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Rating Title Insurance Companies

A.M. Best recognizes that while its rating process generally is applicable to the rating of all insurance companies and groups, the evaluation of title insurance companies must take into account the key differences of title from other lines of insurance and the role that title insurance plays in the overall economy, as well as the susceptibility of title underwriting performance to economic volatility and changes in real estate cycles.

The title industry plays a critical role in the U.S. economy by facilitating the growth of the secondary mortgage market, as the process of insuring the proper transfer of real estate 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 functions of search and examination of title concerning the legal interest affecting the title to real property are components of the title insurance underwriting process. The search-and-examination process very often includes identifying and curing defects to title to indemnify an owner's or lender's financial interest in real property for any covered loss caused by a defect in title that existed as of the effective date of the policy. The title search and examination can require the search of numerous public documents, including tax, court judgment, bankruptcies, deed, encumbrances, etc. Despite increasing automation, this process is often quite labor intensive.

The title insurance industry is highly concentrated, with four national writers accounting for the vast majority of total industry premium. However, there are regional players that do provide effective competition to the national writers.

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.

While comparisons on an operating ratio basis yield similar results for both title and property/casualty (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 property/casualty 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. Property/casualty 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.

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A typical property/casualty policy might involve filling out some basic information, while the 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 property and casualty lines, agents' commissions are generally a lower percentage of premium on policies that agents write relative to title insurance where 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 administration 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 moderately high. This is one factor adding to the higher overall fixed-cost percentage for title insurers as compared with property/casualty insurers.

Title insurers also typically generate far lower investment income from underwriting as compared with property/casualty 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. A title insurer typically has a lower investment income ratio (investment income as a percentage of net written premium) than a P/C insurer. 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 title industry generally operates on a much higher premium-to-surplus ratio than does the average P/C insurer. This is due to title insurance being a loss-prevention line of business characterized by high fixed costs and typically low loss ratios. Therefore, surplus required to protect against unexpected events is typically lower. This differs significantly from the experience of property/casualty companies, which require a relatively larger surplus cushion to protect property underwriters from catastrophes or casualty underwriters from adverse loss-reserve development. Reported net-premium-to-surplus ratios typically range from 3-1 to 5-1 for the title insurance industry, compared with 2-1 or lower ratios for the P/C industry. Also, since title insurance companies do not normally rely on traditional reinsurance, reinsurance dependence is usually negligible.

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 incurred but not reported (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.

Another factor that makes comparing ratios difficult between title companies is the different methods each state uses in accounting for title premium and agent fees. Some states use the Risk Rate (RR) method, which allows agents to deduct search-and-exam fees up front.

Other states use the All-Inclusive (AI) method, whereby the insurer includes the search and exam costs it pays to the agent. The typical commission that the insurer pays to agents in "RR" states therefore is significantly lower than that of the "AI" states. This implies that those companies that primarily do business in "RR" states are likely to have significantly lower expense ratios than companies operating in "AI" states, thereby making combined ratios (termed "composite" ratio in title insurance terminology) difficult to compare between companies that primarily do business in different jurisdictions. Therefore, A.M. Best places greater emphasis on comparing results among title companies by using the return on surplus measure.

The title industry is more susceptible to changes in the real estate cycle than is the P/C industry. As real estate closings generate title orders, the title industry is far more dependent on changes in real estate market conditions, and 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. 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.

Title insurance companies are also subject to agency defalcation risk, especially during economic downturns. Defalcation occurs when agents illegally divert fiduciary escrow funds without authority. Defalcation losses are similar to catastrophe losses experienced by property/casualty insurers. 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.

Although A.M. Best's approach to the evaluation of a title insurer's financial strength and creditworthiness is similar to its approach toward other insurance entities, A.M. Best also recognizes within its evaluation certain unique aspects of title insurance that distinguish it from other forms of insurance.

