

A timeline for title insurance

WASHINGTON -- Aug. 22, 2005 -- WITHOUT THE ADVENT OF TITLE INSURANCE SOME 130 YEARS AGO, the real estate finance industry as we know it could not exist. Title insurance enables a more efficient closing process for buyers, sellers and lenders. It protects buyers and lenders from future problems related to discrepancies of ownership. But perhaps most importantly, it allows for the smooth transition of mortgage assets from the primary market to the secondary market.

The evolution of the real estate finance system in this country is interwoven with the growth and development of the title-insurance industry. Experts predict that will continue to be the case.

Past

The American Land Title Association (ALTA), Washington, D.C., the national association of record for the title and settlement -services industry, was founded in 1907 and currently represents almost 2,000 industry participants, including underwriters, agents and abstractors. Until the late 19th century, however, title insurance did not exist, and the exchange of real property did not include any guarantee.

Typical transactions involved the consultation of a lawyer to obtain a legal opinion as to the status of title to real estate. Court decisions held that, in essence, a lawyer was liable for an erroneous title opinion only if he or she was negligent in preparing and giving the opinion. Even in those cases, however, the lawyer was only accountable for the amount paid for the opinion-not for the loss taken on the real estate transaction. The ultimate responsibility for verifying title fell upon the buyer.

"There were cases around the country in the mid- to late 1800s where a lawyer or abstractor was only liable up to the amount of their fee," says Kerry Schuman, managing partner at Jaffe, Friedman, Schuman, Nemeroff, Applebaum & McCaffery PC, an Elkins Park, Pennsylvania-based law firm and 20-year title industry veteran.

A landmark 1868 Pennsylvania Supreme Court decision was the final catalyst for the creation of the title-insurance industry. In the case of *Watson v. Muirhead*, Muirhead sued his conveyancer after losing his investment at a sheriff's sale as a result of an outstanding prior lien that an attorney had determined invalid. The court ruled that conveyancers and attorneys must not be held liable for erroneous opinions that are made based on professional standards of evaluation, and Muirhead lost his investment.

"What happened here was a real frightening thing to people who were trying to purchase land," says Schuman. "That case really gave a kick in the rear end to the title industry, because people wanted an insurance policy as opposed to simply an opinion from a lawyer."

In 1874, Pennsylvania enacted the first statutes authorizing the issuance of title insurance. As a result, in the year of the country's centennial, a group of Philadelphia conveyancers founded the world's first title-insurance company, Lawyers Title Insurance Co.

"The history starts with Lawyers Title," says Schuman. "Pennsylvania had an enacting statute authorizing title insurance, and Lawyers Title was formed under that enabling legislation."

According to historic records, in its initial advertisement Lawyers Title promised to insure "purchasers of real estate and mortgages against losses from defective title, liens and encumbrances," enabling "the transfer of real estate and real estate securities [to] be made more speedily and with greater security than heretofore." Not long after, title-insurance companies were founded in the nation's largest cities, including New York City, Chicago, Minneapolis, San Francisco and Los Angeles.

"Title insurance was born out of that need to provide a financial resource, to create a strict liability and to create a duty to defend," says John Hollenbeck, senior executive vice president of First American Title Insurance Co., Santa Ana, California.

In the 1940s, servicemen returning victorious from World War II began purchasing homes in record numbers. This dramatic increase in the number of homebuyers coincided with the formation of Fannie Mae as part of Franklin Delano Roosevelt's New Deal (1938), changing the title-insurance industry from a typically local business to a national enterprise. Title insurers were able to convince secondary investors, including the government-sponsored enterprises (GSEs), that title insurance was necessary for the financing of residential real estate. As the market for residential mortgages grew, title-insurance policies helped standardize mortgages and smoothed the way for lenders to sell the mortgages on the secondary market. Freddie Mac was later chartered by Congress in 1970 to purchase mortgages.

"There became a greater call for national standards as the residential mortgage industry learned about securitization, and as Fannie Mae and Freddie Mac created a secondary market for mortgages, title insurance became necessary," says Schuman. "Lenders began to require it for protection."

"Title insurance made those loans fundable," says James Maher, executive vice president of ALTA. "That is the kind of small, low-key, almost invisible but extremely important cog in the mortgage finance wheel that we play."

The 1940s' start and subsequent growth of a nationwide secondary market have enabled millions of American homebuyers to live the American dream of homeownership. The purpose of the secondary market is to increase investment in mortgage financing and to attract funds from areas of the country (and the globe) with excess capital to those parts that need an influx of investment.

