires calculating its net required capital—namely the capital needed to support the financial risks of the rating unit associated with the exposure of its assets and underwriting to adverse economic and market conditions—and determining its capital available to support these risks. **Exhibit B.1** details the exact formula for calculating BCAR.

Exhibit B.1: The BCAR Formula

$$\mathbf{BCAR} = \left(\frac{\mathbf{Available\ Capital} - \mathbf{Net\ Required\ Capital}}{\mathbf{Available\ Capital}}\right) \times \mathbf{100}$$

The following sections describe the adjustments to the BCAR model that account for the unique business practices of title insurers.

Net Required Capital Components

The formula used to calculate net required capital for a title insurer differs from that of a typical US Property/Casualty (P/C) insurer in that it reflects the greater correlation of interest rate risks to other required capital risk components.

Exhibit B.2: Required Capital Risk Components

Required Capital
B1 Fixed Income Securities
B2 Equity Securities
B3 Interest Rate
B4 Credit
B5 Net Loss and LAE Reserves
B6 Net Premiums Written
B7 Business Risk
B8 Potential Shock Losses

Exhibit B.3: Net Required Capital Formula

$$\boldsymbol{Net\ Required\ Capital} = \sqrt{(\boldsymbol{B1})^2 + (\boldsymbol{B2})^2 + (.\mathbf{25} * \boldsymbol{B3})^2 + (.\mathbf{5} * \boldsymbol{B4})^2 + (\boldsymbol{B5})^2 + [(.\mathbf{75} * \boldsymbol{B3}) + (.\mathbf{50} * \boldsymbol{B4}) + (\boldsymbol{B6}) + (\boldsymbol{B8})]^2} + (\boldsymbol{B7})$$

B1 Fixed Income Securities and B2 Equity Securities

Title Agency Affiliates

AM Best recognizes that the affiliated status of such privately held entities, instead of them being branches in the organizational structure of title insurance companies, is largely a matter of form over substance. Therefore, such entities receive a lower investment-risk charge of 15% compared to other private investment affiliates, which will continue to receive a 100% risk charge. However, in the case of companies acquiring such entities, any goodwill resulting from such acquisitions will receive a 100% capital charge.

Title Insurer Affiliates

All investments in affiliated title insurers will be charged 100% to eliminate the stacking of capital, regardless of the investment schedule in which it is recorded (i.e., surplus notes recorded as other investments in Schedule BA, etc.).

Title Plants

Title plants represent the core asset to the operation of any title insurance company. Under statutory accounting regulations, they are carried at original or acquired value. However, a current fair replacement value may be in excess of reported book value, especially in the case of long-standing title plants. Accordingly, if additional information is available and verifiable, AM Best may calculate a fair replacement value for such title plants and assign a risk charge to the entire value of 10%. The credit for the excess fair replacement value, relative to book, is capped at 20% of surplus.

B3 Interest Rate Risk

Interest rate movements and their impact on real estate activity drive demand for title products and consequently have the greatest impact on a title insurance company's prospective revenue and earnings. If an insurer's prospective earnings are insufficient to absorb projected losses and expenses, then that company has a significant exposure to short-term cash needs and may also be exposed to interest rate risk on its investment portfolio. To measure the risk of a decline in the market value of the fixed-income portfolio, AM Best uses an increase in interest rates over a one-year period. The selection of potential increases in interest rates over a one year time period is based on a review of output from an Economic Scenario Generator (ESG).

AM Best uses increases in interest rates that reflect the confidence level being used to generate required capital for interest rate risk. Based upon the ESG's simulated potential movements in the interest rates over the next one year time horizon, the following changes in interest rates are used to estimate the interest rate risk on the market value of bonds, preferred stocks, and mortgage loans: 170 basis points (BP) at the 95th percentile, 240 BP at the 99th percentile, 270 BP at the 99.5th percentile, and 280 BP at the 99.6th percentile.

