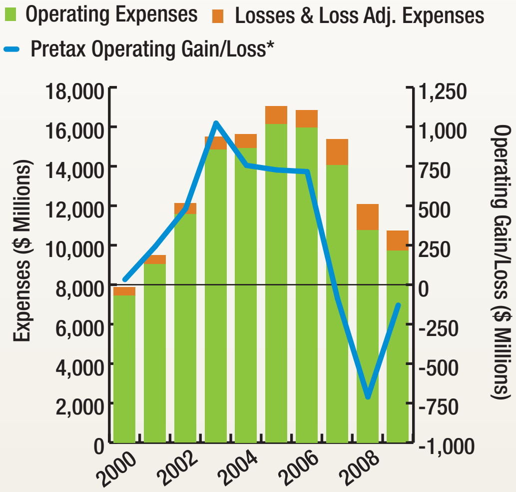
Results Partially Recover in 2009 and 2010; Job Market to Influence 2011

Market Review

December 13, 2010

Sector
Title

U.S. Title Insurance – Gains/Losses and Expenses (2000-2009)
($ Millions)



Source: ALTA, NAIC.
*Pretax Operating Gain/Loss equals Underwriting Gain/Loss including income from services and fees.

The title industry's operating results partially recovered in 2009, after reporting weak premium volumes and profitability in 2008. Although 2009 total industry written premiums declined from 2008 levels, premiums written trended upward in the third and fourth quarters from the same period of the prior year. During the first half of 2010, title insurance revenues stayed relatively unchanged from the first half in 2009 – aided by federal policy and tax incentives – which helped most major underwriters post positive operating margins for the first six months of 2010.

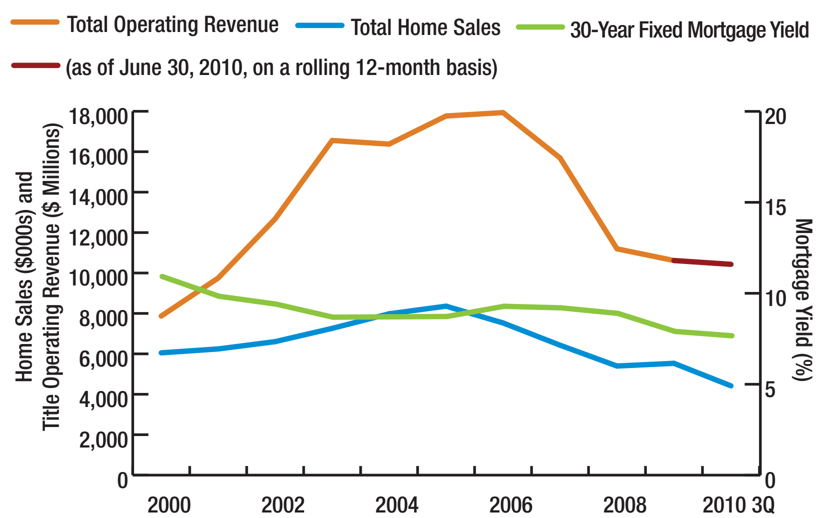
Still, the title industry faces a tough road ahead as the weak housing market continues to be hampered by economic and employment conditions. Sustaining the recent improvement in operating and capitalization trends will depend largely on the length and depth of those conditions.

Results partially recovered in 2009 as reflected by the following:

- The industry posted a far smaller pretax operating loss of $129.5 million compared with a $711.0 million loss in 2008.

- Although total operating revenue was down somewhat in 2009 ($10.6 billion) compared with 2008 ($11.2 billion), the industry's declining expense levels ($9.7 billion in 2009 versus $10.8 billion in 2008) more than made up for the drop in revenue.

U.S. Title Insurance – Revenue and Home Sales Activity (2000-2010)



Notes: All data are annual averages, with the exception of 2010 numbers, which are preliminary September figures. Total home sales is the sum of new and existing home sales. 2010 home sales numbers are the most recent available and reflect seasonally adjusted annual rates.
Sources: U.S. Census Bureau, National Association of Realtors (NAR), Federal Reserve Bank (FRB), Bureau of Economic Analysis (BEA).

Related Reports
2010 Special Report:
U.S. Title – 2009 Financial Review

Rating Analysts
Michael Russo, Financial Analyst
+1 (908) 439-2200 Ext. 5372
Michael.Russo@ambest.com

Neil DasGupta, Senior Financial Analyst
+1 (908) 439-2200 Ext. 5206
Neil.DasGupta@ambest.com

Contributing Author
Michelle L. Korsmo,
Senior Vice President and Chief of Staff
American Land Title Association (ALTA)
+1 (202) 296-3671 Ext. 218

BestWeek subscribers have full access to all statistical studies and special reports at *www.ambest.com/research*. Some special reports are offered to the general public at no cost.

Partial Recovery Seen, Job Market to Influence 2011

Industry Overview

The title industry's operating results partially recovered in 2009, after reporting weak premium volumes and profitability in 2008. Although 2009 total industry written premiums declined from 2008 levels, premiums written trended upward in the third and fourth quarters from the same period of the prior year. During the first half of 2010, title insurance revenues stayed relatively unchanged from the first half in 2009, aided by federal policy and tax incentives. This helped most major underwriters post positive operating margins for the first six months of the year, even though revenues declined in the second quarter of 2010 compared with that of the same period in 2009.

Nonetheless, the title industry still faces challenges as the housing market continues to be hampered by weaknesses in economic and employment conditions. And, sustaining the improved operating and capitalization trends of recent months will depend largely on the length and depth of those conditions. While in recent quarters home prices have inched upward, in certain geographic locations, they are still well below the level of the real estate peak year of 2006.

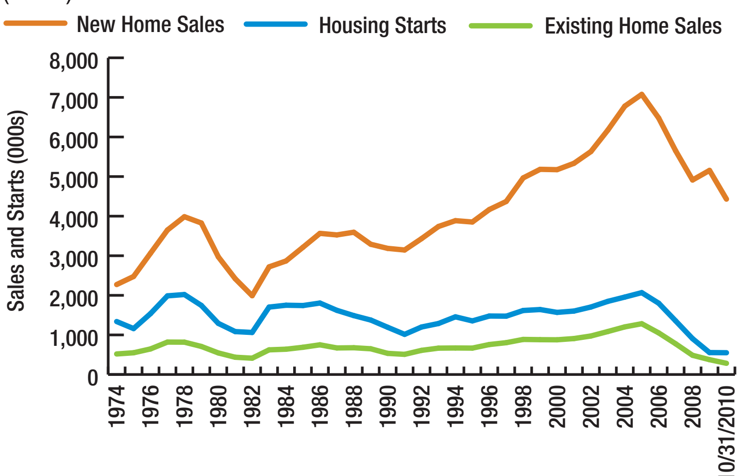
During the housing bubble from 2000 through 2006, the industry's revenue more than doubled. But just as the surge in real estate transactions drove up title insurance revenue – along with a greater incidence of title claims – the housing market downturn (see **Exhibit 1**) pared back revenue significantly, and resulted in negative profitability measures in 2008, which partially recovered in 2009 (see **Exhibits 2** and **3**). The foreclosure and default rates' upward trends, which began in the subprime mortgage segment in 2007, spread to other areas of the mortgage market. We began to see greater numbers of delinquencies and an increased rate of foreclosures in the "Alt-A" (e.g., typically borrowers with higher credit scores but little or no documentation of income or assets) segment, as well as the "prime" mortgage segments.

As a result of record losses from these segments, financial institutions have continued to tighten the availability of credit, and significantly reduce access to mortgage loans for both purchasing and refinancing. Starting in 2008 – and continuing into the first half of 2010, however – the federal government played a more active role in the mortgage market through the Federal Housing Authority (FHA) and the two housing government-sponsored entities (GSEs) Fannie Mae and Freddie Mac. These actions have helped stabilize the mortgage market and have somewhat cushioned the fall in transaction volumes following the end of the housing bubble. Recent tax legislation such as the First-Time Homebuyer Tax Credit of 2008-2009

Exhibit 1

U.S. Housing and Sales Activity (1974-2010)

(000s)



Notes: All data are annual averages, with the exception of 2010 numbers, which are preliminary September figures. Total home sales is the sum of new and existing home sales. 2010 home sales numbers are the most recent available and reflect seasonally adjusted annual rates.
Sources: U.S. Census Bureau, National Association of Realtors (NAR), Federal Reserve Bank (FRB), Bureau of Economic Analysis (BEA).

