

Testimony of the
National Association of Insurance Commissioners

Before the
Subcommittee on Housing and Community Opportunity

Committee on Financial Services
United States House of Representatives

Regarding:
State Insurance Regulators' Investigations of the
Title Insurance Industry

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Introduction

Chairman Ney and Congresswoman Waters, thank you for inviting me to testify before this Subcommittee on our investigations into the title insurance market. My name is Erin Toll and I am the Deputy Commissioner of Insurance for the State of Colorado. I currently serve as the Co-Chairperson of the Title Insurance Issues Working Group of the National Association of Insurance Commissioners (NAIC). Like you, state insurance supervisors are public officials who serve and protect your constituents' interests. We share your goal regarding the importance of regulation that balances the need for vigorous consumer protection with vibrant business competition to provide a healthy insurance marketplace for consumers.

Today, I would like to make a few basic points –

- First, although title insurance is different from other insurance products, it is a valid and important product. It protects buyers and lenders from problems that may arise with real estate title that establishes legal evidence of home ownership.
- Second, title insurance's uniqueness provides fertile ground for certain questionable activities.
- Third, both state and federal laws explicitly prohibit kickbacks – defined as the referral of title insurance business in exchange for something of value. We have found in Colorado, and other insurance officials have found in their states, that some title insurers, title agencies, real estate agents, lenders, homebuilders, and other settlement providers violated these anti-kickback laws by developing improper business arrangements and illegitimate reinsurance programs.

- Fourth, state insurance officials are working aggressively to uncover and prevent improper business practices by insurers and agents in the title insurance industry. State insurance supervisors have imposed penalties, ordered restitution to consumers, and have closed some businesses. We are also working together to strengthen title insurance laws and regulations.
- Fifth, our jurisdiction as state insurance officials extends only to title insurers and, in some states, to the title agencies and agents. Other players in residential real estate transactions, including real estate agents, lenders, and homebuilders, are subject to different oversight by different regulatory bodies.

Title Insurance Overview

What is title insurance? Is it necessary?

Title insurance protects the policyholder from potential disputes or problems with real estate title and allows all parties in the transaction to proceed with confidence. There are two general types of policies: an owner's policy and a lender's policy. An owner's title insurance policy protects the purchaser of residential real estate in the event an undisclosed lien, impairment or "cloud" is found on the property that negatively affects the value of the property. The typical owner's title insurance policy indemnifies the owner up to the purchase price of the home.

A lender's title insurance policy protects the lender, not the owner; though often the owner pays the premium. A lender's policy indemnifies the lender up to the value of the loan so the policy's value decreases as the loan is paid and provides no coverage once the loan is paid off. Though the purchase of title insurance is not typically required by law, a lender generally will not provide a loan to a homebuyer without a lender's title policy. So, with the exception of those who can pay cash for a home, virtually all homebuyers obtain title insurance.

Title insurance is an integral part of a residential real estate transaction that protects homeowners' value in their properties and protects lenders' collateral. The real estate agent contacts a title insurance agency to obtain title insurance for the purchaser. The purchaser of the policy may be the buyer, the seller, or both, and who pays can be negotiated in many states. The title insurance agency performs a title search of the property. The title insurance agency is under contract with a title insurer, the underwriter, who agrees to insure the property. The title agency and insurer are paid. The title insurer issues the title insurance policy to the new property owner in the mail usually a few weeks later.

Unique Characteristics of Title Insurance

Title insurance is a unique product when compared with other types of insurance.