The interest rate risk calculation takes into account a company's potential loss to earnings and surplus from interest rate increases. The potential loss represents the exposure of a company's invested asset portfolio to interest rate risk. The required capital for interest rate risk is calculated by taking the ratio of the company's potential loss to its liquid assets and then applying this factor to the company's decline in market value of fixed-income securities following a rise in interest rates across all VaRs. However, since the increase is not expected to take place instantaneously, but rather over a period of one year, a company may be able to avoid premature liquidation of its fixed-income investments that have a short term to maturity (i.e., less than one year) and thus suffer no potential loss in their market value. Therefore, the required capital is discounted by a factor that takes into account bonds maturing in one year or less to reflect the lower risk to capital from that portion of the portfolio.

By relating the company's potential loss to all liquid assets first, AM Best assumes a company is no more likely to liquidate a fixed-income asset at a loss than it is likely to liquidate any other investment. AM Best applies a potential loss exposure percentage (minimum 10%) against a decline in market value of a company's fixed income securities following a rise in interest rates to recognize that there may be other reasons for a company to have a short-term cash need, such as an agent's defalcation. Defalcation occurs when agents illegally divert fiduciary escrow funds without authority. Agent defalcation claims are the only shock-loss type of claim that has concentrated geographic reach, depending upon the region in which the defrauding agent operates.

B4 Credit Risk

The title insurance industry's unique business practices and statutory regulations often result in a significant accumulation of non-admitted receivable agents' balances. However, these balances typically have shown modest default risk. Therefore, AM Best assigns the same risk charges to these balances as it does to receivables due less than 90 days, which are admitted under statutory accounting regulations. In instances where there is a high concentration of receivables from an entity/agent, the risk charge may be increased. AM Best may also give credit to surplus for the non-admitted balances.

B5 Loss and Loss-Adjustment Expense Reserve Risk

Reserve Equity Adjustments

A company's carried loss reserves are adjusted to an economic basis that reflects AM Best's view of an insurer's ultimate reserves, which are discounted to their present value to recognize the time value of money. Carried loss reserves represent the sum of the known claims reserves and the Incurred But Not Reported (IBNR) reserves, and they are adjusted to an economic basis through two company specific factors: the reserve deficiency factor and the discount factor.

B6 Net Premiums Written Risk

The company profitability factor is used to modify the industry baseline capital factor and could result in either an increase or a reduction to the baseline capital factor. The measurement used to judge the profitability of an individual company is a five-year average of ultimate policy-year losses and expenses expressed as a ratio to premium plus other income.

For title companies, the diversification factor reflects the reduction in overall premium risk within a geographically well-diversified book of business. Those title insurance companies that have a more geographically concentrated book of business are more susceptible to changes in regional real estate markets and economic conditions. Hence, they face greater premium risk than companies that have a greater spread of geographic risk.

B8 Standard & Stress Potential Shock Losses

The objective of AM Best's loss scenario tests for title insurance companies is to measure their ability to withstand the impact of economic shock events, such as a significant increase in mortgage interest rates that negatively impact their capital position. Since a title company's profitability and operating revenue normally are closely tied to the direction of interest rate changes, the tests use statistical relationships between these variables to measure the impact on individual companies' balance sheets.

For the standard base case BCAR, AM Best uses an increase in interest rates over a one-year period. As mentioned, the selection of potential increases in interest rates over this time period was based on a review of output from an ESG. AM Best uses the same simulated changes in interest rates for base case B8 as it uses for B3: 170 BP at the 95th percentile, 240 BP at the 99th percentile, 270 BP at the 99.5th percentile, and 280 BP at the 99.6th percentile.

Additional changes in interest rates are added to B8 when calculating the insurer's stressed BCAR. These are discussed later in this criteria procedure within the Title Stress Test Adjustments to BCAR section.

Exhibit B.4: Sample BCAR Calculation

Net Required Capital (NRC)

