

Demystifying Title Insurance

A Two-Part Report on Title Insurance

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Is it any wonder people get confused and do not understand title insurance when terminology like closer, affiliated business arrangement, closing protection letter, RESPA, direct operations, good faith effort, and title plant is used? People, including regulators and insurance professionals, think title insurance includes such things as title search, abstracts, document preparation fees, curing defects fees, and several other costs. Many seem to think that title insurance is a property and casualty product, but it is not. Items related to financial statements are unique for title insurance compared to other lines of business, and the NAIC has developed annual statement reporting requirements separately for title insurance companies.

Consumers have a hard time understanding what title insurance is as they feel they do not have a choice in choosing their insurance company or their agent. Most people think that title insurance is the price they have to pay so the lender can sleep well at night. Also, the premium drives up the costs they need to shell out at closing. It's not only the premium, but many other costs related to getting a clean title that consumers feel is all wrapped up in purchasing this insurance—"what others tell me I must buy." They simply do not see the benefit.

The coverage

State definitions of title insurance are fairly lengthy. Most (but not all) states have adopted the NAIC model law version of title insurance. In its simplest form, title insurance is a contract insuring or indemnifying *someone* who has a lawful interest in real or personal property against loss or damage arising from *problems* existing on or before the effective date of the policy. We'll get into the full definition shortly.

Did you notice how this definition is different than other lines of business definitions? "*Someone*," as referred to above, is typically the owner(s) or mortgage company.

Title insurance generally comes in two flavors. The first is an owner's policy. For a newlywed couple, the owner's policy protects the two partners for any *problems* discovered regarding the title of their property after the policy effective date. It protects them for any costs associated to remedy the *problems* that were discovered in the title. The second item of importance is the protection they purchased covers them from that point forward; there is no expiration date and they do not even have to own the property any longer. A *problem* with the title or previous ownership of the land and home someone purchased might be discovered many years later and it might be the responsibility of those newlyweds to get the title corrected even if they no longer own the property. They should hold on to their policy because it protects them from the date the policy was effective.

The second form of title insurance is referred to as a lender's policy. The lender's policy protects the lender from any *problems* and associated costs to fix the *problems* up to the amount of the outstanding loan on the policy at the time of the loss. The definition above included the words "lawful interest" and that is why the lender is protected only up to the amount of the loan balance. From that short description, it sounds like a lender's policy does provide a benefit and is a good thing for lenders to purchase. The only problem is that lenders do not purchase the policy; they require the owners purchasing a property to get the policy for the lender. In some cases, it's the seller who purchases the lender's policy on behalf of the purchasers.

Many consumers do not understand insurance. They don't like it and they don't like paying for it. When someone is buying a home and s/he is securing a mortgage, s/he's told that s/he must buy a homeowners policy and title insurance with title insurance coming in two flavors: an owner's policy and a lender's policy. The insurance industry gets the unfortunate bad reputation as consumers often say "I had to buy that insurance" even though it was the



lender requiring them to do so. On top of the two policies purchased, there are all these other costs: title search, abstracts, document preparation fees, curing defects fees, and other costs they had to pay for that they think are a part of insurance. For most people, it's the house that interests them—not the insurance and other costs, which they consider to be a nuisance.

The following is the definition of title insurance policy from the NAIC Title Insurers Model Act (Model Act 628):

"Title insurance policy" or "policy" means a contract insuring or indemnifying owners of, or other persons lawfully interested in, real or personal property or any interest in real property against loss or damage arising from any or all of the following conditions existing on or before the policy date and not excepted or excluded:

- (1) Defects in or liens or encumbrances on the insured title;
- (2) Unmarketability of the insured title;
- (3) Invalidity, lack of priority, or unenforceability of liens or encumbrances on the stated property;
- (4) Lack of legal right of access to the land; or
- (5) Unenforceability of rights in title to the land.

The process of providing title insurance

Following is the process when a title agent or title company receives an order for title insurance. For the most part, I have copied this from the "Title Agent Statistical Data Plan Implementation Guideline" that is

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weaving its way through the implementation process at the NAIC. I like this guideline, as it includes the difference between title insurance and property and casualty insurance. The guideline can be found on the NAIC's website.