- Title insurance insures against things that already have happened. Homeowners, auto and other insurance each insures against unknown future events.
- Consumers often do not have many meaningful options regarding the insurance product or who provides their title insurance. Real estate agents and lenders usually recommend the title insurance provider.
- The title agency normally retains 85 to 90 percent of the premium, and the remaining 10 to 15 percent goes to the insurer. Title insurance is a flat, one-time fee paid along with a host of other fees, as part of a large, complex transaction. Consumers pay for health and auto insurance monthly and these purchases are not part of other transactions.
- Compared to both the overall cost of the home buying process and other insurance lines, title insurance is inexpensive. In Colorado, the cost of title insurance for a \$300,000 home is about \$1,000. Given that the average person buys six homes in a lifetime, an average consumer may pay \$6,000 for title insurance over the course of their lifetime (taking refinances out of the equation for simplicity) and have only six contacts with a title insurer. On the other hand, consumers have many contacts with auto and health insurers and pay more for these products over their lifetime. The average yearly cost of health insurance is about \$2,400 a year

or \$96,000 over one's lifetime. The average yearly cost of auto insurance is about \$1,000 or roughly \$40,000 over one's lifetime.

- Title insurance comprises just 1.9 percent of insurance premium that state regulators oversee, and title insurance represents an extremely small fraction of the consumer complaints and inquiries that state insurance departments handle each year.

Title Insurance Claims and Loss Ratios

One of the unusual characteristics of title insurance is that so few claims are paid. Over 10 years, all 86 title insurers across the country paid slightly more than 5 cents out in claims for every dollar of premium consumers paid.

- Compare this to other lines of insurance:
 - Homeowners: 75 cents for every dollar.
 - Auto: 60 cents for every dollar.
 - Health Maintenance Organizations: 86 cents for every dollar.

However, loss ratios for title insurance really should be at or near zero. The “risk” that there is a problem with a title has already occurred so, if the title search is done correctly, most forgeries, liens, or other problems with a title will be discovered and no claim will ever be made. The real cost of title insurance is the title search, not claims payment. This is why the agency that performs the title search retains up to 90 percent of the total title fee. The core value to title insurance is ensuring clear title.

Marketing of Title Insurance

Most lines of insurance are competitive on coverage, claims payment, service, and price. Currently this is not generally true in title insurance. Unlike other types of insurance, title insurance from any insurer provides virtually the same coverage; so there is little competition around coverage type. Likewise, claims payment is not a major point of competition because payments are so rare and should be nearly non-existent. Because title insurance is marketed to lenders and real estate agents, but paid for by the consumer purchasing the policy, there is a disconnect that allows for little price competition.

When all participants play by the rules, the primary form of competition that benefits consumers in the title insurance market is competition over quality (accuracy and depth of research) and service (speed, customer service, and surety of closing). For example, real estate agents have much greater knowledge about title agencies than the consumer because they have experience with many transactions, so the consumer benefits from the experience of the real estate agent. Since the efficiency of a residential real estate closing is greatly influenced by the competency of the title insurance agency, the real estate agent has a high incentive to choose a competent, reputable title agency. However, when kickbacks enter the equation, any incentive to compete over service is negated by the presence of the kickback, and competition of this type ceases to exist. When bad actors in the industry stop competing on consumers' behalf over quality and service and, instead, compete amongst themselves for the placement of business, consumers lose.

Laws Affecting Title Insurance

State and federal regulators recently have uncovered violations by title entities and settlement providers in the title insurance business that take various forms, but have collectively and accurately been defined under the Real Estate Settlement Procedures Act (RESPA) as "kickbacks." There are multiple parties involved in title insurance transactions and they are subject to different oversight. As a state insurance supervisor, the scope of my authority and testimony applies to the insurers, agencies and agents we supervise. From this perspective, kickbacks are violations of state anti-remuneration laws and RESPA.

- The state of Colorado and most other states have adopted rules prohibiting referral of title insurance business in exchange for something of value. In keeping with the NAIC's commitment to continually improve the state insurance supervisory system, the NAIC's Title Insurance Issues Working Group is charged with monitoring and working with the U.S. Department of Housing and Urban Development (HUD) on any changes to the Real Estate Settlement Procedures

Act (RESPA). The Working Group is also updating the NAIC's Title Insurers Model Act and the Title Insurance Agents Model Act.

- *Sec. 2607. Prohibition against kickbacks and unearned fees* of RESPA stipulates that: “No person shall give and no person shall accept any fee, kickback, or thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to or a part of a real estate settlement service involving a federally related mortgage loan shall be referred to any person.” RESPA also stipulates that “the Secretary, the Attorney General of any State, or the insurance commissioner of any State may bring an action to enjoin violations...”