Special Report

ANALYTICAL COMMUNICATIONS

Carole Ann King, Managing Senior Business Analyst
Brendan Noonan, Managing Senior Business Analyst
Carol Demyanovich, Senior Business Analyst
Joe Niedzielski, Senior Business Analyst
Laura McArdle, Business Analyst
Christopher Sharkey, Business Analyst
Thomas Dawson IV, Associate Editor

PRODUCTION SERVICES

Shannon E. Wallace, Designer

– which was extended for first-time buyers and included certain existing homeowners who had properties under contract as of April 30, 2010 – also helped somewhat to bring more buyers into the market and modestly rejuvenate a largely moribund housing market. While significant foreclosure activity remains a drag on overall housing prices, the incentives have benefited title insurers to some extent in 2009 through June 30, 2010.

During periods of reduced premium volume, title insurers' profit margins depend on their abilities to manage the cycle by reducing expenses. General expenses incurred as part of the title-search process typically make up 85% or more of premium volume, reflecting the loss-prevention nature of title insurance. While major title insurers posted significant losses in 2008, companies that controlled costs aggressively have managed to return to profitability in 2009 and the first half of 2010, despite some erosion in their underwriting margins. Others less actively controlling their cost structures are expected to see further erosion in their margins if premium volume continues to fall.

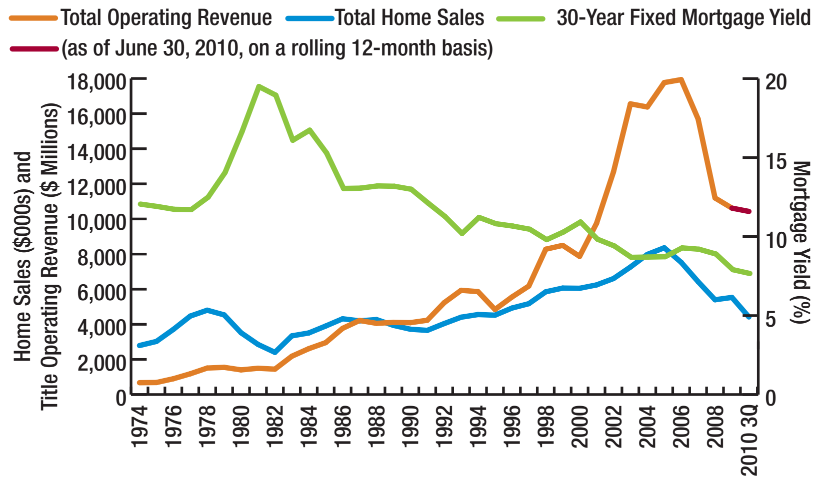
Inadequate loss-reserving practices earlier in the decade, when transaction volume was increasing dramatically, caused incurred losses to rise (see **Exhibit 4**). To make up the shortfall, some title insurers posted significant reserve increases in recent years, most notably in 2007 and 2008. Continued foreclosures and mortgage delinquencies are also driving up claims. While these need not directly lead to a claim, each triggers a title search with the potential to reveal a prior lien or other title defect overlooked during the initial title search. Loss activity stemming from agent- , consumer- , and bank-related fraud activity still remains a concern. Such activity typically goes up during periods of reduced cash flow and generally involves embezzlement of funds held in escrow, potentially resulting in severe losses.

Industry History and Purpose

The title industry continues to play a critical role in the U.S. economy by insuring the proper transfer of real estate from buyer to seller and by facilitating the growth of the secondary mortgage market. This enables Americans to have one of the highest home ownership rates in the world.

Exhibit 2

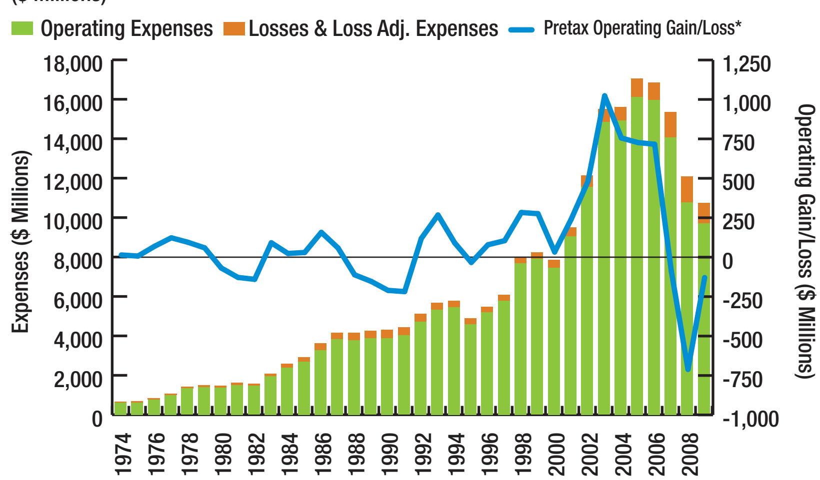
U.S. Title Insurance – Revenue and Home Sales Activity (1974-2010)



Notes: All data are annual averages, with the exception of 2010 numbers, which are preliminary September figures. Total home sales is the sum of new and existing home sales. 2010 home sales numbers are the most recent available and reflect seasonally adjusted annual rates.
Sources: U.S. Census Bureau, National Association of Realtors (NAR), Federal Reserve Bank (FRB), Bureau of Economic Analysis (BEA).

Exhibit 3

U.S. Title Insurance – Pretax Operating Gains/Losses and Expenses (1974-2009)
($ Millions)



Source: ALTA, NAIC.
*Pretax Operating Gain/Loss equals Underwriting Gain/Loss including income from services and fees.

The title assurance industry is composed of abstractors, attorneys, title insurance agents and title insurance companies. At any real estate closing, the parties involved must be assured that the title of the subject real property is as represented and expected. Members of the land title assurance industry are instrumental in helping to deliver and guarantee this assurance.

Exhibit 4

U.S. Property/Casualty – Losses and Loss-Adjustment Expense Ratios, Various Lines (1974-2009)

Title insurance has a much lower average loss and LAE ratio as compared with the general property/casualty industry. Property/casualty figures incorporate an IBNR approach, whereas title involves paid claims.

Year	Title Industry	Surety (Stock)	Property & Casualty (Stock)	Property & Casualty (Mutual)	Boiler & Machinery (Stock)
1974	6.5%	61.6%	75.3%	76.4%	44.6%
1975	8.7	68.8	78.8	80.2	43.8
1976	6.3	49.2	74.6	77.1	36.1
1977	5.3	44.6	70.1	72.4	33.3
1978	5.0	46.8	69.0	72.9	30.8
1979	5.0	39.6	71.7	76.3	20.8
1980	6.6	53.1	73.9	77.0	33.1
1981	8.1	34.1	75.5	79.8	33.2
1982	8.4	37.4	78.6	82.1	38.6
1983	6.3	39.9	81.0	81.9	40.5
1984	7.9	49.9	88.8	87.3	53.8
1985	7.7	77.7	88.8	88.6	41.5
1986	8.8	71.6	80.3	84.3	38.7
1987	7.7	66.1	76.2	82.2	32.7
1988	9.6	49.3	76.2	83.5	44.5
1989	9.5	42.9	80.4	85.9	38.6
1990	10.0	36.3	80.2	87.0	48.2
1991	10.0	26.2	80.1	82.8	57.1
1992	7.4	38.3	89.7	84.4	53.6
1993	5.8	23.0	78.9	81.4	58.1
1994	5.4	34.5	80.3	82.4	44.9
1995	5.8	33.9	78.1	80.7	48.1
1996	4.9	27.2	77.9	79.9	44.1
1997	4.6	25.6	72.3	74.7	45.2
1998	3.8	24.5	75.0	80.1	51.0
1999	4.1	25.0	77.3	81.7	60.6
2000	5.3	27.7	79.4	85.3	51.5
2001	4.8	47.2	87.3	90.8	50.2
2002	4.6	63.7	80.5	82.9	40.0
2003	4.0	72.1	74.4	75.4	28.4
2004	4.3	69.7	72.2	72.5	32.4
2005	5.3	53.4	74.9	74.7	22.8
2006	5.0	31.6	64.1	69.5	35.8
2007	8.6	22.9	66.6	71.5	32.5
2008	11.7	21.4	76.9	79.2	34.5
2009	9.7	31.8	71.8	77.1	34.5
		Averages:			
All Years	**6.6**	**41.9**	**75.1**	**78.0**	**39.8**
Past 10 Years	**6.3**	**44.2**	**74.8**	**77.9**	**36.3**
Past 20 Years	**6.3**	**36.8**	**76.9**	**79.7**	**43.7**

Source: Title industry figures developed from ALTA and NAIC Form 9s. All other data from BestLink® and Best's Aggregates & Averages.