"Rating agencies that securitized bonds ostensibly required title insurance," says Hollenbeck. "The U.S. has the most efficient real property transfer system in the world, and part of that is because of the liquidity available through the secondary market. Title insurance allows imperfect transactions to close, by providing coverage that writes around risks that might otherwise not be acceptable to the buyer or lender."

The need for protection from title problems is even more important to a secondary investor than to the originating lender. A local lender may know the borrower and the attorney rendering an opinion on title, and that may be sufficient for approval. For a national lender, however, that local opinion most certainly is not enough.

With the advent of a national lending market in the middle of the 20th century, title insurance has become ubiquitous with mortgages traded on the secondary market. Marketability of loans is enhanced dramatically when large, financially sound companies

stand behind them. Title policies have enhanced the growth in the availability of mortgage funds, and have been a catalyst for real estate investment nationwide.

"The secondary buyer is now assured that that lien is a valid lien, and that's the most important thing that they are buying—the validity of the lien on that real estate," says Schuman. "Once lenders started creating pools, they realized they needed title insurance as part of risk management. For the small percentage of times when there is a title claim, it is expensive to defend and, if the defense is unsuccessful, a lender has to buy back the entire mortgage from the investor. Relative to the amount of dollars at stake, as a cost of total transaction, it's a small amount."

Present

Underwriting a title on a property involves a review and assessment that is carried out locally because the public records to be searched are usually only available locally. Policies are issued in conjunction with intrinsically local transactions—real estate settlements and mortgage loan closings. Because real estate laws, customs and practices vary by state and sometimes even county, it has not been practical for underwriting to be done on a national basis for title-insurance companies, as is typical of other insurers and mortgage lenders.

"In an odd sort of way, from 100 years ago until now, fundamentally the product is the same," says First American's Hollenbeck. "The process is just more efficient. Basically we still provide the same product since the real estate laws have not changed much. You still have the deed that has to be executed properly, acknowledged and recorded."

With the advent of new types of mortgages and the growth of the secondary market, title-insurance companies have created new policies offering novel types of coverage—for example, covering zoning issues, building permits and survey matters. Many title-insurance companies today are involved in all aspects of the closing process, including document preparation and the collection and disbursement of funds, and some even operate on the servicing side of the business.

"We have seen a diminution to some extent in the amount of respect given to the title-insurance process by those in the mortgage industry as compared to 20 years ago," says ALTA's Maher. "I think that is in part because many folks in the mortgage banking industry today have come from consumer credit and other backgrounds. They have not been in the real property arena. But they recognize that there are systemic advantages and pricing advantages to making a mortgage loan, and third-party investors have required some kind of evidence of adequate title, so title insurance still remains the least expensive form of assurance."

The basis for title insurance is a search of the public records, usually including visits to the offices of county recorders, court clerks and other public officials. Title searchers look in these records for mortgages, judgments, assessments and taxes. The search and examination are more than just an attempt to confirm placement on the record of a subject mortgage. It involves an underwriting process that distinguishes between significant and insignificant conditions affecting title. Often, the search and examination includes the curing of defects to title that are necessary for the transaction to be completed.

According to ALTA, approximately 25 percent of all residential real estate transactions have issues with the title, and title professionals resolve these issues before closing.

"A good 25 percent of our closed transactions involve us doing curative work behind the scenes, cleaning up the public record and removing old documents and otherwise curing defects in the chain of title—all before anybody ever gets to the settlement table," says Maher. "That is part of the process that is invisible to the typical mortgage lender. If you are looking to obtain a valuable and enforceable mortgage of a certain priority, it is a little hard to do that without somebody first of all creating that instrument; second of all recording that instrument in the proper fashion, in the proper time and after proper steps have been taken; and then finally being willing to stand behind the fact that it is a valid and enforceable mortgage."

"Historically, title insurance has been a decentralized, paper- and labor-intensive business," says Hollenbeck. "The records, by their very nature, have been at the local level at the county courthouse. Everything about the transaction has been local—the buyer, the seller and, up until the last 20 years or so, the lender. It is a business that really grew up locally."

As this process is time-consuming and labor-intensive, many title insurance companies have formed title plants that contain virtually the same information as that found in public records. Information in these privately owned title plants is organized geographically so it is easier to search, as opposed to the name indexes county recorders use to maintain records. Today title insurance can be searched and insurance issued within 48 hours in most major cities, due in large part to title plants. The cost to maintain and continuously update records in a title plant is extremely high, contributing to the overall fixed-cost expenses of title insurance companies versus property/casualty insurers.

"Title plants make it easier to abstract records because they are organized better than county records," says Jaffe Friedman's Schuman.