Using the authority granted by these rules and state laws, state insurance regulators aggressively pursue and impose penalties, order restitution, and revoke or suspend the licenses of unscrupulous title entities.

Eliminating kickbacks from the title insurance transaction is the only way to ensure a level playing field where the interests of those selecting the title insurance and those paying for it align. This ultimately requires aggressive enforcement and collaboration among state and federal regulators who have oversight over the various settlement providers engaged in this practice.

Title Insurance Business Practices

State laws and RESPA define acceptable and unacceptable business practices regarding referrals in the title insurance business. These laws empower state insurance commissioners to stop violations.

Acceptable Business Practices

State anti-kickback laws and RESPA do not prohibit a settlement provider from marketing to another settlement provider or providing an incentive to do business with each other so long as it is not based on the referral of business. Conversely, neither state

anti-kickback laws nor RESPA prohibit a settlement provider from referring business to another settlement provider so long as nothing of value is exchanged for that referral. Finally, RESPA and some state laws permit affiliated business arrangements under defined circumstances.

Unacceptable Business Practices: Kickbacks

The practices listed above are legitimate and reflect a market where companies may do business in good faith with one another in ways that provide quality service to consumers. However, bad actors exist, and they have used a variety of direct and indirect ways to deliver kickbacks for the referral of business. One example we uncovered in Colorado was a title agency flying top producing real estate agents on its corporate jet to spa vacations.

Indirect kickbacks: Captive title reinsurance

In February 2005, Colorado uncovered an arrangement where real estate agents, lenders and homebuilders promised to refer all of their business in a defined geographical location to a particular insurer, if that insurer agreed to reinsure the risk with a reinsurance entity owned by those real estate agents, lenders, and homebuilders. Reinsurance itself is legal and encouraged in some circumstances where risk is high, particularly where an insurer sheds off or “cedes” some of its risk above a particular dollar amount. This particular type of reinsurance is known as excess reinsurance, and it helps prevent smaller companies from becoming insolvent from one or two big claims.

To understand why this captive reinsurance arrangement is illegal for title insurance, it is important to understand how title insurers split commissions and to remember that they only pay five cents in claims for every dollar in premium. I have attached a flowchart to facilitate this understanding (Attachment A).

Typically, a title insurer retains only 10 to 15 percent of the premium. A title insurer’s main function is to pay claims. Title agencies get the business and perform the title search, but they do not pay the claims. This split is not set by law. Historically, title

insurers have determined that they can pay all claims, overhead, and premium tax and make a profit by retaining only 10 to 15 percent of the premium.

Yet in these illegal reinsurance deals, the insurer sheds off or cedes 50 percent of the “risk” for 50 percent of the premium, less a “processing fee.” The processing fee covers the cost of the title search performed by the insurer. The title agent is not a party to these transactions. In other words, even though in a “normal” non-reinsured transaction, they only retain 10 to 15 percent of the premium to cover the risk that they will have to pay claims, they pay the reinsurance entity 50 percent of the total premium (less a processing fee) for 50 percent of the risk. If they were appropriately pricing this “reinsurance,” the price for half of the risk would be no more than half of what they retain to pay claims – five to seven-and-a-half-cents on the dollar, instead of about thirty-five cents (after deducting the processing fee then paying 50 percent of the remainder).

This difference between what this reinsurance should cost and what the insurer pays and what the person referring of the business receives, is a thing of value or kickback as defined by law, and therefore illegal. Although it seems like a small amount, when these entities act together to take a small amount of money from consumers in every transaction, they add up to millions and millions of dollars in kickbacks.

Another way to look at these transactions is to consider the loss ratio discussed earlier. Title insurers over ten years have paid out five cents for every dollar of premium the consumer pays. Since the risk is that they have to pay a claim, the cost of shedding 50 percent of the risk should be two-and-a-half cents per dollar. Therefore, the only reason to pay the referrer’s reinsurance entity thirty-five cents per dollar is to deliver a kickback. Nationally, not one of the reinsurers involved in these arrangements has paid a covered claim over the nine years since their inception.