The functions of the title search and examination provide the basic information concerning the legal interest affecting the title to the real property. The title search and examination are more than an attempt to confirm the placement on the record of a subject mortgage: they are the underwriting process that distinguishes between significant and insignificant conditions affecting title. The search and examination very often include the curing of defects to the title necessary to complete the transaction. It is acknowledged that few properties have perfect title conditions and, as such, title insurance was developed to guarantee the current status of title, based on search and examination.

Depending on the jurisdiction, the title search and examination can require a search by title insurance personnel of numerous public documents, including tax, court-judgment, deed, encumbrance, federal and state records, as well as the evaluation of real property characteristics such as flood zone, location and construction type.

To assure that real property rights are conveyed as represented, most transactions are covered by title insurance to guarantee the condition of ownership and property rights as represented. A title insurance policy provides indemnification to an insured that has a fee interest, leasehold or mortgage lien for a specified property for any covered loss caused by a defect in title that existed as of the effective date of the policy.

Title insurance involves the acceptance of past transactional events rather than future occurrence events associated with all other property and catastrophe exposures. In addition, title insurance, unlike most other property/casualty exposures, has no termination date and no time limitation on filing claims.

Since title insurance usually involves the acceptance of prior transaction-related risk rather than future risk, the underwriting process in the title insurance industry differs markedly from the typical property/casualty underwriting process (see **Exhibit 5**). The title underwriting process is designed to limit risk exposure through a thorough search of the recorded documents affecting a particular property. The insurance component of a title product only indemnifies for existing – but unidentified, or specifically underwritten – defects in the condition of a property's title. In other words, title insurance – unlike typical property/casualty insurance – usually does not respond to future occurrences but only to past defects that were in place at the time the property was sold, and not recognized as a problem until after the property was transferred or was insured over.

Property/casualty underwriters are concerned with determining the probability of loss based on the characteristics of the insured risk. Title underwriters, on the other hand, are concerned with reducing the possibility of loss by discovering as much information about the past as possible through extensive searches of public records and stringent examinations of title. Some state title insurance codes provide that no policy or contract of title insurance shall be written unless it is based upon a reasonable examination of title, and unless a determination of insurability of the title has been made in accordance with sound underwriting practices.

The general underwriting examination and search requirements, coupled with the disarray and geographic dispersion of records, have fostered the development of privately owned, indexed databases or title plants. These title plants must be maintained regardless of the level of real estate activity during any given period. The Financial Accounting Standards Board (FASB) has ruled that a title plant is a unique asset that if properly updated, does not diminish in value over time. The cost to maintain the economic life of a title plant and continuously update the records is extremely high. This is one factor adding to the higher overall fixed-cost percentage for title insurers as compared with property/casualty insurers.

Both property/casualty insurers and title insurers must physically produce policies, but the processes and requirements differ significantly. A typical property/casualty policy might involve filling out a few blanks on a form, 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 liability lines, agents' commissions generally are in the range of 10% to 25% of the premium on the policies that agents write. In title insurance, the agent retains a much larger proportion of the amount charged (see **Exhibit 6**). There was a drop in expense ratio from 97.4 in 2008, to 93.1 in 2009. There have been drops in other years, but not nearly as big. Commissions for title insurance are more properly described as agent's retention or agent's labor or work charges.

Exhibit 5

U.S. Title vs. Property/Casualty – Comparison of Key Elements

Key elements of the title insurance that distinguish it from personal lines classes of property/casualty insurance.

Features	Title Insurance	PC Insurance
Protection	Against Past Events	Against Future Events
Scope of coverage	Specific	Broad
Actuarially Defined Rates	Evolving	Yes
Administrative / Acquisition Costs	High	Low
Loss Costs	Low	High
Policy Term	Potentially Unlimited	Finite
Premium (GAAP)	Fully Earned at Issuance	Earned Over Policy Term
Rate Regulation	Varies by State	High
Rate Activity	Varies by State	Tied to Inflation and Underwriting Business Cycles
Loss Frequency	Low to Moderate	High
Loss Severity	Low	Moderate
Distribution	Agents / Direct	Agents / Direct /Mass Market
Marketing Success	Based on Service	Based on Rates
Competition	Semi-Concentrated Market	Fragmented Market
Premium Collection	After	In advance
Financial Leverage	Low	High
Sensitivity to Real Estate Markets	High	Moderate

The title insurance activities of search and examination generally are carried out locally, because the public records to be searched are usually only available locally. This activity might be performed by directly owned branch operations of the insurer or by title agents. Payments to a title agent not only reflect an origination commission but 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 a title plant or searching public records, contribute to the high fixed costs, the high ratio of salaries to total expenses and the high percentage of total revenues retained by agents.

In addition, with the requirement that each real estate parcel be evaluated and insured based upon the myriad and varying local laws, customs and records, the traditional insurance structure of local marketing and home-office underwriting cannot reasonably and cost-effectively be maintained in the title insurance industry. Since real estate

Exhibit 6

U.S. Property/Casualty – Operating Expense Ratios, Various Lines (1974-2009)

Title insurance has a much higher average expense ratio as compared with traditional property/casualty lines.

Year	Title Industry	Surety (Stock)	Property & Casualty (Stock)	Property & Casualty (Mutual)	Boiler & Machinery (Stock)
1974	91.5%	52.1%	29.7%	24.8%	59.0%
1975	90.3	53.2	28.7	24.2	52.4
1976	86.0	53.8	27.4	22.5	57.6
1977	84.3	51.6	26.9	21.5	53.4
1978	88.7	50.3	27.6	21.7	53.3
1979	91.2	50.6	27.9	21.7	55.4
1980	98.3	52.8	28.5	22.1	57.7
1981	100.5	51.6	29.4	23.1	58.6
1982	101.3	51.7	30.1	23.5	62.1
1983	89.6	47.7	30.8	23.4	63.3
1984	91.2	45.6	30.1	23.3	64.5
1985	91.3	34.2	27.7	21.9	48.4
1986	87.0	45.5	26.6	21.8	48.2
1987	90.9	49.9	27.1	21.4	48.2
1988	93.1	51.2	27.8	21.1	52.6
1989	94.3	51.0	28.2	21.2	54.6
1990	95.1	51.1	28.2	21.5	52.8
1991	95.1	48.8	28.6	22.0	52.6
1992	90.4	45.4	28.7	22.3	49.5
1993	89.7	42.4	28.2	21.9	45.5
1994	93.1	48.3	27.8	22.4	43.1
1995	90.0	45.4	27.8	23.1	43.0
1996	93.6	44.0	27.8	23.1	41.9
1997	93.7	43.2	28.3	24.3	43.0
1998	92.7	43.5	29.0	24.9	44.0
1999	92.9	42.6	29.1	25.5	48.9
2000	94.7	44.1	28.6	25.2	41.8
2001	92.7	40.8	27.4	24.9	41.9
2002	91.6	51.6	25.7	24.9	39.7
2003	89.8	49.1	25.0	24.4	39.7
2004	89.4	47.2	26.3	24.4	43.7
2005	89.0	47.4	26.3	24.6	40.0
2006	89.9	48.5	26.5	25.9	40.8
2007	90.9	46.6	27.5	26.3	38.5
2008	97.4	44.6	27.8	26.6	40.3
2009	93.1	46.6	28.2	27.5	40.9
Averages:					
All Years	**89.5**	**46.2**	**27.2**	**22.8**	**47.3**
Past 10 Years	**91.8**	**46.7**	**26.9**	**25.5**	**40.7**
Past 20 Years	**92.2**	**46.1**	**27.6**	**24.3**	**43.6**

Source: Title industry figures developed from ALTA and NAIC Form 9s. All other data from BestLink® and Best's Aggregates & Averages.

laws, customs and practices vary, at least on a state-by-state and sometimes on a county-by-county basis, it has not been practical for underwriting to be performed on a national basis by a team of underwriters in the home office. Therefore, the economies of scale – made possible by establishing a centralized, skilled technical support staff of actuaries and underwriters to price products and make underwriting decisions – are absent in the title industry.

Rate Regulation

Like the rates for other forms of insurance, rates for title insurance usually are regulated by state governments to ensure that premiums are not excessive, inadequate or unfairly discriminatory to the public. States have different methods of regulating title insurance rates. The types of rate regulation used are:

- **Promulgation —** State regulatory body sets the rates.

- **Prior Approval —** Insurers propose rates, which must be reviewed formally and approved explicitly or deemed approved by the regulatory body before they can be charged.

- **File and Use —** Insurers set rates, but they cannot be charged until the regulator has been notified and allowed time for review and action, if necessary. In some prior-approval states, almost the same result is achieved through a so-called deemer provision. Under a deemer, rates proposed by insurers are deemed approved if the regulatory body takes no action to disapprove a filing within a specified time, and the filer notifies the state that the rates are being deemed approved.