Great Chicago Fire as catalyst for progress

The Great Chicago Fire in October 1871 played a part in making the modern title plant a reality. That blaze destroyed much of the city, and with it the real estate records stored in the Cook County recorder's office. Three abstracting companies took their records out of the city before the fire reached their building (one of them, according to legend, accomplished this by hijacking a wagon at gunpoint). In April 1872, the Illinois Legislature passed the Burnt Records Act, and the existing records of the three companies were made admissible as evidence in all courts of record.

"These three private companies that had been abstracting since the 1850s had created an early title plant," says Schuman. "Out of that fire in Chicago you started to see more standardization in how abstractors went to the public records, followed up and issued title commitments, which basically is a title report showing liens, encumbrances and problems with the title."

The acquisition and maintenance of title plants is becoming gradually more cost-effective as records become digitized. Title insurance companies today use technology to automate or increase efficiencies in order taking, title search and examination, and policy issuance. Technological advances have enabled increased production without a correspondent increase in staffing, helping to limit the impact of mortgage volume cycles on the industry's bottom line.

"What started over 20 years ago is the computerization of those records," says Hollenbeck. "What has transpired since then is databases becoming more consolidated and being put on

enterprisewide platforms. The information is now ubiquitous because of the advent of the Internet and fiber optics."

Regulatory factors shape industry

The Real Estate Settlement Procedures Act (RESPA) was passed in 1974 to provide consumers with a better understanding of the complicated settlement process, and to protect those borrowers from excess costs as a result of kickbacks and other untoward agreements among industry participants.

"Because title insurance is not a product most people buy more than a few times in their lives, the government has been very strong in enforcing the anti-kickback regulations in RESPA," says Schuman. "A lot of [realty agents, mortgage companies and lawyers have gotten in trouble because their practices did not comply with section 8 of the regulations."

Former Department of Housing and Urban Development (HUD) secretary MeI Martinez issued proposed revisions to RESPA in 2002 that proposed offering consumers a single guaranteed mortgage package, often referred to as bundling, that would include all costs related to the closing. Due to opposition from many sides of the industry, as well as consumer-advocacy groups, HUD withdrew its proposal in March 2004. In June of this year, new HUD secretary Alphonso Jackson notified the housing industry and consumer groups of his department's plans to discuss what might be incorporated in new proposals through a series of semi-public meetings.

"The title industry and the small businesses that surround it do not like bundling, because it will make it harder for small businesses to compete," says Schuman. "It seems that HUD's plan now is to take it slow and get everyone's opinion in order to build a consensus. There is a middle ground that, with enough public comment and discourse, could be had that works for the public and the industry."

Current industry performance

So how is the industry doing? According to ALTA, revenue for the title-insurance industry was relatively flat in the first quarter of 2005 compared with the same quarter last year. Total revenue for the first quarter of 2005 was \$3.7 billion, while the same period in 2004 saw revenues of \$3.688 billion—an increase of only one-third of 1 percent.

According to Oldwick, New Jersey-based A.M. Best Co.'s October 2004 special report, Title Industry Running on All Cylinders, "The industry evolved rapidly in recent years due to several factors, which include: consolidation activity; introduction of new and expanded products; technology advancements; entry into new lines of business; and national and international expansion."

"The latest advancement is the automated collection of the raw materials that you use to do the title search," says Hollenbeck. "We have automated the collection of the data. Instead of a human going to those computers to pull the data, a computer can go through rules-based steps to access all the various databases and pull together what we call a search packet, which is a compilation of all the documents an examiner would need to examine the title."

Future

The future of the title-insurance industry ties directly to the real estate finance industry's need to increase efficiencies and decrease costs. As in the broader industry, technology and tighter integration will continue to evolve to meet this need for insurers. Nationalization of

title insurance appears to be a long shot due to the local nature of the business. Experts point to electronic closing and electronic recording as key areas where the industry will see the greatest challenges and the most change.

"The key issue, it seems to me, is whether the whole process of real estate settlement is going to continue to be a local market bottom-up kind of delivery system, or some kind of business-to-business top-down kind of approach," says ALTA's Maher.

"The answer to that question is going to be a sort of mixed bag of 'yes and no.' I think the issues associated with RESPA reform really split on a realization on the part of small to medium-sized lenders that the point-of-sale control was never something that could be vested by some federal regulation in the hands of lenders when, in the purchase-and-sale context, it is always going to be controlled by the real estate sales broker and agent," Maher contends.

Maher adds, "It is very hard to imagine a regulatory-driven, topdown kind of delivery system. Depending on what direction the marketplace goes, a great deal of efficiency, a great deal of standardization and a great deal of multi-jurisdictional pricing and practices can be developed. In the absence of that, as long as the title order and the closing decision [are] made at the local level, it remains a challenge to provide the kind of standardization and economies of scale that would be necessary for some sort of major change in the delivery system-at least in the purchaseand-sale context."

