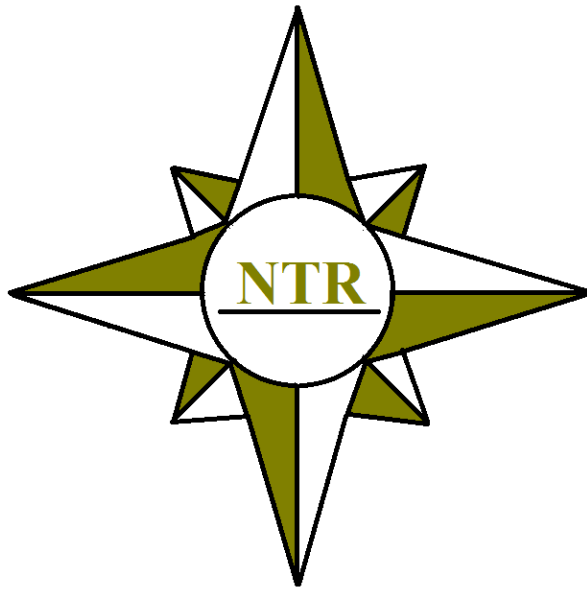


Gateway Barriers and Oversight in the Title Industry



National

Title Resources Corp.

Joel Holstad, President

July 27, 2012

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Analysts: Gilbert Wenzel and Patrick O'Brien

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Abstract

Inspired by a recent study, we compiled title premium rates for each state, adjusted them to an arbitrary par value to display losses as a percent that isn't influenced by variable premium fees. After determining the par premium ratio for each state, we multiplied this ratio by the states' loss rate to determine their relative loss rates. Using these values, we divided the states into groups determined by their barriers to entry and analyzed the effects that oversight had on the states in each group. It was determined that, ultimately, oversight had little significant impact on loss rates for each state, as loss rates were incredibly variable regardless of oversight levels. There was, however, a strong correlation between entry barriers and low loss rates, specifically mandated title plant reference in title searches and abstracting practices and direct attorney involvement in settlements. It was also determined that states with high levels of oversight also charge greater premium fees than states with low oversight levels, which also more commonly require attorney involvement in settlements.

Origin of Study

In June, 2012, a report was published by Demotech, Inc. that was intended to show the correlation between high operational oversight as mandated by the NAIC and lower occurrences of escrow theft and, by extension, losses incurred by the title industry. While their report posed some interesting thoughts, their methodology appeared to be deeply flawed and their conclusions were not strongly supported by their evidence.

Our primary concerns about Demotech's report are based on their qualifications for "well regulated" states in the title industry. Background checks for prospective agents, licenses, entry exams, regular audits or inspections, mandated segregated accounts, and the other miscellaneous operating regulations Demotech considered when determining their ratings are certainly helpful in maintaining smooth operations, but one major factor was rather obviously neglected in their study: the value of strong gateway barriers to the industry. In many of the states Demotech determined to be poorly regulated, title insurance, closings, and escrow activities are commonly managed by attorneys or are required to maintain a title plant. These two qualifications greatly limit the number of individuals that can enter the title industry due to their relatively high scarcity. It is our hypothesis that having higher standards for entry to the title industry has a far greater influence on loss rates than operational oversight as mandated by the NAIC.

Process

For our study, we began by using the annual financial statements provided by the American Land Title Association (ALTA), beginning with 2003 and ending in 2011, a selection that spans the entirety of the ALTA's readily available data. In the eight annual financial statements used, the information in "Schedule T – Exhibit of Premiums Written by States and Territories" was most pertinent; as it contains data for "Net Premiums Earned" and "Direct Losses and Allocated Loss Adjustment Expenses Incurred." These sets of data provide the foundation of both our study and Demotech's.

We arranged the data in a spreadsheet for each state and the District of Columbia, displaying incurred losses as a percentage of net premiums earned in each available year. After completing this step, it was apparent that Demotech's findings were not inaccurate: the states that were deemed "more highly regulated" (henceforth known as highly regulated states) in their study did, typically, have lower loss rates. Though this is irrefutable, the core problem with Demotech's report is that their figures are used incorrectly. Upon closer inspection, it becomes apparent that there is a strong correlation between high oversight levels and high premium costs, which we obtained using online premium calculators and cross-referenced with the *Title Insurance Regulatory Survey*.