- **Use and File —** Insurers set rates that can be charged immediately, as long as the new rate schedule is filed with the regulatory body.

- **No Direct Rate Regulation —** Insurers set rates that can be changed at an insurer's discretion. Even in this apparent unregulated situation, a regulatory body still is charged with overseeing the title insurance industry and can question the propriety of a rate that appears to be unfairly discriminatory or otherwise violates statutory standards.

Title insurance premium rates largely are determined by operating and acquisition cost factors, as compared with property/casualty rates that are based on the actuarial determination of expected losses. The risk of title loss is a function of many factors, which can vary considerably from jurisdiction to jurisdiction and transaction to transaction. Also, the services covered by the title insurance premium vary from state to state. It is difficult to compare a pure title insurance risk premium with an all-inclusive rate that covers not only the risk of loss but also the title search, examination, title opinion and closing.

Rate Adequacy and Stability

Title insurance premium rates are based on five cost considerations, including those related to:

1. Maintaining current title information on property local to that operation, i.e., title plant.

2. Searching and examining the title to subject properties.

3. Resolving or clearing defects to title.

4. Covering title defects.

5. Allowing for a reasonable profit.

Loss Characteristics Among Companies

Title insurance loss experience varies considerably among individual companies based on a wide array of factors, including:

1. Experience and technical competency of agents and title underwriters.

2. Quality and quantity of title documentation and evidence (both public and private) underlying the search-and-examination process.

3. Regional differences in title insurance customs and practices, underlying title insurance risks, the mix of residential sale, residential refinance and commercial business, and defalcation risks.

4. Adequacy and effectiveness of underwriting controls and agency management systems.

5. Differences in the proportion of agency business versus direct business.

6. Differences in the proportion of commercial versus residential business.

7. Differences in claim-administration processes, such as claim recognition, evaluation, timing of settlement and recoupment.

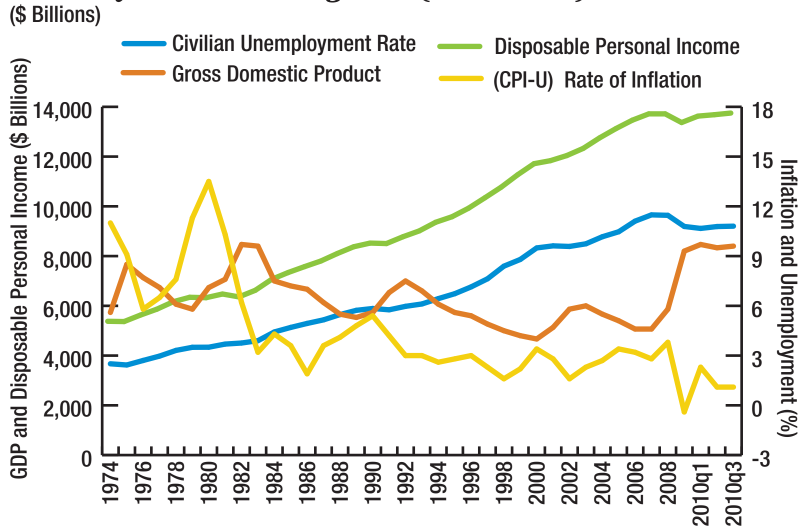
The Economy

After a period of strong growth dating back to late 2002, the economy took a sharp turn for the worse in 2008 – with gross domestic product (GDP) virtually flat compared with 2007 – while in 2009, the GDP contracted by 2.6%. The marked reversal of growth rates in 2008 and 2009 represented a significantly different growth environment than the one witnessed over the previous four years (see **Exhibit 7**). However, GDP growth did resume in 2010, although the rate of growth remained moderate with annualized growth averaging 2.9% over the first nine months of the year. The $787 billion Economic Stimulus Package of 2009 – along with that year's other tax legislation programs, "Cash for Clunkers" and the First-Time Homebuyer Tax Credit, which was extended through June 2010, both designed to boost the auto and housing sectors – has, to some extent, helped in moderating the negative impact of ongoing difficult economic circumstances. However, the outlook for the U.S. economy remains uncertain given the ongoing macro economic conditions, especially surrounding the housing sector. In addition, it remains unclear whether this positive growth trend can be sustained following the expiration of these fiscal measures.

Exhibit 7

U.S. Key Economic Figures (1974-2010)

($ Billions)



Notes: All data are annual averages. Gross domestic product (GDP) and disposable personal income (DPI) are adjusted for inflation, reported in billions of chained 2005 dollars by the Bureau of Economic Analysis (2Q-2010). Consumer Price Index (CPI) quarterly data is based upon adjusted 12-month quarter-end data. The unemployment rate is the number of unemployed as a percentage of the civilian labor force as reported by the Bureau of Labor Statistics (June 2010*). 2010 numbers are as of the 2nd quarter.
*The unemployment rate as of October 2010 is 9.6%
Sources: U.S. Census Bureau, NAR, FRB, BEA

Exhibit 8

Top 10 Title Insurance States* by % Change in 1-Unit Housing Starts (2006-2009)

	1-Unit Privately Owned Housing Starts			
	Avg 1-Year % Change (2006 - 2009)	1-Year % Change (2008-2009)	Units 2009	Units 2006
Florida	-20.5%	-31.2%	26,636	146,236
Arizona	-19.2%	-33.0%	12,826	55,633
California	-19.1%	-21.3%	25,525	107,714
Michigan	-18.7%	-30.6%	6,236	24,782
Ohio	-15.4%	-17.7%	10,593	27,514
Texas	-14.7%	-15.8%	67,069	162,750
Virginia	-14.6%	-18.4%	16,268	38,977
New Jersey	-14.5%	-21.4%	7,211	17,113
Pennsylvania	-13.4%	-24.2%	15,341	33,121
New York	-12.9%	-24.2%	9,656	19,981

*By % of 2009 title direct premiums written.
Source: U.S. Census Bureau.

Following the initial economic slowdown, which started in the second half of 2007, the Federal Reserve cut the Fed Funds Target Rate by 1 percentage point in the fourth quarter of 2007 – reversing its three-year trend of increasing the short-term interest rate. The rate cuts were in response to a troubled mortgage and housing sector, in which many adjustable-rate mortgages were resetting at higher levels than homeowners anticipated and could afford. The cuts continued through the second quarter of 2008, as the Fed reduced its benchmark fed funds rate – the rate at which banks lend to each other – to a historic low range between 0% and 0.25%, and it has held it at that low level since that time.

Rates continued to dip to low levels as of October 2010, with the long-term 30-year fixed rate mortgage at approximately 4.3%, down from an already low rate of 5.0% in 2009. In fact, over the course of the past two years, the 30-year fixed rate mortgage has decreased nearly 2 percentage points, and has set off a "mini refinance boom" in 2009 and 2010. Along with the homebuyer tax credit legislation, these favorable conditions in personal home financing had helped to modestly stabilize home prices and boost existing home sales in 2009 and the first half of 2010. However, with the expiration of the tax credit in June 2010, sales in recent months have fallen compared to the same period in 2009 and prices have modestly retreated.

The U.S. housing market's future direction thus remains uncertain as the market deals with the expiration of these incentives. Meanwhile, questions have also been raised recently regarding the foreclosure practices of major lending institutions. While some banks and lending institutions had announced a temporary moratorium in the processing and sales of foreclosed properties as they reviewed their policies and procedures, most have since resumed processing. However, as these procedures come under greater regulatory scrutiny – as well as litigation activity – there may be a significant slowdown in the foreclosure pipeline (which comprises nearly a third of all home sales in 2010) with the REO (bank-owned properties) taking significantly longer to come to market.

In 2009, U.S. privately-owned housing starts dropped to 554,000 units, on an annual basis, down 75% from their peak year in 2005, and nearly 40% lower than the already-low 2008 annual figure. However, housing starts through October 2010 (the last period for which data is available), were relatively unchanged from the depressed 2009 levels, with approximately 550,000 units started on an annual basis (see **Exhibit 1**).

Especially hard hit by the economic downturn have been the Pacific, West, South Atlantic and Midwest regions of the United States, It is no surprise that the previously booming real estate markets of California, Florida, and Arizona have had extremely large declines in housing starts between 2006 (the peak of the boom) and 2009 (see **Exhibit 8**) due to excess inventory and weakening economies, and that conditions in these markets continue to remain weak in 2010. Driving the ongoing shrinking demand for new homes – along with relatively high costs of construction – is the persistantly high unemployment, uncertainty in the job markets and continued supply of existing homes that are stemming from the high number of foreclosed homes entering the market.