Balance Sheet Strength

Leverage Tests and Capitalization

Measurement and analysis of a title insurer's underwriting, asset and financial leverage are key components in determining its capital adequacy. The primary objective of an evaluation of balance sheet strength is to determine the exposure of a company's surplus to operating and financial risks. While a highly leveraged company can demonstrate strongly favorable rates of return on surplus, it also may be exposed to a greater degree of volatility in its earnings and may be hindered in its

Typical Rating Information Requested

1. Annual financial reports – latest five years preferably or credible projections for a less-experienced or start-up company
2. Audited financial statements for parent and subsidiary companies, if applicable
3. Actuarial reports, both internal and external
4. Corporate structure and history
5. Management structure and key executive committees
6. Biographical information on principal officers
7. Operating and business plans
8. Capital management strategies
9. Any other information management believes is relevant to the rating process
10. Any other reasonable information requested by A.M. Best, including but not limited to:
    (a) Estimated impact (net and gross) from economic or other unusual events
    (b) Details of changes in ownership, management, products or operations
    (c) Projection of year-end results
    (d) Plans to mitigate losses and/or to correct an identified problem
11. Pro forma projections for title insurer and parent, if applicable
12. History of losses and premiums
13. Organizational structure for parent organization and subsidiaries
14. Additional data as needed including responses to A.M. Best's Supplemental Rating Questionnaire.

ability to withstand financial and market risk events. Companies that are more conservatively leveraged, however, may not show high rates of return on surplus, but they generally produce earnings that are less volatile and are generally better able to manage risks to surplus. 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. However, in measuring leverage ratios for title insurers, A.M. Best recognizes that because of statutory premium reserve requirements as mandated by title insurance regulators in most states, reported surplus can be understated, which may result in inflated leverage measures.

Ratios therefore 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. Underwriting leverage includes premium writings to surplus, which is a measure of the exposure of a company's capital to risk of underpricing its book of business. Other measures of underwriting leverage include net liabilities to surplus, which measures exposure of unpaid obligations to surplus, and premiums and reserves ceded and related reinsurance recoverables to surplus, which measure reinsurance dependence. Since title insurance companies do not normally rely on traditional reinsurance, the latter measure is usually negligible. To assess the appropriateness of a company's underwriting leverage, consideration also is given to its geographic spread of risk; type of title insurance business written (residential versus commercial); origin of business written (purchase versus refinancing); and distribution mix (agency versus direct).

A.M. Best also evaluates asset leverage, which measures the exposure of a title insurer's surplus to investment, credit and interest rate risks. These leverage measures take into account the credit quality, market volatility and asset-class concentration of a title insurer's investment portfolio, and its impact on balance sheet strength. The quality and diversification of a company's asset base may also impact the amount of underwriting risk a company may assume for a given rating level.

A company's underwriting, financial and asset leverage also are subjected to an evaluation by the Best's Capital Adequacy Ratio (BCAR) model, which allows for an integrated review of these leverage measures.

A.M. Best also reviews a company's financial leverage, which measures to what extent debt or debt-like instruments may place a burden on a title insurer's earnings and consequently impact its cash flow. Common measures of financial leverage include debt-to-capital and debt-to-equity ratios, as well as coverage ratios, which measure the extent to which a company's earnings and cash flow cover interest payments and other fixed obligations. However, in determining whether a company's financial leverage is excessive, consideration is also given to management's history in managing debt. In cases where a title insurer has a parent, the analysis is conducted at the holding-company level. Holding companies and their associated capital structures can have a significant impact on a subsidiary company's financial strength. While holding-company structures can provide greater financial flexibility and access to capital to a title insurance subsidiary, excessive debt or debt-like obligations at the holding company level also can reduce financial flexibility and place greater strain on future growth in earnings and surplus of the operating subsidiary. A holding company may have obligations comprising debt, preferred stock or hybrid securities in its capital structure. Therefore, A.M. Best places great emphasis on evaluating the quality of capital of both the operating company and its parent and reviews both the debt and equity components of individual securities in determining overall financial leverage.

Adequacy of Loss Reserves

Although title insurers have relatively low levels of case loss reserves called Known Claim Reserves (KCR), they also carry statutory premium reserves (SPR) as liabilities on their balance sheet. The comparison of SPR and KCR reserves to estimated IBNR and KCR determines whether a title insurer is reserved adequately. If SPR and KCR is less than the combined IBNR and KCR, then a supplemental reserve must be posted to make up the difference. However, if the SPR and KCR is greater than the IBNR and KCR, then the resulting "excess reserves" on a tax-effected basis are included as a component of surplus in A.M. Best's evaluation of a title insurer's overall capitalization.

Quality and Diversification of Assets

The quality and diversification of a title insurer's invested assets is an important indicator of its balance sheet strength and overall financial stability. The quality of assets is evaluated to assess the risk of default and premature liquidation. Greater diversification also contributes to greater stability of investment income and lessens the impact of a default on the balance sheet. A.M. Best reviews a title insurer's investment portfolio for any concentration of asset classes, geographic and industry spread of risk, and the presence of any large single investment that exceeds 10% of a company's total capital. Title insurers that hold illiquid, concentrated and/or speculative assets may experience high volatility in investment earnings from sudden changes in economic and market conditions, which could pose greater risks to policyholders' surplus.