Because title premiums are determined by a rate on the cost of the property, cost of living is irrelevant when determining premium cost. As such, we determined that for the purpose of displaying loss rates more honestly, we would assign a "par" premium cost that we would relate each state's premium to. We choose three dollars per thousand as our par because it rests well above the lowest and well below the highest, though this method could use any number as par and achieve the same results because it is simply relating all premium costs to each other in a simple manner. Using the actual premium to par ratio, we determined what the actual losses for each state would be if all premiums were billed at the same price. Unsurprisingly, when each state's losses were compared on a relative scale, the states with dramatically higher premiums also had much higher loss rates.

After compiling the data, we were able to generate summary statistics including adjusted average annual loss as a percentage of premiums generated, and standard deviations on both a by-state and national scale. To eliminate any statistical anomalies, we omitted any data points that lay outside two standard deviations of a state's average losses. Ultimately, only five points out of the four hundred we used were omitted for this reason.

We then analyzed the barriers to entry as a title agent in each state. The areas of focus were, licensing, entry examinations, continuing education, title plants, abstractors licensing, and attorney regulations as described in the *Title Insurance Regulatory Survey*. We divided the states into groups determined by

gateway barriers and summary statistics were calculated using each state's average payout and standard deviation. Comparisons could be made based on varying barrier to entry requirements.

We decided it would be best to replicate Demotech's format decision so that comparisons can be drawn easily from our analysis and theirs. As such, we created an average loss rate for each group as determined by their at-par loss by gateway barrier. We then applied these numbers to the groupings Demotech assigned in their study to maintain continuity and transparency. We trusted that Demotech's assessment of oversight in their study was relatively accurate, but we also investigated oversight levels in the states to confirm the accuracy of their categories. Generally satisfied with the results of our research, we decided to compress Demotech's categories to three groups of "high," "moderate," and "low" oversight. Again, we compared each category in the areas of average payout, standard deviation, and premium cost.

Analysis of Data

We decided that our primary point of interest was how the states' loss rates compared to those used by Demotech. To achieve this goal, we arranged our adjusted loss rates by state, from lowest to highest, and separated them into deciles. The first decile, populated by North Dakota, Connecticut, South Carolina, Iowa, and Rhode Island, averaged an adjusted loss rate of 2.56% over the eight years our data ranged. The last decile, populated by Indiana, Nevada, Colorado, the District of Columbia, Michigan, and Illinois, averaged an adjusted loss rate of 31.82% over the eight years our data ranged. While this is a dramatic difference, it is important to remain mindful that because our par number is arbitrarily chosen, these numbers are meant only to show a relationship, not actual loss. The disparity between the first and tenth deciles piqued our curiosity and so we charted the deciles and investigated the regulations in the states and the influence they may have over loss rates.

North Dakota, consistently one of the best performing states despite its low revenue, also happened to be placed in Demotech's "Group 3," which was qualified as "slightly less regulation than the NAIC Model Act." North Dakota's title premium is just over three dollars per thousand, which is very close to what we set as par for this study. The state displays very consistent revenue and losses, which were below 2% of revenue in each year with a single exception. In 2011, North Dakota suffered 3.33% loss at par, but this also happened to be a statistical outlier because their average over the other years was 1.10%. While North Dakota has moderate oversight, the state requires that title searches use plants as their sources. If a search is to be done without a title plant, a complete set of recorded documents in the county the search falls within is required. This provides a significant to entering the title industry in North Dakota because of the

relative difficulty of acquiring access to these title plants. As a result, title searches are incredibly accurate and done only by experienced individuals.

The four remaining states in the top decile, Connecticut (1), South Carolina (2), Iowa (0), and Rhode Island (1), all ranked among the bottom three groups in Demotech's study, as indicated by the parenthesized numbers next to the state. If Demotech's conclusion that high oversight levels reduce losses is correct, then these states should not perform so well. The common element in each of these states' regulations is that they all require title work to be done directly by an attorney, an attorney's subordinate, or require searches to be done according to a title plant. While a small sample of five states does not provide irrefutable proof that requiring title work to be practice of law or referencing title plants reduces losses, it provides a strong pull in that direction.