	VaR 95		VaR 99		VaR 99.5		VaR 99.6	
	Required Capital Amount	% Gross Required Capital	Required Capital Amount	% Gross Required Capital	Required Capital Amount	% Gross Required Capital	Required Capital Amount	% Gross Required Capital
B1 Fixed Income Securities Risk	24,760	8	27,721	6	28,671	6	29,216	5
B2 Equity Securities Risk	74,025	24	99,975	23	110,025	22	113,055	21
B3 Interest Rate Risk	7,733	2	10,917	3	12,282	2	12,737	2
B4 Credit Risk	10,012	3	11,846	3	13,842	3	14,926	3
Total	**116,530**	**37**	**150,459**	**35**	**164,820**	**32**	**169,934**	**31**
B5 Loss & LAE Reserves Risk	69,886	22	105,551	25	119,715	24	124,175	23
B6 Net Written Premiums Risk	61,779	20	93,674	22	106,278	21	110,233	20
Total	**131,665**	**42**	**199,225**	**46**	**225,993**	**44**	**234,408**	**43**
B7 Business Risk	3,080	1	3,080	1	3,080	1	3,080	1
B8 Standard Potential Loss Yr 1	62,000	20	77,000	18	115,000	23	140,000	26
B8 Stressed Additional Potential Loss Yr 2	0	0	0	0	0	0	0	0
Gross Required Capital (GRC)	**313,275**	**100**	**429,764**	**100**	**508,893**	**100**	**547,422**	**100**
Less: Covariance Adjustment	173,356	55	234,974	55	277,845	55	297,322	54
Net Required Capital (NRC)	**139,919**	**45**	**194,791**	**45**	**231,048**	**45**	**250,099**	**46**

Available Capital

Capital & Capital Adjustments	**Amount**	**% to Reported Capital**
Reported Capital (Surplus)	**180,000**	**100**
Equity Adjustments:		
Provision for Reinsurance	1,000	1
Excess Statutory Premium Reserve	16,250	9
Loss Reserves Equity	15,433	9
Fixed Income Equity	14,400	8
Title Plant Fair Value Adjustment	10,000	6
Agents' Balances over 90 Days Due	5,000	3
Other Adjustments:		
Surplus Notes	0	0
Off-Balance Sheet Losses	0	0
Future Dividends	0	0
Protected Cell Surplus	0	0
Goodwill & Intangibles	0	0
Available Capital (AC)	**242,083**	**134**

Effective Tax Rate = 20.0%

	Best's Capital Adequacy Ratio			
	VaR 95	**VaR 99**	**VaR 99.5**	**VaR 99.6**
BCAR = (AC - NRC) / AC	**42.2**	**19.5**	**4.6**	**-3.3**

Available Capital (Surplus)

Within the model, AM Best makes a number of adjustments to a company's reported surplus to provide a more economic and comparable basis for evaluating capital adequacy. These adjustments are related largely to the uniqueness of title insurance and its governing statutory regulations. Some of the significant positive adjustments to surplus include credits for statutory premium reserves in excess of IBNR; excess of replacement value over book for title plants (subject to a cap of 20% of surplus); and substantial credit for the non-admitted portion of agents' balances.

Exhibit B.5: Typical Components of Available Capital

Available Capital
Reported Capital (Surplus)
Equity Adjustments
Unearned Premiums
Assets
Loss Reserves
Reinsurance
Debt Adjustments
Surplus Notes
Debt Service Requirements
Other Adjustments
Future Operating Losses
Intangibles
Goodwill

Excess Statutory Premium Reserves

Title insurers carry a statutory liability known as the Statutory Premium Reserve (SPR), which is mandated by each state to be kept aside to provide ultimate loss protection to policyholders. This is in addition to the Known Claims Reserve (KCR). Rules for maintaining the level and length of time of these reserves vary by state. To compare companies domiciled in different states, the excess of the SPR over IBNR reserves on a tax-effected basis is treated as an adjustment to surplus when calculating a title company's overall capitalization and its leverage and return on surplus ratios. The excess of the change in SPR over change in IBNR is treated as an adjustment to earnings when calculating the loss ratio as well as return on revenue.

In measuring leverage ratios for title insurers, AM Best recognizes that because of statutory premium reserve requirements as mandated by title insurance regulators in most states, reported surplus may be understated, which results in inflated leverage measures. Ratios, therefore, are calculated on the basis of both reported surplus and surplus adjusted for statutory premium reserves in excess of IBNR reserves when evaluating underwriting, asset, and financial leverage. Leverage ratios on a reported basis tend to be higher than those measured on an adjusted basis.

In cases where SPR may be in excess of IBNR, AM Best credits a company's reported surplus with the excess of SPR over that of IBNR reserves on an after-tax basis. In those cases where the SPR is below that of the IBNR reserves, the company posts supplemental reserves to bring the SPR up to the level of the net IBNR reserves, thus eliminating the shortfall.