Liquidity

A title insurer's liquidity impacts its ability to meet its short and long-term obligations to policyholders and other creditors. The holding of liquid, high-quality investments and solid operating cash flow provides a high degree of liquidity, enabling a title insurer to meet unanticipated needs for cash without the untimely sale of investments and fixed assets that could result in significant realized losses under adverse market conditions. A.M. Best evaluates several liquidity measures, including quick liquidity, which measures a company's ability to meet short-term liquidity needs with cash or assets readily convertible to cash, and current liquidity, which measures a company's ability to meet its long-term liquidity needs with cash and unaffiliated invested assets. A.M. Best also reviews a company's operating and net cash flows as an indicator of its ability to meet liquidity needs, provided that they are positive, stable and large relative to cash requirements.

Operating Performance

As companies move up the ratings scale, operating performance takes on greater importance. To reinforce and enhance its balance sheet strength, a title insurer should demonstrate profitable statutory operating earnings over time. A.M. Best reviews the components of a company's statutory earnings over the most recent five-year period to assess the sources of growth in earnings and how profitability measures are trending. 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 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.

Profitability

A.M. 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 then is applied to premium and operating earnings when calculating the combined ratio (called composite ratio in the title industry, which also includes escrow and other fee income) and rates of return on operating revenue and surplus on an adjusted basis. A.M. Best also recognizes that there may be differences in composite ratios and return on revenue between title insurance companies, depending on their geographic mix of business. This is because some states, called "Risk Rate" states, exclude certain premiums and their associated expenses such as title agent fees and services as part of underwriting expenses.

Other states, known as "All-Inclusive" states, require all fees and services to be accounted for when calculating underwriting income or loss. Since these fees 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 starkly different regulatory regimes. For this reason, A.M. Best places a greater emphasis on return-on-surplus measures when comparing operating performance across the industry.

Business Profile

Business profile is an important qualitative component of the overall rating evaluation. Along with solid capitalization and consistent, profitable operating performance, highly rated companies must demonstrate a strong business profile that reflects the title insurer's competitive market position, the degree of risk inherent in the company's book of business, and the quality and stability of its management, which can have a significant impact on its ability to manage enterprise-wide risks as well as sustain and enhance its market position.

Geographic and Product Segment Spread of Risk

Title insurance is a mono-line 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. A.M. 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.

Competitive Market Position

As stated above, 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), companies may benefit from a predominantly agency distribution mix during real estate down cycles; 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.

Similarly, effective utilization and leveraging of technology, superior service, underwriting expertise, careful monitoring of agents' business practices, financial flexibility, and access to capital will allow companies to be in a better position to both weather down cycles and take advantage of market upturns, and therefore to sustain and enhance their competitive market positions.

Regulatory, Market and Event Risk

Title insurance companies, as all other insurance lines of business, are subject to state regulation where title insurance premium and underwriter retention rates are mandated by the state and they are subject to revision, given changes in the regulatory environment. While these systemic risks are common to all market participants, title insurers also face a high 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; or 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 does not afford them a favorable spread of risk and a competitive market position.

Management Quality

The experience and depth of management represents a critical component in the evaluation of a company's overall business profile. Since the insurance business is based on a model of fiduciary responsibility, prudent guidance of management generally plays a more vital role than in other industries. Because of the high degree of competitive pressure in the title insurance marketplace, the ability of management to develop and execute a coherent, sustainable and competitive operating strategy is vital to a company's long-term financial success. A.M. Best's assessment of management's active monitoring and mitigation of enterprise-wide risks and a clear understanding of management's operating goals is inherent in the qualitative evaluation of a company's prospective operating performance and its ability to sustain and enhance balance sheet strength. A.M. Best places great emphasis on ongoing communication and periodic meetings between its analytical team and company management. These interactions provide A.M. Best with crucial insight into the organization's operating mission and whether and how management policies are designed to implement that mission on an ongoing basis.

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METHODOLOGY

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Best's Financial Strength Rating (FSR): an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. An FSR is not assigned to specific insurance policies or contracts.

Best's Issuer Credit Rating (ICR): an independent opinion of an entity's ability to meet its ongoing financial obligations and can be issued on either a long- or short-term basis.

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