Of the ten states that require, or strongly favor, title plants, only two rank average adjusted losses above 9% and rank in the bottom half of the states according to our data. Similarly, only four of the twelve states that consider title work to be the practice of law suffer loss rates greater than 9% and rank in the bottom half of the states. With only 20% and 25% placement in the lower half of states, these two entry requirements appear to be effective methods of minimizing losses. Interestingly, the two "title plant" states outside the top half are also the two most highly regulated of these states according to both Demotech's survey and our research in the *Title Insurance Regulatory Survey*. It no longer appears that enforcing high degrees of oversight has only minimal effect on losses, but may in fact do more damage than good in these states.

To further investigate this possibility, we decided to look into the adjusted loss rates for the states Demotech determined to be very well regulated, namely Group 5 and Group 6. Fully 50% of these highly regulated states suffered from adjusted loss rates above 13%, and the two states composing Demotech's Group 6 were in this group. Furthermore, eight of the ten states composing Demotech's "NAIC Model Act or Equivalent" group, numbered 4, suffered losses above 9%. Of the seven states from these three groups that have adjusted loss rates less than 9%, four of them require title plants or attorneys.

While Group 6's apparent failing is intriguing, the wide variety in adjusted loss rates among these highly regulated states indicates that, in most cases, regulation without strong entry barriers is unreliable at best and ineffective at worst, but not necessarily a purely negative influence. It's important to note that the four groups Demotech's survey labeled as "less regulated" suffered similar variability, partly because there are more of these states, but the states requiring title plants or attorney involvement consistently display superior performance. Correlation doesn't equate to causation, but the evidence suggests a strong relationship between attorney or title plant involvement and low loss rates.

It can be expected that knowing this information would worry members of the title industry. Attorneys are typically higher paid and more difficult to find than most employees, causing a higher cost for the agent which would undoubtedly be passed onto the buyer. Acquiring access to a well-maintained title plant

would also cause similar anxieties. Our data shows that, of all states, attorney-run states have the lowest average premium fees, while title plant states are far less consistent, but also more common in the southwest, where premium fees are highest. As a point of interest, it can be noted that there is a strong correlation between high premium costs and high oversight levels according to the categories Demotech assigned in their recent study.

Conclusions

Ultimately, we determined that once premium rates are adjusted to reflect their losses on a relative scale, the states that Demotech determined to be well regulated would typically suffer higher losses than their less regulated and less costly counterparts. What appears to have the highest effect on minimizing losses appears to be direct attorney or title plant involvement in title and settlement processes, which averaged losses between 5.69% and 7.45%. Other factors, such as licensing, continuing education, admittance exams, and direct abstractor involvement have some effect on minimizing losses, with the states requiring only those having average adjusted losses between 8.73% and 11.17%. Only five of the twelve states that required direct attorney involvement had premium fees greater than \$300, while all other entry barrier groups averaged between \$450 and \$730. Oversight level did not highly affect average loss rates, but states with lower direct oversight had a slight tendency to have lower losses. Overall, we determined that there is far too much variability in loss rates for states based on their oversight level, but loss rates are consistently lower in states that have direct attorney or title plant involvement in the settlement process.

Source Materials

Kirkpatrick & Lockhart LLP, Et Al. "Volumes I-VI." *Title Insurance Regulatory Survey*. Washington, DC: American Land Title Association, 2003.

Petrelli, Joseph L. and Coleman, W. Burke. *Escrow Theft: Today's Challenge in Title Insurance*. Columbus, Ohio: Demotech, Inc. 2012.

"Title Insurance Industry Annual Financial Statements." *ALTA®*. American Land Title Association, n.d. Web. 12 July, 2012.
<<http://www.alta.org/industry/financial.cfm>>.

Exhibit A:

Top 5	Avg.	StDev	6 to 10	Avg.	StDev	11 to 15	Avg.	StDev
North Dakota	1.10%	0.007	South Dakota	3.68%	0.025	Wyoming	4.59%	0.022
Connecticut	1.70%	0.008	New Hampshire	3.95%	0.019	Alaska	4.92%	0.035
South Carolina	3.09%	0.010	Vermont	4.00%	0.018	Delaware	5.60%	0.035
Iowa	3.26%	0.030	Nebraska	4.11%	0.026	Oregon	5.85%	0.029
Rhode Island	3.67%	0.020	Kansas	4.53%	0.012	Maine	6.16%	0.024
Group Average	2.56%	0.015	Group Average	4.05%	0.020	Group Average	5.42%	0.029