For all of these reasons, it is our firm belief as state regulators that these reinsurance arrangements, where the value of risk transferred is not commensurate with the money

paid, are nothing more than vehicles established to provide kickbacks to real estate agents, homebuilders and lenders who referred business to the title insurer.

Indirect kickbacks: Sham affiliated business arrangements.

The other indirect form of kickback that state regulators and HUD are seeing across nearly all states is illegitimate or “sham” affiliated business arrangements. Affiliated business arrangements (AfBAs) are ownership arrangements between and among title insurance entities and settlement service providers (lenders, homebuilders, real estate agents, among others). State and federal regulators and the industry itself have been grappling with their legality for years. HUD issued guidelines and a test to determine whether an AfBA is a sham. Nationally, for several years certain title insurance competitors have proposed legislation imposing percentage limitations on the amount of business that can be referred from an affiliated source.

In 2005 the Colorado Division of Insurance commenced an investigation of every title insurance agency in the state. Although that investigation continues, there have been some interesting discoveries that will be discussed in the next section of this testimony.

In Colorado, the pervasiveness of kickback schemes in the residential real estate transaction process has created a black market that makes it impossible for those who play by the rules to compete. The cost of providing kickbacks is passed on to consumers and rolled into the rate.

State Actions in Response to Improper Business Practices

The title insurance marketplace has evolved and expanded greatly over the last 30 years as lenders typically require confidence in the title for a real estate transaction to progress smoothly. We just have witnessed the largest housing boom in our nation’s history, where home ownership is at an all-time high and interest rates were at all-time lows. The sheer volume of transactions has contributed to the explosion in the size of the title insurance market. In fact, title insurance premium volume has increased 400 percent

over the last ten years. As the title insurance market has grown, so have the number of bad actors looking to exploit it.

What Are We Doing About It?

Many of the title insurers the Colorado Division of Insurance investigated operate in multiple states, and it is evident from our investigations that illegal practices are likely occurring in nearly all states. The Division shared its findings with the NAIC's Market Analysis Working Group and together, the states have taken significant regulatory steps to end these practices.

As mentioned in the previous section, the Colorado Division of Insurance commenced an investigation last year of every title insurance agency in the state, looking in particular for sham AfBAs. Our goal was to identify and distinguish between good AfBAs and bad AfBAs. State laws and RESPA provide guidance as to what is a legitimate AfBA and what is a sham AfBA. In Colorado, we believe that AfBAs are not inherently bad and that consumers like the convenience offered from the "one-stop-shopping" that legitimate AfBAs afford. We are in the initial stages of our investigation and, at this point, have examined about 15 agencies. We targeted these 15 agencies because we believed 14 were shams operated by the same title agent and one was legitimate. Indeed, our assumptions were correct. The legitimate AfBA had its own management, a discrete office location from its referral source, it performed its own searches, it was adequately capitalized and it had its own staff. The sham AfBAs are described in more detail below. Although the investigation into all agencies is ongoing, we have made some interesting discoveries.

The number of title agencies in our state exploded from 200 to over 500 in three years, growth that other states shared as well. More than 40 percent of all agencies polled responded that they were AfBAs. More than 20 percent failed to respond because the addresses listed were wrong, they had already ceased operations, or they never commenced operations. In many cases, the Division determined that multiple agencies

were conducting business from the exact same addresses and under the same management.

The Division then conducted “no-knock” investigations of targeted agencies. We discerned that the first grouping of AfBAs that we investigated were shams for various reasons, including they had no staff, the same address was listed for more than five agencies, there was little or no capital infusion and title services were contracted out to another title agency. Please refer to the flow chart to better understand these operations (Attachment B).

The Division concluded that the only purpose for establishment of these entities was to create vehicles to provide kickbacks to the real estate agents and mortgage brokers who owned the businesses, and we shut them down. The Division also has refused to provide licenses for new agencies to those involved in these scams. In addition, we contacted the sham agencies’ underwriters and held them responsible for running off any existing business to prevent consumer harm.