Loss-Reserve Equity

AM Best adjusts surplus to reflect the net equity embedded within loss reserves. This equity represents the difference between a company's economic reserves, which reflect AM Best's view of ultimate reserves on a discounted basis, and carried reserves. For title insurers the carried reserves equal the sum of the KCR and IBNR reserves.

Title Plants

Due to statutory accounting regulations, title plants must be carried on the balance sheet at original or acquired value, while maintenance and improvements cannot be capitalized and must be expensed. Consequently, this leads to an understatement of the value of long-standing, established title plants. In recognition of the frequent understatement of the value of this asset on title companies' balance sheets, which in turn understates reported surplus, AM Best will estimate a current fair replacement value of a company's title plant based on all information made available.

The initial estimate of fair replacement value may be based on the original or acquisition cost and any maintenance/improvements made on the plant over time, adjusted to current dollars using an inflation factor. Any additional information provided such as an independent, third-party evaluation, may be used in determining a final estimate of the title plant's current fair replacement value. The excess of this replacement value over book may be credited to surplus on a tax-effected basis, subject to a cap of 20% of reported surplus.

Accounts Receivable Over 90 Days

Unique business practices within the title insurance industry often result in significantly large non-admitted agents' balances, reflecting accounts receivable more than 90 days overdue. The over-90-day balance is primarily the result of the significant time lag between when the real estate transaction closes and when the policy is reported to the underwriter. Since the aging is based on policy effective date and not when notice of the policy is received by the underwriter, the receivable frequently is 90 days past due at the time the policy is reported to the underwriter. However, these balances historically have shown minimal default risk. In recognition of this industry characteristic, AM Best's capital model gives significant credit to surplus for the non-admitted portion of premium balances, subject to an evaluation of the agent concentration risk of such receivables.

Title Stress Test Adjustments to BCAR

Loss Scenario Testing

Title insurance is unique among most insurance lines in that the demand for its product is derived largely from a single industry, i.e., real estate. Since a residential or commercial title policy is either sold or renewed only when a home or business is either purchased or the mortgage on that asset is refinanced, title industry revenues and earnings are largely a function of the level and trend of activity in real estate markets. Real estate market activity, in turn, is partly determined by interest rate movements. Generally, a rapid rise in mortgage interest rates results in reduced transactions in real estate markets and consequently a decline in demand for title insurance.

The loss scenario tests typically are structured to capture the impact from two successive interest rate events: a rise in interest rates in the first year as described earlier, followed by an additional rise in rates in the second year. Although both events are designed to stress the capital position of an individual company, the one year increase in rates is included as part of a standard, base case BCAR. The second year additional increase produces the stressed BCAR.

The loss scenario tests use a basic statistical relationship between changes in interest rates and pretax operating income (underwriting results including escrow and other title fees and services) to determine the impact on a company's earnings and surplus. The basic relationship is based on statistical modeling and econometric analysis of interest rate and earnings data for the industry, which demonstrates that for every 100 BP increase in interest rates, the pretax operating margin was reduced by 2.5 points. **Note:** Pretax operating margin is defined as Pretax Operating Income (PTOI) divided by pretax operating revenue.

This basic relationship is then used to calculate the first year and second year impact on a company's pretax operating income and surplus. For example, a 250 BP increase in interest rates represents a reduction in pretax operating margin of 6.25% (250 BP increase = (250/100) × 2.5% change in PTOI = 6.25% reduction in pretax operating margin.)

During periods of strong real estate market activity when title insurance companies are generally profitable, the impact of an increase in interest rates may not result in a loss of surplus, depending on the company's initial margin of profitability. However, during downturns in the real estate market when profit margins are weak or negative, the impact of an increase in interest rates is likely to be negative, resulting in a loss of surplus. In such cases, any resulting operating loss is deducted from beginning surplus on a post-tax basis.

AM Best selected the following changes in interest rates to be added as the additional stressed potential loss for year two within the B8 component: 15 BP at the 95th percentile, 30 BP at the 99th percentile, 70 BP at the 99.5th percentile, and 85 BP at the 99.6th percentile.