In the course of searching for and examining land records, title agencies fulfill their main role in the title insurance process of identifying actual and/or potential clouds or defects on the title that may lead to future losses. Agents may work to correct or eliminate the title defects that can be fixed and inform the insured of which ones cannot be cured by the agent and will be listed as exceptions in the policy. Title agents may also cure defects at the direction of the buyer, the lending institution, or the title insurer. Depending on the state, this function may be performed by an escrow agent, a title agent, or another third party.

Sometimes, an entity will spend numerous hours evaluating and eliminating risk before the premium is even paid. This is one of the fundamental differences between title insurance and casualty insurance. While technology helps to some extent, automated land records do not eliminate the cost of searching for and addressing defects in title. In most jurisdictions, automated land records are no more than automated indices and images of documents. Although these systems can reduce the time and effort necessary to search land records, the actual process is unchanged. Title insurance producers or abstractors still must search all records, find those related to a property, and manually examine each document. While some software systems collect and store information, they can be prohibitively expensive for many agencies.

The title agent often performs the functions of an underwriter, which is another difference between property and casualty insurance and the other lines of business. The following is the definition from the NAIC Title Insurers Model Act:

“Title insurance agent” or “agent” means an authorized person, other than a bona fide employee of the title insurer, who, on behalf of the title insurer, performs the following acts in conjunction with the issuance of a title insurance report or policy:

- (1) Determines insurability and issues title insurance reports or policies, or both, based upon the performance or review of a search or abstract of title; and
- (2) Performs one or more of the following functions:
 - (a) Collects or disburses premiums, escrow or security deposits, or other funds;
 - (b) Handles escrows, settlements, or closings;
 - (c) Solicits or negotiates title insurance business; or
 - (d) Records closing documents.

Because the process of issuing a title policy involves underwriting to be sure the land title is clean before a policy is written, the number of resulting claims is therefore lower. Commission structures of title agents are very dissimilar to property and casualty insurance. Due to the underwriting done before a policy is issued, the acquisitions costs are higher as compared to property and casualty and, with the upfront underwriting performed, the loss ratios for title insurance are much lower as compared to property and casualty insurance.

Earlier in my simple definition of title insurance, I used the word *problems* which are covered in a policy. The NAIC definition of title insurance policy also includes some generalities regarding what is covered on a policy. Here are some specific defects found and/or fixed in a search when title insurance is purchased: the land may not have been indexed properly in the land records; missing or unknown heirs to an estate come to light after a property is sold; there could be forged deeds; there may be invalid deeds; and there may be mistakes in recording legal documents.

Title agents can provide abstracts unrelated to providing title insurance. The NAIC definition: “Abstract of title” or “abstract” means a written history, synopsis, or summary of the recorded instruments affecting the title to real property. Title agents may or may not perform closings. A closer is someone who handles the settlement or closing or escrow transactions, which involves the written documents and

money/funds in the process of transferring title. Because this is a separate function, an escrow, settlement, or closing fee will be charged, even if the title agent is involved in this function.

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Closing protection letters

At the closing, it is incumbent upon the parties that all liens are paid on the property before title is passed to the new owner. One way to ensure this occurs is the use of closing protection letters. Closing protection letters are sometimes used in the process of purchasing real property. Some advocate for their use in all property transactions; it's possible to mitigate title agent defalcations through the use of closing protection letters as the letter includes protection against the fraud or dishonesty of the agent issuing the title underwriter's policy. A closing protection letter provides an assurance that all funds will be correctly handled to clear all the encumbrances (debts owed as all lienholders will be paid what they are owed) on the property and provides an indemnification due to the issuing agent's handling of funds or documents in connection with the closing. Closing protection letters are issued to lenders and owners when required by law or to a lender or owner who requests them. Because a different function is performed and additional documents are prepared, there will more than likely be an additional charge for providing closing protection letters.

RESPA's involvement

When consumers are told by their mortgage company or their real estate broker that “I must buy” title insurance, a product they do not know or understand, what do they do next? Generally, the consumers listen to the person who told them to buy this insurance and use the title agent and/or title company referred to them. Purchasers of real property do have a choice at this

point to shop around for title insurance. However, most consumers, such as the newlyweds mentioned earlier, are focusing on buying the new home and wondering how to get everything in order and purchase new furnishings for their home. Excitement is in the air—and shopping for title insurance is not part of that excitement.