This market conduct examination report and the actions we have taken can all be reviewed on our website at <http://www.dora.state.co.us/insurance>.

Ultimately, in Colorado there are a number of AfBAs that exist only as mechanisms to provide kickbacks, and they are harming consumers in several ways. As mentioned earlier, title insurers compete mainly on service, and where sham AfBAs are operating, that service is compromised. Where the real estate agent, lender and homebuilder pick a title insurance entity based upon the kickbacks it receives and not upon quality and service, the consumer suffers. Examples of cases we have seen proving that quality and service are compromised:

- The agency fails to remit premium to the insurer and therefore policies are not issued even years after the closing. It is unclear whether exceptions to title were deleted because the consumer does not have a policy.

- Fly by night AfBAs close their doors after six months to a year and the records of the transaction are lost forever. Title insurance is a long claim tail business, meaning claims are made many years after the insurance is purchased. Problems leading to a claim usually are discovered when the homeowner goes to sell his or her home. By then, the AfBA is long gone, and the claim goes unpaid.
- Legal instruments are not recorded in a timely manner creating title problems down the road.
- Loan proceeds are not disbursed timely or appropriately and the consumer suffers financial harm.

Colorado shared its investigative processes and findings with other states at the last several NAIC meetings. Other states are reporting findings similar to ours. We spent a great deal of effort researching and analyzing HUD's guidelines, RESPA and laws in Colorado and in other states to define a sham business operation. However, it often is just a question of peering into a title agency's window to discern if it is a sham.

Results of Investigations into Title Insurers

After commencing an investigation of all title insurers operating in the state of Colorado, the Colorado Division of Insurance determined that three of the nation's largest insurers were engaged in illegal captive title reinsurance arrangements. Indeed, these three insurers, which do business in virtually all states (except Iowa) under a variety of names, control about 75 percent of the national title insurance market.

In February of last year, Colorado negotiated a settlement with the country's second largest title insurer, where they agreed to refund \$24 million to consumers in all eight states where they engaged in captive title reinsurance arrangements. The Colorado Division of Insurance asserted that the captive title reinsurance arrangements into which the insurer entered were kickback schemes.

In September of last year, Colorado negotiated another multi-state settlement with the nation's largest title insurer concerning captive title reinsurance arrangements. Colorado

worked with the NAIC's collaborative action committee to coordinate state efforts. Fully 26 states signed onto the settlement. The agreement provided consumer refunds of about \$1.3 million in all 26 states.

Although the one remaining insurer has refused to enter into a multi-state agreement, Colorado, with assistance from the NAIC, so far has returned over \$25 million to consumers. In addition, several other states have concluded their own settlements regarding these arrangements, including California, Arizona and Virginia. All together, the states have assessed \$49.7 million in fines and penalties.

In Colorado and in other states insurance officials are looking at ways to reduce the premium and put more emphasis on price competition. We have posted an interactive premium comparison guide to our website where consumers can shop for rates. We already have witnessed increased rate competition as this new transparency encourages insurers to lower their rates. We also are looking more closely at rate justification requirements, among other things.

In addition, Colorado and several other states currently are investigating and taking actions to shutter the doors on sham affiliated business arrangements. Working through the NAIC, state officials have been able to share information and forge a unified approach to addressing the proliferation of sham title entities. To facilitate this level of inter-state collaboration, every state insurance department has a Collaborative Action Designee (CAD) who works within the NAIC's Market Analysis Working Group to ensure their state is up to speed on the challenges and approaches to solutions being taken by different states. The NAIC's Title Insurance Issues Working Group, which I co-chair, is re-examining the Title Insurance Agents and Title Insurers Model Acts to ensure that they reflect the evolving title insurance market, and the level of sophistication of improper business practices.