AM Best also recognizes that as interest rates rise, operating revenue tends to decline. Therefore, based on statistical modeling of historical industry revenue and interest rate data, the model uses an operating revenue decline of 7% for every 100 BP increase in interest rates. For example, a 250 BP increase in interest rates represents a reduction in operating revenue of 17.5% (250 BP increase = (250/100) × 7% change in pretax operating revenue = 17.5% reduction).

AM Best acknowledges that interest rates are only one of a number of economic variables that may impact a title insurer's operating results and future financial strength. Therefore, either the magnitude of the interest rate increase or the type of economic variable used for the above tests may change in the future, depending on prevailing market circumstances. In addition, the application of the stress test can vary over the real estate cycle. During the down phase of a cycle, the stress test may be used as a directional measure of the rating as part of the balance sheet assessment. Since this test looks out into the future two years, companies have ample time to take corrective actions such as reducing expenses to mitigate operating losses during this difficult period. This part of the balance sheet assessment is based not only on the stress test, but also on discussions with management to determine if there are any mitigating actions they would take and how well they historically have navigated through previous down cycles in the real estate and financial markets.

BCAR Stress Test Calculations

The following steps describe the calculations that are completed in the BCAR model for the title stress test:

1. The reported surplus is reduced by the 1-in-100-year net post-tax standard potential shock loss for year one.
2. The B3 interest rate risk is increased for the potential impact to the fixed-income portfolio from increasing interest rates over a two year time frame.
3. The standard potential shock loss for year one in B8 is replaced by the stressed additional potential shock loss for year two.

Note: The reduction to surplus in Step 1 is conducted on a post-tax basis only if the analyst believes that the company will be able to use the tax benefit. Otherwise, the calculation is done on a pretax basis.

After calculating both a rating unit's standard and stressed BCAR, AM Best compares the results of these two analyses. AM Best uses **Exhibit B.6** to determine the initial standard and stressed BCAR assessments.

Exhibit B.6: BCAR Assessments

VaR Confidence Level (%)	BCAR	BCAR Assessment
99.6	> 25 at 99.6	Strongest
99.6	> 10 at 99.6 & ≤ 25 at 99.6	Very Strong
99.5	> 0 at 99.5 & ≤ 10 at 99.6	Strong
99	> 0 at 99 & ≤ 0 at 99.5	Adequate
95	> 0 at 95 & ≤ 0 at 99	Weak
95	≤ 0 at 95	Very Weak

The ultimate interpretation of the stressed BCAR results typically follows the path outlined in **Exhibit B.7,** which describes AM Best's tolerances for a decline in BCAR.

Exhibit B.7: Stress Test Tolerances for Rating Units with Financial Flexibility

Standard BCAR Assessment	Stressed BCAR Tolerance	Revised BCAR Assessment
Strongest > 25 at 99.6	> 0 at 99.5	**= Strongest**
Very Strong > 10 at 99.6 & ≤ 25 at 99.6	> 0 at 99	**= Very Strong**
Strong > 0 at 99.5 & ≤ 10 at 99.6	> 0 at 95	**= Strong**
Adequate > 0 at 99 & ≤ 0 at 99.5	> 0 at 95	**= Adequate**
Adequate > 0 at 99 & ≤ 0 at 99.5	≤ 0 at 95	**= Weak**
Weak > 0 at 95 & ≤ 0 at 99	≤ 0 at 95	**= Very Weak**

The tolerances outlined in **Exhibit B.7** only apply to insurers that have the financial flexibility to quickly replace lost surplus after events. For those insurers with limited financial flexibility or that exceed the tolerances described above, the stressed BCAR tolerance is reduced as determined by analytical review of the insurer and its specific circumstances. AM Best's view of an insurer's financial flexibility does consider overall market conditions, which vary over time.

Leverage

Because title insurance is a loss-prevention line of business that results in lower loss ratios and a resulting low level of required loss reserves, title insurers can and often do have significantly higher premium leverage than their P/C counterparts. A significant portion of premiums is used for loss prevention rather than for funding claims.