16 to 20	Avg.	StDev	21 to 25	Avg.	StDev	26 to 30	Avg.	StDev
Massachusetts	7.39%	0.025	Texas	8.99%	0.016	Louisiana	10.19%	0.026
Virginia	7.78%	0.043	Tennessee	9.21%	0.048	New York	10.79%	0.035
Wisconsin	8.31%	0.045	Arkansas	9.28%	0.045	Missouri	11.34%	0.051
Oklahoma	8.49%	0.070	Kentucky	9.89%	0.036	Washington	11.41%	0.048
Montana	8.66%	0.049	Ohio	10.17%	0.031	West Virginia	11.62%	0.110
Group Average	8.13%	0.046	Group Average	9.51%	0.035	Group Average	11.07%	0.054

31 to 35	Avg.	StDev	36 to 40	Avg.	StDev	41 to 45	Avg.	StDev
North Carolina	12.30%	0.071	Idaho	13.49%	0.099	Arizona	15.97%	0.095
Maryland	12.45%	0.074	Pennsylvania	13.52%	0.048	Florida	17.04%	0.111
Alabama	12.65%	0.045	Hawaii	14.25%	0.073	Minnesota	18.45%	0.110
New Jersey	12.66%	0.034	Utah	15.74%	0.120	Mississippi	19.11%	0.085
New Mexico	13.04%	0.041	Georgia	15.89%	0.052	California	20.00%	0.117
Group Average	12.62%	0.053	Group Average	14.58%	0.079	Group Average	18.11%	0.104

46 to 51	Avg.	StDev
Indiana	21.65%	0.053
Nevada	24.46%	0.203
Colorado	28.32%	0.150
DC	29.50%	0.159
Michigan	31.53%	0.115
Illinois	55.47%	0.144
Group Average	31.82%	0.137

Exhibit B: Average Adjusted Loss by Decile

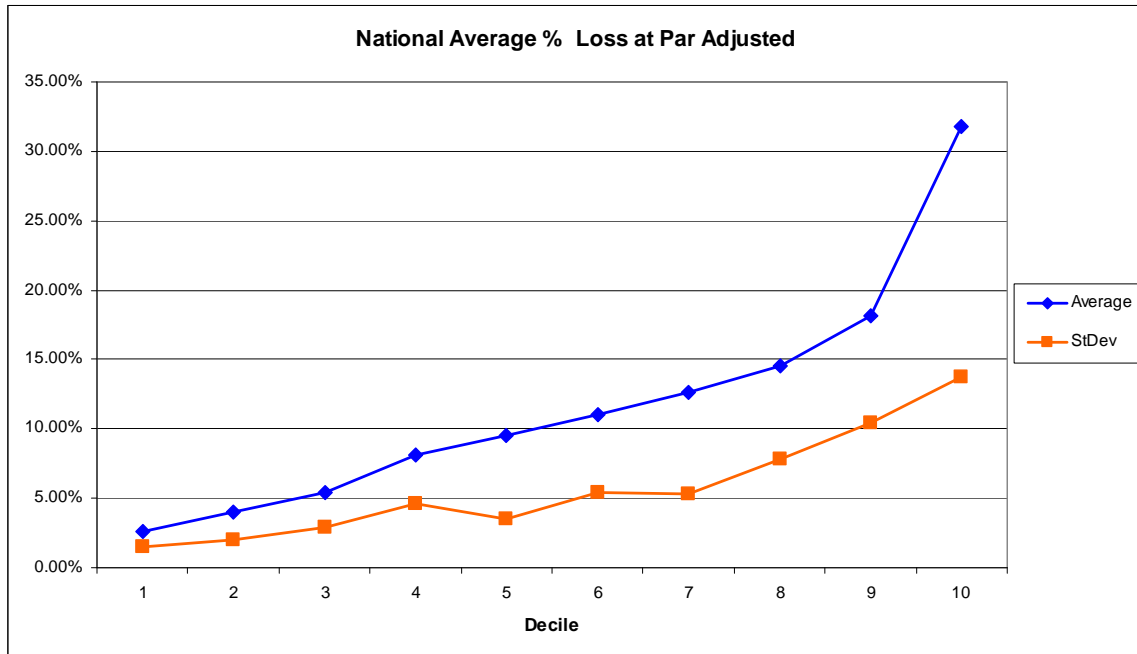


Exhibit C:

	Requirements	Title Agent License	TA License with Continuing Education	Test Requirement for License	Title Plant	Attorneys	Abstractors License
Alabama	Yes	Yes	No	No	No	Yes	No
Alaska	Yes	Yes	Yes	Yes	Yes	No	No
Arizona	Yes	Yes	No	Yes	Yes	No	No
Arkansas	Yes	Yes	No	Yes	No	No	Yes
California	Yes	Yes	No	No	No	No	Yes
Colorado	Yes	Yes	No	Yes	No	No	No
Connecticut	Yes	No	No	No	No	Yes	No
DC	No	No	No	No	No	No	No
Delaware	Yes	Yes	No	Yes	No	No	No
Florida	Yes	Yes	Yes	Yes	No	No	No
Georgia	Yes	Yes	No	No	No	No	No
Hawaii	Yes	Yes	No	Yes	No	No	Yes
Idaho	Yes	Yes	No	No	No	No	No
Illinois	No	No	No	No	No	No	No
Indiana	Yes	Yes	Yes	No	No	No	No
Iowa	Yes	Yes	No	No	Yes	Yes	Yes
Kansas	Yes	Yes	Yes	Yes	No	No	Yes
Kentucky	No	No	No	No	No	No	No
Louisiana	Yes	Yes	No	Yes	No	Yes	No
Maine	Yes	Yes	Yes	Yes	No	No	No
Maryland	Yes	Yes	Yes	Yes	No	No	No
Massachusetts	Yes	Yes	Yes	No	No	Yes	No
Michigan	Yes	Yes	No	Yes	No	No	No
Minnesota	Yes	Yes	No	no	No	No	Yes
Mississippi	Yes	Yes	No	No	No	No	No
Missouri	Yes	Yes	No	No	No	No	No
Montana	Yes	Yes	Yes	Yes	No	No	No
Nebraska	Yes	Yes	Yes	Yes	No	No	Yes
Nevada	Yes	Yes	Yes	No	No	No	No
New Hampshire	Yes	Yes	No	Yes	No	No	No
New Jersey	Yes	Yes	Yes	Yes	No	No	No
New Mexico	Yes	Yes	Yes	Yes	Yes	No	Yes
New York	Yes	No	No	No	No	Yes	No
North Carolina	Yes	Yes	No	Yes	No	Yes	No
North Dakota	Yes	Yes	No	No	Yes	No	Yes
Ohio	Yes	Yes	Yes	Yes	No	No	No
Oklahoma	Yes	Yes	Yes	Yes	Yes	Yes	Yes

	Requirements	Title Agent License	TA License with Continuing Education	Test Requirement for License	Title Plant	Attorneys	Abstractors License
Oregon	Yes	Yes	No	No	Yes	No	No
Pennsylvania	Yes	Yes	Yes	No	No	No	No
Rhode Island	Yes	Yes	No	Yes	No	Yes	No
South Carolina	Yes	Yes	No	Yes	No	Yes	No
South Dakota	Yes	Yes	No	Yes	Yes	No	Yes
Tennessee	Yes	Yes	Yes	Yes	No	No	No
Texas	Yes	Yes	Yes	No	Yes	No	No
Utah	Yes	Yes	Yes	Yes	No	No	No
Vermont	Yes	Yes	Yes	Yes	No	Yes	No
Virginia	Yes	Yes	Yes	Yes	No	No	No
Washington	Yes	Yes	No	Yes	No	No	No
West Virginia	Yes	Yes	No	No	No	Yes	No
Wisconsin	Yes	Yes	Yes	Yes	No	No	No
Wyoming	Yes	Yes	Yes	Yes	Yes	No	Yes

Exhibit D:

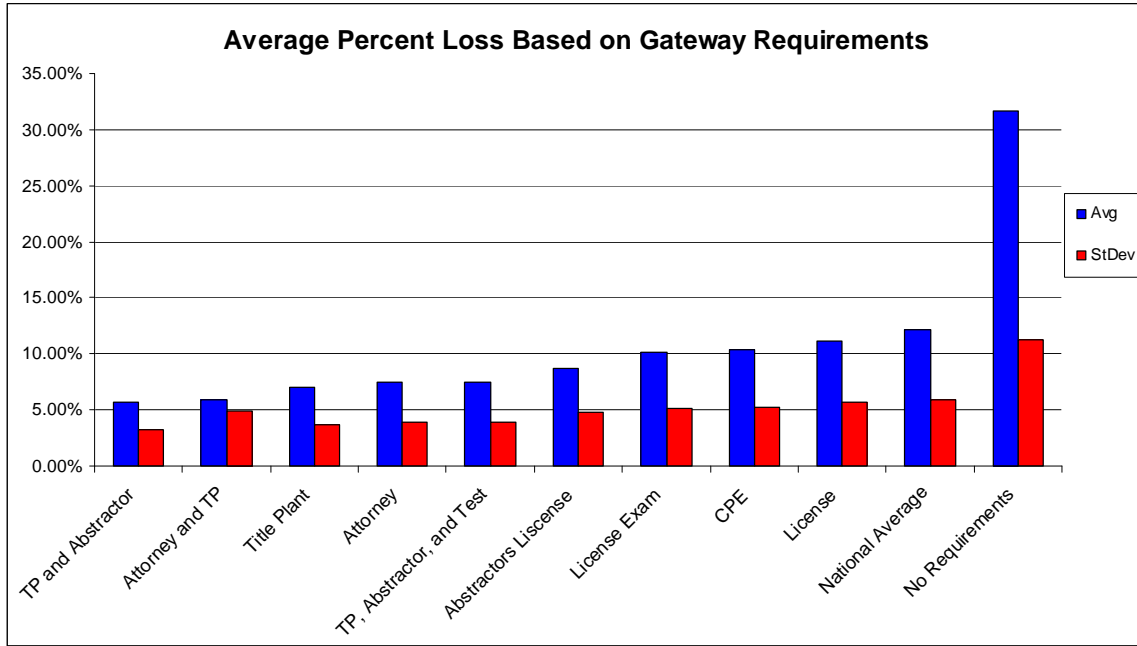


Exhibit E:

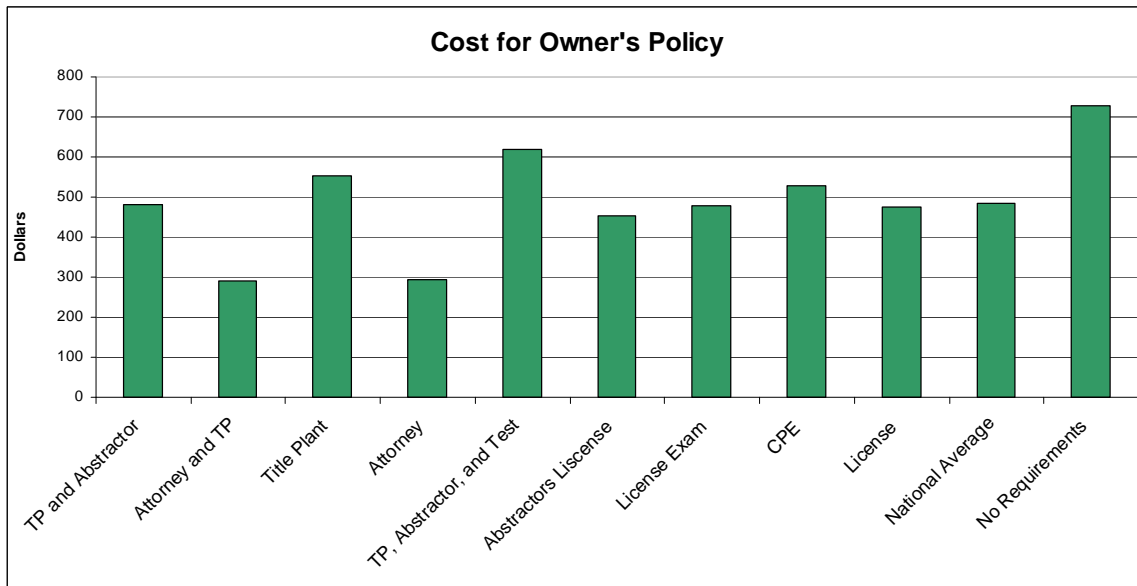


Exhibit F:

Abstractors License Requirement

States that Require	Avg	StDev	Cost
Arkansas	9.28%	0.045	325
California	20.00%	0.117	589
Hawaii	14.25%	0.073	534
Iowa	3.26%	0.030	100
Kansas	4.53%	0.012	325
Minnesota	18.45%	0.110	356
Nebraska	4.11%	0.026	407.5
New Mexico	13.04%	0.041	811
North Dakota	1.10%	0.007	325
Oklahoma	8.49%	0.070	480
South Dakota	3.68%	0.025	603.75
Wyoming	4.59%	0.022	575
Group Averages	8.73%	0.048	453

Attorney Requirement

States that Require	Avg	StDev	Cost
Alabama	12.65%	0.045	350
Connecticut	1.70%	0.008	60
Iowa	3.26%	0.030	100
Louisiana	10.19%	0.026	599.72
Massachusetts	7.39%	0.025	300
New York	10.79%	0.035	614
North Carolina	12.30%	0.071	220
Oklahoma	8.49%	0.070	480
Rhode Island	3.67%	0.020	150
South Carolina	3.09%	0.010	100
Vermont	4.00%	0.018	137.5
West Virginia	11.62%	0.110	400
Group Averages	7.43%	0.039	293

Title Plant Requirement

States that Require	Avg	StDev	Cost
Alaska	4.92%	0.035	582
Arizona	15.97%	0.095	749
Iowa	3.26%	0.030	100
New Mexico	13.04%	0.041	811
North Dakota	1.10%	0.007	325
Oklahoma	8.49%	0.070	480
Oregon	5.85%	0.029	450
South Dakota	3.68%	0.025	603.75
Texas	8.99%	0.016	843
Wyoming	4.59%	0.022	575
Group Averages	6.99%	0.037	552

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Exhibit G: Premium Cost by Relative Oversight Level by State

High Oversight (4, 5, 6)			Premium Cost	Moderate Oversight (2, 3)			Premium Cost	Low Oversight (0, 1)			Premium Cost
Avg	StDev			Avg	StDev			Avg	StDev		
Arizona	15.97%	0.095	749	Colorado	28.32%	0.150	1113	Alabama	12.65%	0.045	350
Arkansas	9.28%	0.045	325	Minnesota	18.45%	0.110	356	Connecticut	1.70%	0.008	60
DC	29.50%	0.159	684	Delaware	5.60%	0.035	385	Iowa	3.26%	0.030	100
Idaho	13.49%	0.099	666	North Carolina	12.30%	0.071	220	Georgia	15.89%	0.052	375
Maryland	12.45%	0.074	475	Indiana	21.65%	0.053	600.50	Kentucky	9.89%	0.036	330
Ohio	10.17%	0.031	575	Michigan	31.53%	0.115	717.25	Mississippi	19.11%	0.085	400
Alaska	4.92%	0.035	582	Wisconsin	8.31%	0.045	450	Massachusetts	7.39%	0.025	300
Florida	17.04%	0.111	575	Illinois	55.47%	0.144	1175	New Hampshire	3.95%	0.019	150
Montana	8.66%	0.049	573	Maine	6.16%	0.024	225	New York	10.79%	0.035	614
Nevada	24.46%	0.203	697	Missouri	11.34%	0.051	130	Rhode Island	3.67%	0.020	150
Virginia	7.78%	0.043	468	New Jersey	12.66%	0.034	500	South Dakota	3.68%	0.025	604
Utah	15.74%	0.120	715	Pennsylvania	13.52%	0.048	900	Vermont	4.00%	0.018	138
California	20.00%	0.117	589	Tennessee	9.21%	0.048	375				
Hawaii	14.25%	0.073	534	Washington	11.41%	0.048	417				
Kansas	4.53%	0.012	325	North Dakota	1.10%	0.007	325				
Louisiana	10.19%	0.026	600	Oklahoma	8.49%	0.070	480				
Nebraska	4.11%	0.026	408	South Carolina	3.09%	0.010	100				
New Mexico	13.04%	0.041	811	West Virginia	11.62%	0.110	400				
Oregon	5.85%	0.029	450	Wyoming	4.59%	0.022	575				
Texas	8.99%	0.016	843								
Group Average	12.52%	0.070	\$ 582	Group Average	14.46%	0.063	\$ 497	Group Average	8.00%	0.033	\$ 298