Both existing- and new-home sales have trended lower since 2005. However, while total home sales in 2008, fell 16% from 2007, total home sales were up modestly in 2009 – approximately 3% from 2008 levels – partly due to the homebuyer tax credits as well as continued low interest rates. However, since the tax incentives expired in June 2010, annualized sales through the third quarter of 2010 have fallen approximately 20% from the levels seen during the same period of 2009. This decline is affecting both the new and resale segments of the market, and continuing to put home prices under pressure. As a result, based on the Housing Affordability Index, housing has become more affordable than it has been in the past 30 years. The Housing Affordability Index, which had increased from 169 in 2009, from 138 in 2008, for existing home sales – with a higher index reading meaning housing is more affordable – further increased to 172 at the end of September 2010 (see **Exhibit 9**). This figure – representative of a household earning the median income to qualify for a mortgage loan with a 20% down payment on a median-priced home – has continued to show steady improvement since 2006's reading of 108, when the housing boom effectively ended.

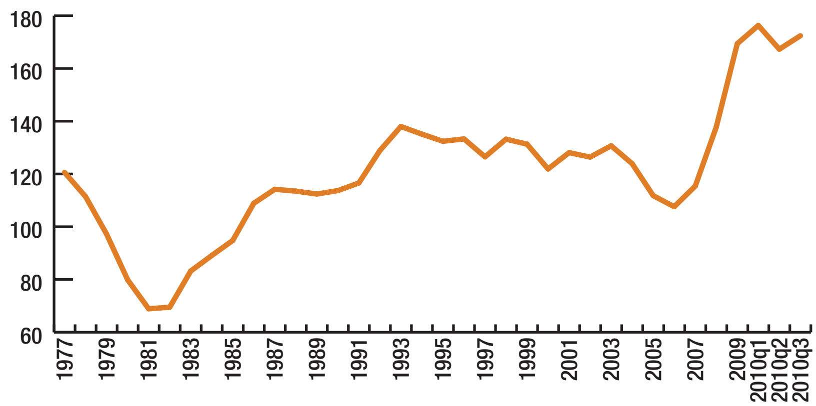
One measure of slight improvement in the housing market has been a decrease in existing homes available for sale. As of September 2010, there were 4.04 million existing homes available for sale, or approximately 10 months' supply at current sales rates. While this is still much higher than the traditional measure of six months' supply, considered as a market 'balanced' between sellers and buyers, it does represent a 12% decline from the record inventory of 4.58 million homes available for sale reached in July 2008. While this may, on the surface, seem positive, some of the decline may be due to homeowners pulling their homes off the market due to inadequate demand and/or mismatches in bid and ask prices. Nevertheless, the still-high inventory levels portend that housing starts and permits are expected to continue to decline through 2010 and possibly much of 2011.

Inflation, which had decreased dramatically in 2008, from the middle part of the decade, had actually turned negative in 2009, as the economic downturn unfolded. Although the inflation rate has turned positive in 2010, the annualized rate through the third quarter remains low. The rate of inflation, represented by the Consumer Price Index for All Urban Consumers (CPI-U) was reported down 0.4% for the 2009 year, compared with the 3.8% increase in the 2008 calendar year. As mentioned above, 2010 continues to witness a very modest pace of inflation with consumer prices at an unadjusted 1.1% year-over-year change as of September.

Exhibit 9

U.S. Housing Affordability (1977-2010)

The housing affordability index measures the percentage of income the median-income family has toward qualifying for a median-priced home with a 20% down payment. A higher index reading means housing is more affordable. As of September 2010, the median-income family – with an income of $61,652 – had 172.4% of the income needed to qualify for the median-priced home of $177,900.



Source: NAR

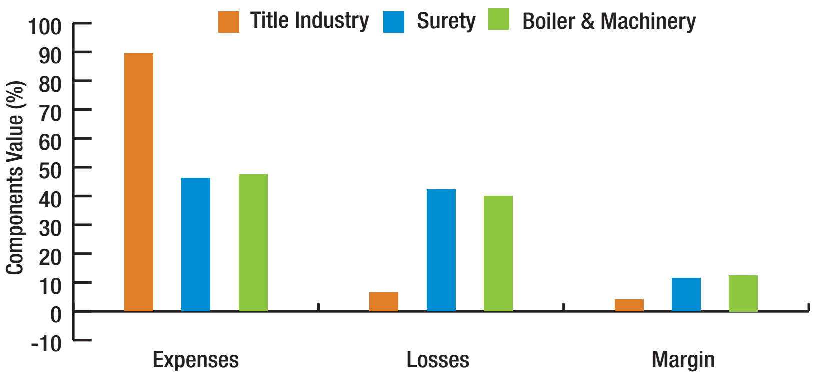
The unemployment rate, which increased significantly in late 2008 and 2009, still remains persistently high and stands at 9.6% as of October 2010, up significantly from the annual average of 5.8% in 2008. The rapid increase in unemployment poses a more-traditional threat to the housing market and to the title insurance industry as it bears directly on the ability of buyers to purchase homes, and their subsequent need to obtain title insurance. (See **Exhibit 7**).

The latest data suggest that current economic trends – namely weak economic growth, low inflation, low interest rates and a weak labor market characterized by a continued high unemployment rate – may persist through at least the first half of 2011, and may result in additional pressure on factors affecting real estate demand.

The Title Industry and Real Estate Economics

The title industry is highly dependent on real estate markets, which, in turn, are highly sensitive to mortgage interest rates and the overall economic well-being. Typically, there is an inverse relationship between mortgage rate changes

Exhibit 10
U.S. Title Insurance – Title, Surety and Boiler & Machinery: Components of Combined Ratio (Average from 1974 - 2009)



Source: BestLink

and real estate activity, and therefore, operating revenue for title insurers.

As interest rates fall, real estate transactions generally increase along with the greater demand for title products, and title insurers' operating revenues generally rise. The reverse occurs when interest rates rise. Changes in mortgage interest rates create corresponding fluctuations in title insurers' total operating revenue and pretax operating gains. Since 2006, however, other factors have interfered with the conventional relationship between interest rates and real estate activity.

While the real estate market has slowed down significantly in recent years, the mortgage interest rate environment has continued to be favorable. As of the third quarter of 2010, the 30-year fixed-rate mortgage yield has decreased 24 basis points from the yield as of year-end 2009, which had declined by 99 basis points when compared to the yield as of year-end 2008 (see **Exhibit 2**). This favorable interest rate environment has helped to stabilize overall housing market activity has resulted in a "mini-refinance boom" in 2009. Although not as significant as the unprecedented refinance boom of 2003, the current mini-boom remains an important positive contributor to the modest rebound in home sales and prices in recent months.

Another significant factor has been the federal government's active role in both providing home financing through the FHA, Fannie Mae and Freddie Mac, as well as through tax incentives geared towards potential home buyers. However, the stability and eventual recovery of the housing market will, of course, depend on the future direction of long-term interest rates, and the wider availability of credit. The latter is strongly linked to a slowdown in the currently high levels of defaults and foreclosures, as well as a broader economic recovery characterized by a return to sustained growth and employment.

How Title Insurance Differs From Other Lines of Insurance

Since title insurance is an evidence-producing/loss-prevention line of insurance, its loss expense is less than – and its operating expense is greater than – that of other property/casualty lines of business. Insurance expenses are loss-prevention/underwriting-related and loss–related.

A typical loss-prevention insurance line – such as title, boiler and machinery or surety – usually has higher operating costs and lower losses than other insurance lines (see **Exhibit 10**). It should be noted that according to the statutory accounting rules for title insurance, only reported claims are reflected in the loss expense, while in other lines – both reported and unreported (incurred but not reported, or IBNR) claims are included in the loss expense. As a result, timing differences occur in the reporting of losses and loss-adjustment expenses for title insurance when compared to other lines. In addition to known claims, title insurers – unlike insurers in other lines – carry a statutory liability known as the statutory premium reserve that provides ultimate loss protection for policyholders. However, it is not counted as a loss statistic.

Because of the large service and underwriting component of title insurance, its closest property/casualty counterparts are service, underwriting and loss-control-intensive sectors. Lines of insurance containing these features include surety, and boiler and machinery.

Operating expenses are the largest component of a title company's costs. A title company's ability to expand its infrastructure and maximize operating profits in good market conditions, and to contract and control costs in poor market conditions, is critical to its long-term financial success and solvency. This isn't necessarily the case with property/casualty companies, where the control of loss costs is more critical to success and solvency.