Ratios are calculated both on a reported surplus basis and on surplus adjusted for excess statutory premium reserves when evaluating underwriting, asset, and financial leverage. Leverage ratios on a reported basis tend to be higher than those measured on an adjusted basis. Generally, the title industry operates on a much higher premium-to-surplus ratio than does the average P/C insurer as the surplus required to protect title insurers against unexpected events is typically lower. This differs significantly from the experience of other P/C companies, which require a relatively larger surplus cushion to protect themselves from catastrophes or adverse loss-reserve development. Also, since title insurance companies do not normally rely on traditional reinsurance, reinsurance dependence is usually negligible.

C. Operating Performance

While comparisons on an operating ratio basis yield similar results for both title and P/C companies, there are important differences for the combined ratio and the investment ratio, which are the major components of the operating ratio. Since title insurance usually involves the acceptance of prior transaction-related risk, the underwriting process in the title insurance industry differs markedly from the typical P/C underwriting process. The title underwriting process is based on loss prevention designed to limit risk exposure through a thorough search of the recorded documents affecting a particular property. P/C underwriters are concerned with determining the probability of loss based on the characteristics of the insured, while title underwriters are concerned with reducing the possibility of loss by discovering as much information as possible about the past through extensive searches of public records and stringent examinations of title. This results in typical loss and loss-adjustment expense ratios that are lower for title insurers compared with typical ratios in the P/C industry.

The title industry is characterized by high fixed costs, unlike the P/C industry where expense ratios are comparatively lower. This is because title insurers must physically produce policies, which is labor and system intensive. A typical P/C policy might involve filling out some basic information, while a title policy might require the transcription of a complex legal description unique to the insured property, along with enumeration of often equally complex and unique terms of easements or other special property rights.

In P/C lines, agents' commissions are generally a lower percentage of premium on policies written relative to title insurance. For title insurance, the agent retains a much larger proportion of the amount charged, depending on the state, which is more properly described as agent's retention or agent's labor or work charges. Agents' activities not only reflect a sales commission but also incorporate underwriting, loss prevention, and administrative costs that title insurers would incur if policies were issued directly. These unique characteristics of the title insurance industry, combined with the necessity of maintaining indexed databases (i.e., title plant) or searching public records, contribute to the high fixed costs.

The general underwriting examination and search requirements, coupled with the disarray and geographical dispersion of records, has fostered the development of privately owned title plants. These title plants must be maintained regardless of the level of real estate activity during any given period. The cost to maintain the economic life of a title plant and continuously update the records is high. This is one factor adding to the higher overall fixed-cost percentage for title insurers as compared with P/C insurers.

Title insurers also typically generate far lower investment income from underwriting as compared to P/C companies because of the large up-front commission payment to title agencies. These payments result in a smaller retained portion of the original premium available to title insurers for investments. The typical title insurer has an investment income ratio (investment income as a percentage of net written premium) that is lower than a P/C company. Thus, while individual components of the operating ratio differ significantly when comparing title with P/C companies, the 10-year average operating ratios are similar.

The economy's disproportionate impact on title insurance, which is synchronized with the business cycle rather than the underwriting cycle that characterizes the P/C industry, is a major factor in the evaluation of title insurance companies and their ability to withstand downturns in the economy and the real estate market. Since, relative to P/C lines, a significant portion of the cost structure is fixed, sudden declines in revenue can have a disproportionate negative impact on profitability. Companies that have more flexible operating cost structures, as evidenced by balanced management of the distribution mix (agency versus direct), are in a better position to respond to rapidly changing economic conditions.

Profitability

In the case of title insurance, where companies face high fixed costs and highly volatile revenues, profitability is correlated with the ability of a company to manage its variable expenses over the course of the business cycle. Generally, title insurers that have more flexible cost structures and can anticipate and adapt to sudden changes in real estate markets, including changes in credit market conditions and rapid interest rate movements, tend to demonstrate greater consistency in generating profitable operating earnings.