In addition to these activities, officials in Colorado have taken the following actions:

- Legislation has passed the Colorado legislature granting additional fining authority to the Commissioner of Insurance and the Director of the Division of Real Estate. The legislation grants both bodies the same oversight authority and penalty as HUD, and allows for restitution to all aggrieved parties, in addition to existing fining authority. This legislation tracks RESPA by requiring disclosures of AfBAs. This legislation also requires the two Divisions to share information regarding illegal practices, and to consult with each other to promulgate appropriate rules. (HB 1141).
- Colorado heads up an NAIC subgroup to rework the title insurance section of the Market Conduct Handbook.
- Colorado is in the process of increasing the testing requirements for title insurance agents to include more information anti-remuneration statute compliance, RESPA compliance and kickbacks in general.
- Colorado is examining ways to reduce rates, including examining and requiring greater justification for the agency retention rate.
- Colorado reviews background checks of the principals, not just the responsible producer, when processing a new request for an agency license. The Division has denied licenses where principals were associated with sham companies.
- Three proposed bills concerning the mortgage lending industry are proceeding through the Colorado legislature. The Department of Regulatory Agencies, the umbrella agency for the Division of Insurance, supports one. It is a mortgage broker registration and bonding program run by the Division of Real Estate. The other two bills concern mortgage fraud.
- Colorado will be amending its title insurance rule (3-5-1) to define sham AfBAs and to impose measures designed to stop their proliferation. (Capitalization requirements, staffing requirements, provision of core services, etc.)

California co-chairs the NAIC Title Insurance Working Group and has been a leader in the fight against title insurance fraud. They have taken the following actions:

- In December 2005 the California Department of Insurance fined one company \$1 million for illegal rebating. In addition, the Department restricted the company's license for 18 months in all counties and for two years in San Diego County. The illegal kickbacks provided to real estate agents and brokers totaled more than \$455,000, including cash payments, fraudulent billings, fraudulent invoices, printing services, and other miscellaneous items. In return the agents were expected to steer business to the company.
- In June 2004 the Department seized \$500,000 in escrowed funds that were part of a 2002 settlement with one company, due to evidence of continued illegal rebating. The Department's investigation uncovered suspected illegal activity including: the compensation of employees for fraudulent and fabricated invoices and expense reports in excess of \$47,000; providing food, beverages, and entertainment in excess of \$174,000; providing gifts and gift certificates in excess of \$62,000; and providing business support services in excess of \$218,000, all to benefit real estate agents and brokers.
- In April 2005, the Department fined yet another company \$590,000 and ordered it to pay \$160,000 in restitution in connection with illegal kickbacks. The Department's investigation found that the inducements Stewart gave to agents amounted to \$594,102. They came in the form of payments for business support services, providing gift certificates and door prizes for realtor events, making rent payments, funding special events, and sponsoring broker activities.
- Also in April, Commissioner John Garimendi held a public hearing into illegal kickbacks in the title industry, including phony reinsurance arrangements.
- In July 2005, the Department settled with three large title insurers in connection with the fraudulent reinsurance scam described above. The three companies agreed to pay a total of \$12.5 million in penalties.

Conclusion

The unique structure of the title insurance industry involves a variety of groups subject to different laws and levels of oversight. As insurance supervisors, we have an obligation to protect consumers from bad actors in this marketplace, but our authority is limited.

Colorado has regulatory authority over the title insurers, title agencies and title agents, but some states only regulate the title insurer, not the agencies. For our efforts to enforce aggressively the laws governing these groups to have the greatest impact, the entities enforcing laws over the other settlement providers need to be aggressive and effective as well. Ultimately, a collaboration of federal and state law and supervision is necessary to protect consumers from improper business practices in the title insurance industry.

As state officials, we will continue aggressively to enforce our laws prohibiting these practices. However, even when RESPA and state laws are aggressively enforced, they are not potent enough to deter these practices. RESPA only provides state regulators authority to enjoin violations, not impose penalties. The penalties for violating RESPA and state laws should be much greater. In Colorado, our General Assembly saw the problems with our current statutes and legislation increasing our fining authority recently passed the Colorado House and Senate. Again, since our jurisdiction extends only to those providing the kickbacks (the insurance industry), other regulatory bodies with jurisdiction over the recipients of the kickbacks need greater fining and regulatory authority as well.