"Because title insurance is subject to local custom and practice, it would be very hard to nationalize the product so it is uniform in all 50 states," says Schuman. "It is still local. Although most underwriters are on a national scale, title insurance is still subject to local customs. The underwriters have figured it out so they can compete on a national basis, however."

In April, Arizona Governor Janet Napolitano signed the Uniform Real Property Electronic Recording Act (URPERA), legislation that gives county clerks and recorders legal authority to accept and store real property records, including mortgages, in electronic form. The law goes into effect Jan. 1, 2006. URPERA was drafted and approved by the National Conference of Commissioners on Uniform State Laws in summer 2004 to expedite real estate sales at lower costs.

The adoption of the Uniform Electronic Transactions Act (UETA) in 48 states and the federal enactment of the Electronic Signatures in Global and National Commerce Act (E-SIGN) allow electronic records and signatures to record land-sales contracts. The eventual impact of electronic closings and recordings appears to be certain. The uncertainty that remains revolves around the time frame before significant impact will be felt.

"In the short to intermediate term, I don't see the purchase and sale transaction changing significantly," predicts Maher. "Because the closing is still going to involve local consumers in a local place going someplace to sign documents in some form or another, the closing transaction is probably not going to be electronic for at least three to seven years. The more progressive companies and progressive recorder's offices are capable of doing it, but it is going to take a while to get it out to all 3,300 counties. Even for the top 100 counties, it is going to take time."

Maher does add one caveat, however: "In refinance transactions, because the lender and borrower are only concerned with the interest rate and fees-and particularly with the trend

toward incorporating the costs into some sort of package-there we will see pressure on the title industry and its component parts to reduce the costs and streamline the process," he says.

"eCommerce is changing the nature and shape of how searches are done," says Schuman. "At some point in time, electronic filing will be the norm, and it is already taking place. Title searches will be done remotely via the Internet. This raises concerns about errors related to data entry-garbage in, garbage out-but the industry will figure it out and get past it."

"What's really going to make the title industry more efficient is the computerization of public records, both privately in title plants and publicly through online systems," says First American's Hollenbeck.

"The need to go to the courthouse is reduced today, and is continuing to [decline] because county governments are making records available online. There are a meaningful number of county recorders and tax collectors that now have their records online. Over time, records will become more computerized and more available online," he says.

Hollenbeck adds, "In areas where there are title plants, there is no need for records to be online because they will not be as efficient to search. Online county records will fill the gaps where title plants do not exist. It trumps going to the courthouse."

Adds Schuman, "What used to be incredibly paperintense is now becoming electronic, speeding up transactions, giving people access more quickly and killing fewer trees."

"The next step is automated examination, and over the next five years I think there will be a lot of growth in that area," says Hollenbeck. "A computer system will analyze the data and come up with results, going through the same decision-making process a human being would, but on an automated basis. Someday, maybe 10 years from now, a fair number of transactions will be completely automated. It won't be everywhere, but it will start to grab hold."

"In large markets where title plants are available, expert systems could produce what is called a 'pre-examined product' that is untouched by human hands through rules that are established in software," says Maher. "You cannot afford to do that outside of major metropolitan centers right now, but in the future it may be possible to do that."

"What we cannot allow to happen is the degradation of the product in the course of automating the product. We cannot just run it through the system and say, 'This is a grade-A title/ and be good to go. We still need to know the legal description, who owns the property, what are the encumbrances against it and so forth," says Hollenbeck.

"In my opinion, electronic transactions will eventually become commonplace in real estate, though I think it's going to take time," continues Hollenbeck. "It is going to be an evolutionary process, because implementing those changes requires modifications in workflow on the part of all of the participants in the mortgage transaction, starting with the lender. I don't see a fundamental change to the product occurring, but I do see fundamental changes to the process. Data integration will happen from stem to stern. If you look at the whole life cycle of the loan transaction, lenders and title companies need to be integrated in order to gain efficiencies."

"We recognize that there are going to be a lot of mortgage lenders who want to see costs reduced and time reduced, and they are going to be looking for the quickest, cheapest and

easiest way out," says Maher. "To some extent, we as an industry are going to have to respond to that with new and different products and combat that with information as to why lenders should not go in that direction. But we have to do many different things in order to respond to that pressure. Part of the answer is technology, but there are a lot of systemic and regulatory challenges that are going to have to be addressed before technology can be brought to bear on these issues."

The title insurance industry has evolved quietly into an integral part of the mortgage lending process. The challenge for the future-not just for the title industry but for the industry in general-is to remain true to the practices that have enabled the country to achieve unprecedented levels of homeownership.