AM Best reviews several areas of profitability, including underwriting, investments, capital gains and losses, and total operating earnings, on both a pretax and an after-tax basis. Similar to the adjustment made to reported surplus for any excess statutory premium reserves and KCR over IBNR and KCR, reported earnings also are adjusted for any potential "earnings credit" by calculating the difference between the change in SPR and the change in net IBNR. This credit is then applied to premium and operating earnings when calculating the combined ratio (composite ratio), which also includes escrow and other fee income, and rates of return on operating revenue and surplus on an adjusted basis. Depending on their geographic mix of business, AM Best recognizes that there may be differences in composite ratios and return on revenue between title insurance companies. This is because some states, called "Risk Rate" states, exclude certain premiums and their associated expenses such as title agent fees and services from reported premiums and underwriting expenses. Other states, known as "All-Inclusive" states, require all fees and services to be accounted for when calculating premiums and underwriting income or loss. Since these items often can be a large portion of a title company's underwriting expenses and premium base, they potentially can make comparisons of composite ratios and return on revenue difficult between companies that primarily operate in states with significantly different regulatory reporting regimes. For this reason, AM Best places a greater emphasis on return-on-surplus measures when comparing operating performance across the industry.

D. Business Profile

Within the business profile assessment, concentration, type of title insurance business written (residential versus commercial), origin of business written (purchase versus refinancing), and distribution mix (agency versus direct) are particularly important.

Market Position

A title insurer's historical presence in markets where it operates may give it a competitive advantage over its peers. However, given that the title insurance industry is subject to high levels of fixed costs and volatile earnings, the ability of a company to respond quickly to such challenges ultimately will determine the sustainability of its competitive advantage. The ability to manage costs and use distribution channels efficiently is critical for a title insurer in maintaining a competitive advantage over its peers. Because title agents retain a significant portion of title insurance charges (i.e., premiums and fees) and costs (including fixed costs), companies may benefit from a predominantly agency distribution mix during real estate down cycles because this cost structure automatically reduces expenses as revenue falls. Conversely, when real estate markets are on an upswing, resulting in stronger demand for title insurance, companies that write mostly direct business with relatively fixed labor costs may benefit more in an environment of rapid growth in revenue. Thus, companies with a flexible cost structure that can adapt quickly to changes in the real estate cycle can afford a greater degree of control over variable costs through the use of multiple distribution channels.

Geographic/Product Concentration

Title insurance is a monoline business that derives its income from the residential and commercial real estate industry. It is also subject to highly volatile revenue and earnings, as the demand for its product depends greatly on changes in the economic environment, real estate market cycles, sudden interest rate movements and changes in credit market conditions. As such, it is critical for title insurance companies to achieve greater spread of risk geographically to mitigate their product and industry concentrations. Generally, larger companies with a nationwide book of business have a natural spread of risk. However, smaller companies that have a long-standing presence in certain markets and efficient distribution channels may be able to compensate for their more concentrated books of business. While most title insurance companies are predominantly writers of residential title policies, the commercial title market represents an important source of revenue because of the high value of premiums and typically higher profit margins associated with these policies. The commercial segment also requires title insurers to have greater underwriting sophistication in writing these large policies. Title insurers that have an established presence in the commercial market segment characterized by a long history of commercial underwriting may be at a greater advantage than companies that are new to this market segment. AM Best takes into consideration a title insurer's geographic and product-segment spread of risk, as well as a company's operating history and market presence, to assess the quality of the company's overall spread of risk.

Rating Title Insurance Companies

Regulatory, Event, Market, and Country Risks

As real estate closings generate title orders, the title industry is far more closely linked to changes in real estate market conditions than the wider P/C industry. Therefore, title premiums and profitability are far more sensitive to changes in interest rates and availability of mortgage credit than they are in the P/C industry.

Additionally, title insurance companies are subject to state regulation under which title insurance premium and underwriter retention rates are mandated by the state, and are subject to revision arising from changes in the regulatory environment. While these systemic risks are common to all market participants, title insurers face a higher degree of market risk due to the nature of the demand for their product, which is derived from the real estate and financial markets. Any adverse developments in these markets such as changes or reforms in the financial services industry; changes in tax laws that negatively impact the mortgage and real estate industries; a sudden downturn in property prices; a reduction in demand owing to recessionary business and economic cycles; a sharp increase in mortgage interest rates or a sudden tightening in the availability of mortgage credit are likely to have a greater negative impact on title insurers, whose business profile typically does not afford them a favorable spread of risk and a competitive market position, than for the wider P/C industry.

Published by A.M. Best Rating Services, Inc.

METHODOLOGY AND CRITERIA

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Version 011624