Because of title insurers' dependency on the health of the real estate market and favorable interest rates – as well as their being required by law in most states to be monoline writers – title industry revenues and profitability are susceptible to volatility. To dampen this volatility, title insurers have:

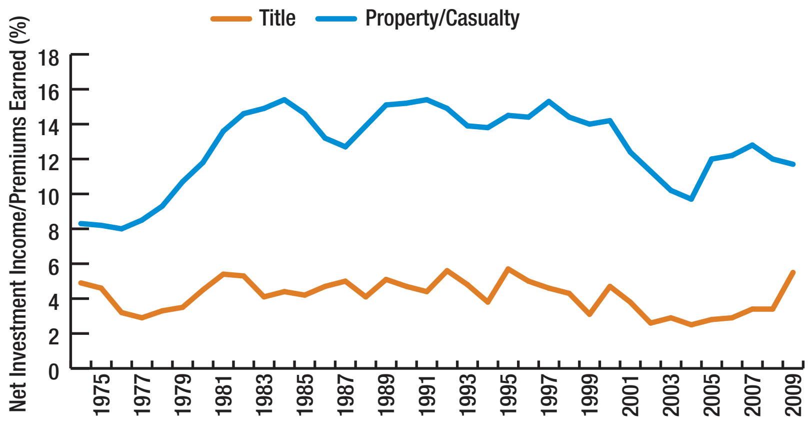
- Improved their technology and work-flow processes.

- Diversified their operating revenue by introducing new title products and expanding nationally and internationally.

Exhibit 11

U.S. Title vs. Property/Casualty – Net Investment Income as a Percent of Premiums Earned (1974-2009)

The average ratio of net investment income earned to premiums for property/casualty insurers is about three times larger than for title insurers.



Source: ALTA, NAIC, A.M. Best Co.'s BestLink®: Statement File - 99200

Investment Income Characteristics

Important differences exist between title insurers' and traditional property/casualty companies in their abilities to generate investment income (see **Exhibit 11**). Property/casualty insurers collect premiums in advance and hold them until they must indemnify claimants for losses. These premiums constitute a large cash flow that companies generally invest in intermediate and long-term, investment-grade assets. The investment income generated is reinvested, and a company's asset base grows at a compounded rate until losses on policies materialize and are paid. Claims for the long-tail casualty business lines might take decades to appear and the accruing premiums can add significantly to a company's assets. As a property/casualty company's ratio of written premiums to surplus (equity) increases, the fraction of total assets that are financed by advanced premiums from policyholders also increases. In other words, writing property/casualty insurance can create financial leverage.

These property/casualty reserves are debt, in that if a policy is canceled, the reserves are owed to the former policyholder, yet they bear no rate of interest. Hence, this kind of financial leverage does not burden the property/casualty insurer with additional fixed charges and, as long as rates are adequate, it provides all the conventional benefits of leverage without much of the downside risk.

Title companies collect premiums after the largest component of their costs – operating expenses – has been incurred. As shown in **Exhibit 6**, title companies' expense ratio typically averages more than 90, while the property/casualty industry's expense ratio is less than 30. The title industry's higher expense ratio results in a significant reduction in available cash flow for companies to invest. Although the remainder of the title premium is available for investment, the relative percentage of premium collected and invested is significantly less than that of the property/casualty industry. As such, the title industry's financial leverage is relatively low.

Title insurers sell protection against losses caused by problems with legal title to real property arising out of events prior to the effective date of the policy. Because most uncertainty about the past can be reduced by careful research, a title insurer can exert a great deal of control over the risks it underwrites.

For example, by looking up property tax records, a title insurer can almost eliminate the possibility that a real estate title will become encumbered by a lien for past unpaid real estate taxes. However, hidden defects in a real estate title, such as errors in public records, will cause losses. Because of the great importance of real estate titles, title insurers establish highly stringent underwriting criteria, eliminating all the risks they possibly can through careful examination of title before issuing insurance.

Title insurers use much of the premiums collected to cover the underwriting costs associated with the issuance of a title insurance policy. In contrast to property/casualty insurers, title insurers expend premium dollars before collection, and therefore do not retain most of the premium dollars before they are expended in the ordinary course of business.

On the other hand, the loss tail for title insurers is much longer than that of most other lines of insurance, and it constitutes a form of leverage where some percentage of premiums is set aside and held for future claims. The loss-tail leverage constitutes only a small percentage of the premiums, however.

Title Insurance Profitability

The financial strength and surplus of title companies, however, might be more critical than that of property/casualty underwriters. The title industry's premium volume and profitability is highly dependent on real estate sales and mortgage-refinancing activity. Since large infrastructures of personnel and title plants must be maintained to provide title services, a title company's profitability is highly sensitive to real estate market activity. A significant portion of a title company's cost structure is fixed, and the variable component largely is related to personnel. It is as difficult for a company to reduce its costs of doing business in the face of a downturn in real estate activity as it is to reacquire trained staff when activity rebounds.

Surplus plays a critical role by providing a cushion that permits a title insurer to ride out poor real estate markets, since not all of its costs are variable and able to be reduced. Property/casualty companies have a built-in level of demand. Many property/casualty coverages are required by law or business judgment and have to be purchased annually.

As with every industry, the title industry has certain inherent risks that must be understood to properly evaluate an individual company's operational strengths and weaknesses, balance-sheet vulnerabilities and volatility of earnings. The major business risks a title insurer faces are:

- Volatility of revenue;
- Expense control;
- Mix of business;
- Distribution mix (agency or direct);
- Defalcations;
- Rate adequacy and stability; and
- Legislative reform.

The title industry's revenue is more volatile than that of the property/casualty industry. Cyclicality in a line of insurance creates challenges but isn't always a negative quality, since it creates opportunities for well-managed companies. In such businesses, management must make sure the company's operating structure is flexible and responsive to both increases and decreases in revenue over a relatively short period. A well-managed company must be able to access trained staff to service business adequately when demand for title insurance is rising.

Likewise, when the demand for title insurance is sharply reduced, a company must be able to downsize its infrastructure and personnel in an efficient and orderly manner so that servicing of its current orders is not interrupted. Property/casualty insurers, in general, are larger and therefore have a more difficult time fluidly adjusting expenses around macroeconomic cycles; whereas the title industry's margins have historically been more controlled (see **Exhibit 12**).

Temporary personnel do not provide a total solution to this problem. Unskilled and part-time personnel can satisfy the need for an increase in title messengers or clerks, but they typically cannot fill the roles of more highly skilled positions, such as title searchers and underwriters.

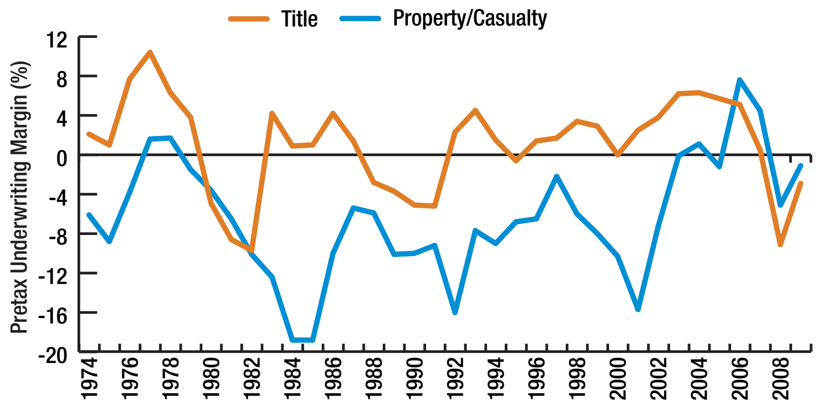
Title plans also are a significant component of fixed costs. They are important because they are the raw material of the underwriting process and require both an initial investment and constant updating of various records. Even in slow markets, title plants must be current, with each day's recordings entered into the plant's database. If a title plant becomes outdated, it will become a source of errors and lead to title insurance losses.

The acquisition and maintenance of title plants gradually is becoming more cost effective as the business becomes computerized. Modern title insurance companies feature the computerization of order taking, title search and examinations, and policy issuance. These advances have permitted companies to increase premium volume capacity dramatically with only a modest increase in personnel. This capability not only enhances the profitability of a title company but also makes it easier to manage expense levels during slow real estate markets.

Exhibit 12

U.S. Title vs. Property/Casualty – Pretax Underwriting Margin (1974-2009)

The title industry has, on average, a higher underwriting margin than property/casualty underwriters.



Source: ALTA, NAIC, A.M. Best Co.'s BestLink®: Statement File - 99200 Total US PC Industry.

Title insurance provides coverage for the following basic types of real estate transactions listed in ascending order of underwriting complexity:

- Residential mortgage refinancing or equity lines.
- Residential resale or new construction.
- Commercial resale or new construction.