The federal Real Estate Settlement Procedures Act (RESPA) helps consumers become better shoppers for settlement services and is in place to eliminate kickbacks and referral fees. RESPA prohibits a person from giving or accepting anything of value for referrals of settlement service business related to a federally related mortgage loan. It prohibits a person from giving or accepting any part of a charge for services that are not performed. It also prohibits home sellers from requiring home buyers to purchase title insurance from a particular company. Many insurance departments, the NAIC, and other entities have been involved and will continue to be involved in providing additional information to consumers about their choices related to purchasing title insurance and the other related expenses associated with purchasing property.

When borrowers apply for a mortgage loan, mortgage brokers and/or lenders must give the borrowers a Special Information Booklet, which contains consumer information regarding various real estate settlement services, and a Good Faith Estimate (GFE) of settlement costs, which lists the charges the buyer is likely to pay at settlement. This is only an estimate and the actual charges may differ. If a lender requires the borrower to use a particular settlement provider, then the lender must disclose this requirement on the GFE and a Mortgage Servicing Disclosure Statement, which discloses to the borrower whether the lender intends to service the loan or transfer it to another lender. If the borrowers do not get these documents at the time of application, the lender must mail them within three business days of receiving the loan application. RESPA has other requirements for disclosures, including some that are disclosed after the settlement occurs.

The HUD-1 Settlement Statement is a standard form that clearly shows all charges

imposed on borrowers and sellers in connection with a settlement. RESPA allows the borrower to request to see the HUD-1 one day before the actual settlement. The settlement agent must then provide the borrower with a completed HUD-1 based on information known to the agent at that time. Separate HUD-1 forms may be prepared for the borrower and the seller.

Other terms

The term “title agents” includes various and different types of people and entities. Some are not agents at all as attorneys provide the functions of a title agent. Following is a listing of the different groups.

- An “affiliated title agency” is a title agency that is owned, either wholly or in part, by a title insurance company/underwriter but does not operate as an underwriter direct agency.
- An “attorney firm/title agency” is a title agency that is owned and operated by an attorney or law firm.
- An “independent title agency” is a title agency that is not part of an ownership arrangement with a real estate settlement producer or with a title insurance company/underwriter.
- A “direct operation” involves the title company also having title agents on staff as employees in procuring title insurance or a title agency that is wholly owned and operated by a title insurance company. The licensing of title agents, attorneys and the like varies by state.
- An “affiliated business arrangement” is an arrangement in which a settlement producer (such as a real estate broker, developer, mortgage loan originator, or bank, or any other individual or entity that is in a position, directly or indirectly, to refer settlement business to a title entity) also maintains a direct or beneficial ownership interest in that title entity.
- A “title plant” means a set of records consisting of documents, maps, surveys, or entries affecting title to real property or any interest in or encumbrance on the property, which have been filed or recorded in the jurisdiction for which the title plant is established or maintained.

The Title Insurance (C) Task Force of the NAIC conducted a survey of each jurisdiction’s laws and regulations regarding the collection of title agent data and other issues related to title insurance. The survey was conducted by the NAIC and began in August 2009. Respondents were the insurance department or other jurisdictional agency responsible for title agents or title insurance as appropriate in each jurisdiction. The survey was concluded and summarized in March 2010. The survey includes information by state related to such items as the different functions allowed or performed by different entities and what entities are licensed or appointed. The results are available at http://www.naic.org/documents/committees_c_title_tf_survey_state_laws.pdf.

Summary of benefits to consumers

Consumer benefits of purchasing title insurance and obtaining a closing protection letter include:

- Providing peace of mind knowing there is clear title and, if the title is not clear, there is insurance to protect the owner for any losses involved;
- Believing all payments were made to prior lienholders;
- Covering the owners for an unlimited amount of time;
- Paying for title insurance once; and
- Knowing that escrow funds were set up properly.

Regulators must be certain that the benefits are provided to consumers.

The next issue of *The Regulator* will include information related to market conduct examinations of title insurers and title insurance agents. ■

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