Each successive product requires a significantly increased effort to market, underwrite and administer claims. The production costs necessary to generate each of these products also vary significantly.

First, residential mortgage refinancing is a classic, high-volume, commodity business, that tends to come in waves based on the relative level and trend of mortgage interest rates. During typical economic cycles when rates go down quickly – such as in 1992-93, 2001 and 2003 – the volume of new title orders increases dramatically. During such times, title industry companies must hire large numbers of workers to service orders to maintain market share. However, the level of title orders can contract as quickly as it surges, and well-managed companies must adjust their personnel (cost) levels accordingly.

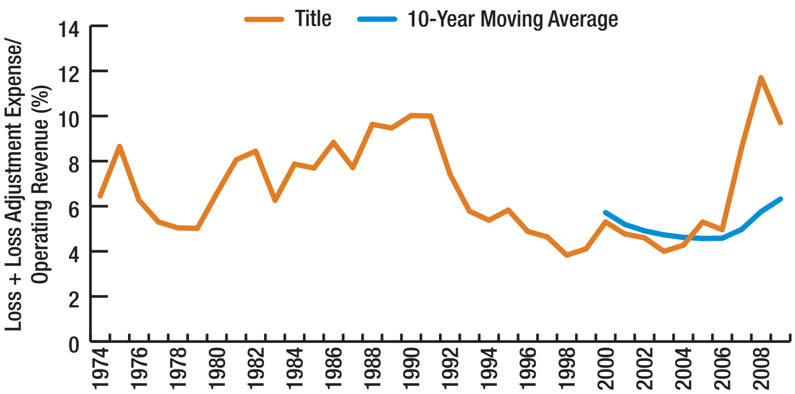
In underwriting refinance transactions, the title insurer, or its agent, performs a more limited title search than is necessary for a resale transaction. This less-comprehensive title search occurs because only the position of the lender of the refinanced mortgage has to be determined to assure the lender of its priority. No owner's coverage arises from these transactions, since the original owner's title policy, whenever purchased, continues to protect the basic title in the name of the property owner.

In addition to the challenges of managing the surges and contractions of title orders, companies also face difficulties managing the claims process. Some companies believe the best practice to minimize claim losses is to settle claims early to minimize legal fees, which are a large component of most claims. Other companies litigate claims when possible – which incurs more up-front expense – to establish and maintain a deterrent against fraud and future nuisance claims.

This tactic can be particularly effective in those regions where a small number of law firms specialize in representing title claimants. Whether a company's approach is successful or not can be determined only when the results of that approach are compared with industry averages.

Exhibit 13

U.S. Title Insurance – Loss and Loss-Adjustment Expense as a Percentage of Operating Revenue (1974-2009)



Source: ALTA, NAIC.

Companies must recognize when it is prudent to settle small-dollar claims quickly and when to litigate certain claims in order to establish a reputation within the legal community. What's more, claims approaches are dependent on the region of the country and the local legal and claims environment.

Secondly, more profitable and complex than refinance orders is the residential purchase business. And lastly, underwriting commercial transactions represent the highest profit margin for title insurers. In a typical sale/development of an office building, both buyers and sellers generally are knowledgeable and sophisticated and retain lawyers to represent their competing interests. Generally, both title insurers and lenders assign senior underwriters to manage and underwrite commercial transactions. This more intensive underwriting process – undertaken by both the buyer and the seller – results in fewer mistakes and title defects and, consequently, reduces the risk of loss. Since title premiums are linked to property values, large-value commercial title business generally generates the highest underwriting profit.

Loss Experience in the Title Industry

Exhibit 13 shows that the average loss experience for the title industry improved dramatically from 1993 to 2009 compared with the prior 20 years. This improvement is primarily due to better up-front underwriting as well as more stringent monitoring of agents to help avoid defalcations. However, loss experience in 2007 and 2008 did deteriorate noticeably, partly as a result of inadequate reserving for future claims during the period of the housing boom of 2000-2006. The end of the housing boom and the subsequent rapid increase in defaults and foreclosures has led to significantly greater incidence of title claims arising out of those calendar years. The improved loss experience in 2009 was driven mainly by the lack of major reserve strengthening following the significant reserving actions taken in the prior years.

Title insurance policies have no set termination date and no limitation on filing claims. However, the only fees collected are the one-time charges when the policy is issued. Thus, losses reported in any one year will affect that year's profitability for statutory accounting purposes but are not, in the main, generated by that year's business activity. By the nature of the business, most title losses are reported and paid within the first five to seven years after policy issuance. However, the tail for title policy claims is at least 20 years.

All insurance companies require adequate loss reserves to cover all known and future losses, as well as adequate surplus levels to provide a cushion for reserve shortfalls, contingencies and unexpected losses from underwriting and investment activities. For title companies, the potential adverse loss-reserve development is not as problematic as it is for casualty lines of business, since losses are a relatively small percentage of the total.

Although large title claims are infrequent, they do occur. They can arise in the context of the transfer of upscale, single-family residential properties; single family or multifamily real estate developments; or office buildings, shopping centers or other commercial developments. Overlapping tasks and regulatory hurdles involved with these complex transactions complicate these claims. For instance, often there are entitlement issues, easement, ingress/egress issues and mechanic-lien risks associated with construction.

The term of a title policy generally ends upon the sale, transfer or refinancing of the underlying property, which means that title insurers are unable to determine which and how many of its policies still are in force. This situation arises because the title insurer is not advised of the new policy, unless that insurer is fortunate enough to have written both the new and the old coverage. This feature provides for significant differences in the nature of claims and the reporting of financial information between the property/casualty business and that of the title insurer.

Title losses vary by a wide array of factors, including the:

- Local patterns and practices of land holding.

- Local record-keeping system.

- Value of the actual property.

- Length of time the property has been owned or encumbered by mortgages or liens.

However, without the ability to pinpoint the exposure from in-force policies, companies are unable to translate this loss/claims information into definitive reserving data. Instead, they use assumptions and extrapolation methods that are detailed in the **Reserving Characteristics** section of this report.

Title claims experience has an emergence pattern similar to that of a property/casualty product line with a moderate-length tail, such as personal automobile. Like personal auto, title insurance experiences a high frequency of low-dollar claims, occasionally generating a severe claim. Title underwriters have the ability to cure modest defects that occur frequently at a nominal cost. In many cases, the defect can be solved and the title loss averted simply by recording a document to correct, or confirm, the true property interests of the parties. However, a severe title defect or agent defalcation can result in a costly claim that might take years to settle.

The typical property/casualty company operates with a loss and loss-adjustment expense ratio between 70% and 80%, depending on its lines of business. This compares with a typical title company's loss and loss-adjustment expense ratio of 5% to 10%. This difference appears dramatic and leads most property/casualty-oriented analysts to assume that the business must be extremely profitable. However, the low loss and loss-adjustment expense (LAE) ratio is the result of the large expense component associated with underwriting and servicing a title product. This brings the overall profitability of title insurance, as measured by the combined ratio, more in line with property/casualty products (see **Exhibit 14**).

Exhibit 14

U.S. Property/Casualty – Combined Ratios, Various Lines (1974-2009)

Although the components of the combined ratio are markedly different among the various insurance lines, the average combined ratios are somewhat similar.

Year	Title Industry	Surety (Stock)	Property/ Casualty (Stock)	Property/ Casualty (Mutual)	Boiler & Machinery (Stock)
1974	98.0%	113.7%	105.0%	101.2%	103.6%
1975	99.0	122.0	107.5	104.4	96.2
1976	92.3	103.0	102.0	99.6	93.7
1977	89.6	96.2	97.0	93.9	86.7
1978	93.7	97.1	96.6	94.6	84.1
1979	96.2	90.2	99.6	98.0	76.2
1980	104.9	105.9	102.4	99.1	90.8
1981	108.6	85.7	104.9	102.9	91.8
1982	109.7	89.1	108.7	105.6	100.7
1983	95.9	87.6	111.8	105.3	103.8
1984	99.1	95.5	118.9	110.6	118.3
1985	99.0	111.9	116.5	110.5	89.9
1986	95.8	117.1	106.9	106.1	86.9
1987	98.6	116.0	103.3	103.6	80.9
1988	102.7	100.5	103.9	104.6	97.1
1989	103.8	93.9	108.6	108.0	93.2
1990	105.1	87.4	108.4	98.5	101.0
1991	105.2	75.6	109.5	106.4	109.8
1992	97.7	84.2	119.1	108.4	103.3
1993	95.5	65.8	107.9	104.8	103.7
1994	98.5	83.2	108.9	106.8	88.1
1995	95.8	79.7	106.7	105.4	91.2
1996	98.5	71.5	106.3	104.6	86.0
1997	94.1	69.2	101.4	101.9	88.3
1998	96.6	68.4	104.8	108.7	95.0
1999	97.1	68.1	107.2	109.9	109.5
2000	100.0	72.3	108.0	115.2	93.3
2001	97.5	88.7	115.4	117.4	92.1
2002	96.2	116.2	106.4	109.6	79.7
2003	93.8	122.3	99.7	100.9	68.0
2004	93.7	117.8	99.0	98.4	76.2
2005	94.3	101.4	102.1	99.6	62.8
2006	94.9	81.2	90.5	97.2	76.6
2007	99.5	70.2	94.0	99.6	71.0
2008	109.1	67.1	104.9	107.2	74.7
2009	102.9	79.2	100.3	105.5	75.4
Averages					
All Years	**96.0**	**88.4**	**102.5**	**101.5**	**87.1**
Past 10 Years	**98.2**	**91.6**	**102.0**	**105.1**	**77.0**
Past 20 Years	**98.3**	**83.5**	**105.0**	**105.3**	**87.3**

Source: ALTA, NAIC, A.M. Best Co.'s BestLink: Best's Statement File - 99200 Total US PC Industry.

Much of the stability in the title industry's loss ratio stems from the relatively low risk inherent in title insurance. The bulk of title insurance claims occurs shortly after closing and represents low-dollar costs. In these instances, the title company or its agent amends or corrects the title documentation and makes any required refilings and notifications. The policyholder might not be made aware of these technical corrections and does not receive any cash payment. Typically, the title company uses a staff underwriter or counsel to correct the problem, and the loss cost is relatively small.

Title companies that service multifamily real estate developments must have a well-trained and knowledgeable staff. Some of the larger title insurers have specialized departments dedicated to servicing these large-scale developments. In this way, title insurers limit risk by controlling the transaction at the outset and taking it through each step of the process – from acquisition work to construction disbursements to closing. Substantial costs are expended in these projects. More sophisticated title insurers have relationships with developers and are given insight into whether the transaction will be problematic at the outset. Although the magnitude of these losses can be higher than the typical title claim, the frequency of this type of loss is small.

Some of the most severe and difficult claims involve agent defalcations. Defalcation is the act of diverting fiduciary escrow funds without authority and without applying those funds to satisfy or pay off the existing mortgages, liens and encumbrances on the property that is the subject of the escrow. 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 a concentrated geographic effect, depending upon the region controlled by the defrauding agent.

Because the title industry's loss reserves are more stable, have less-adverse development and represent lower exposure to the industry's surplus, it follows that less surplus is required to protect against unexpected or catastrophic underwriting events. 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.

Reserving Characteristics

Title insurance companies file annual financial statements (National Association of Insurance Commissioners Form 9) with their respective state insurance regulators in accordance with statutory accounting principles. Statutory accounting principles are more conservative than generally accepted accounting principles (GAAP) because assets and liabilities are valued on a liquidation basis versus a GAAP going-concern basis. As a result, all statutory balance-sheet items are valued as though the company intended to discontinue its business and discharge all liabilities immediately, including claims, before a final distribution of remaining assets to its shareholders. As such, only assets that consist of cash – or those that can be converted into cash in a relatively short period – generally are allowed to be admitted to a company's financial statement under statutory accounting principles. Assets that are contingent in nature, whose values are uncertain or whose collectibility is questionable, are not assigned value and are classified as nonadmitted assets.

By statute, title insurers are required to carry two liability reserves: known claims and statutory premium. The known claims reserve is the aggregate estimated amount required to settle all claims submitted to the company and unpaid as of the balance sheet date. The known claims reserve is similar to the property/casualty industry's case reserve. Over the decades, most title insurers have established reasonable baseline case reserves by tracking and analyzing historical claims data. Based on these data, individual known claims reserves are estimated by a company and are modified for special circumstances. These estimates must be reviewed at least annually and adjusted as necessary.

The statutory premium reserve is a liquidation reserve, the amount of which is determined by state-mandated formulas that establish a liability reserve and a charge to income based on the amount of business written. Defined by a formula, the initial reserve is reduced gradually, with an offsetting gain to income over a stated period, generally 10 to 20 years, depending on the rules of the domiciliary state.

Since title policies have no termination date, the statutory premium reserve is required and is reduced gradually to reflect the long-tail nature of the company's liability. The statutory premium reserve is equivalent to the property/casualty industry's incurred-but-not-reported (IBNR) reserve, which also is established and held for many years for long-tail liabilities. The major difference is the statutory premium reserve is determined and reduced by prescribed state formulas, whereas a property/casualty company has more discretion in establishing and reducing its IBNR reserves.

The statutory premium reserve is considered a liquidation reserve, since state statutes also require a company to segregate investment-grade assets in an amount equal to its statutory premium reserve. If a title insurer becomes insolvent, such segregated assets can be used only to pay future claims or to purchase reinsurance to settle future claims. These segregated assets may not be used to pay current claims, operating expenses or distributions to shareholders. This feature is unique to the title industry. In contrast, the assets of a property/casualty company are not segregated and are available to pay any claims.

The required segregation of assets to support reserves assures policyholders that the company will not utilize these funds to pay losses or other expenses in the ordinary course of business or make distributions to shareholders. This provision and its protections are part of the title insurance industry's regulatory framework, and much of the industry's financial structure is built around these statutory reserves.

Statutory premium reserve formulas vary significantly from state to state and reflect a state's underlying title framework and customs, but not necessarily its loss experience.

Under GAAP, the statutory premium reserve is not recognized as an expense and isn't included as part of a title insurer's liability. It does, however, exist as restricted equity. Title insurers that are required to file GAAP financial reports, or are part of a consolidated group of companies that are required to file under Securities and Exchange Commission (SEC) rules, normally develop an IBNR component like any other insurance line and include it as part of their GAAP liabilities.

For the property/casualty industry, IBNR is derived from actuarial predictions of future occurrences based on current loss data, and it is an unsecured liability. The title industry's statutory premium reserves are set by statute at a rate that is somewhat arbitrary. Few states, if any, currently can support the establishment or change of their statutory premium reserving levels based upon their title industries' actual loss experience. This situation has created inconsistent statutory premium reserves among companies across the country.

Additionally, since the statutory premium reserve is a charge to income, variances for individual title insurers' operating results (operating gain or loss) often reflect different statutory premium reserve requirements rather than actual differences in operations.

In addition to the statutory premium reserve and the known claims reserve, the title insurers' statutory financial statements provide for a supplemental reserve. Title insurers are required to have an actuarial certification of the adequacy of their reserves. If the actuary indicates that the statutory premium reserve plus the known-claims reserve is less than the estimated dollar value of known-plus-expected future claims, plus expected loss-adjustment expenses, the title company would have to fund the shortfall in the supplemental reserve. Since the supplemental reserve is not tax deductible, the best interest of title insurers is to have the statutory premium reserve as close as possible to actuarial estimates, if not actually more than the estimates.

In regions that experience significant real estate appreciation, turnover of homes is higher as owners sell their homes and use their realized gains to buy more expensive homes. Depressed regions of the country generally experience slower real estate activity as homeowners wait for the turnaround and try to avoid losing the equity in their homes.

Although faster claims development might be one by-product of a higher turnover rate, a property becomes a better title insurance risk the more it is bought and sold because a property's title and tax records are searched each time it is sold. Frequent examination of a property's title records increases the odds of perfecting the property's title. The benefit, of course, comes from the fact that the new policy not only supersedes and effectively terminates the old policy but also generates new revenue. The term "perfecting" is the removal of any discovered potential defects in the title to real property, prior to closing.

Published by A.M. Best Company

Special Report

CHAIRMAN & PRESIDENT **Arthur Snyder III**

EXECUTIVE VICE PRESIDENT **Larry G. Mayewski**

EXECUTIVE VICE PRESIDENT **Paul C. Tinnirello**

SENIOR VICE PRESIDENTS **Manfred Nowacki, Matthew Mosher, Rita L. Tedesco**

A.M. BEST COMPANY
WORLD HEADQUARTERS
Ambest Road, Oldwick, N.J. 08858
Phone: +1 (908) 439-2200

NEWS BUREAU
830 National Press Building
529 14th Street N.W., Washington, D.C. 20045
Phone: +1 (202) 347-3090

A.M. BEST EUROPE RATING SERVICES LTD.
A.M. BEST EUROPE INFORMATION SERVICES LTD.
12 Arthur Street, 6th Floor, London, UK EC4R9AB
Phone: +44 (0)20 7626-6264

A.M. BEST ASIA-PACIFIC LTD.
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
Phone: +852 2827-3400

SR-2010-055