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Bright Prospects for Title Insurers

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In the Fall 2012 issue of ***PDV Observations,*** we wrote about the improving homebuilding industry. In this article, we explore a related area – the title insurance industry. The title insurers suffered severely in recent years from the housing market depression. During this period, title insurance orders and revenues plummeted, as mortgage originations and refinance activities declined amid falling home prices, limited mortgage funding, and tight lending standards.

With the housing market rebounding, the outlook for title insurance companies is looking much more positive. This article discusses why the title insurers will likely prosper going forward.

Lower reserves for claim losses

Title companies insure good title to real property, issuing policies that are integral to and facilitate real estate transactions. Unlike traditional insurance companies which insure against unpredictable future events, title insurers search for and insure against pre-existing property title problems. Title companies have much more control over the risks they assume because they are dealing with past problems, rather than having to predict the future. Through due diligence title insurers should be able to mitigate much of their underwriting risks, by identifying and addressing pre-existing title defects ahead of policy issuance.

Despite having more control over the insured risks, title companies saw their policy losses skyrocket during the housing bubble period. Such high losses were due primarily to the exploding volume of transactions, which caused more errors in title search and examination and encouraged fraudulent activities. As claims and losses piled up, title companies were required to boost the levels of their loss reserves, which had the effect of punishing their reported earnings. Their stock prices plummeted along with their declining fortunes.

Thanks for your referrals!

As we conclude our eighteenth year of publishing *Observations,* we would like to take this opportunity to express our gratitude and appreciation to all our clients and friends for their client referrals over the past year. We always welcome the opportunity to be of service to relatives, friends, and acquaintances of our clients. As many of you know, we do not market our services to people with whom we are not acquainted. Our business has grown over the past seventeen years primarily due to satisfied clients adding business and through their referrals. We hope you'll think of us if you come across anyone who would benefit from our services. Thanks again!

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The prospects for title insurers are looking much better going forward, because policy claims and losses are trailing off. According to the largest title companies, most claims and claim payments are made within the first six years after policy issuance. This is significant because the most recent housing cycle peaked in 2006, or 6 years ago. Generalizing from the claims experience of the nation's three largest title insurers, most of the losses from the housing bubble years likely have cycled through. Consequently, there is less need going forward to build up loss reserves, thereby reducing the charges that hit reported earnings.

Further, the more stringent underwriting standards since the housing bubble burst have cut down on mortgage fraud, which was a significant source of losses during the bubble period. Both the passage of time and the tighter underwriting standards point to much lower losses hitting the title insurers going forward, thereby greatly boosting their reported earnings.

More transactions, higher premiums, and more favorable mix of policies

The rebound in the housing market will also benefit title insurers through more transactions, higher premiums and a more favorable mix of policies. This is because each transaction, whether a refinance or a purchase transaction, requires the issuance of one or more title policies that generate revenues (in the form of premiums) for the title insurers. The growing housing transactional activity will produce higher title premiums.

Another favorable trend benefitting title insurers comes from rising housing prices. This is because premiums go up when policy limits increase in response to higher priced transactions. Further, the underwriting risk faced by title insurers does not rise in direct proportion to higher policy limits. Here's why. With traditional property and casualty insurance, it is indeed more risky to insure a $1,000,000 home versus a $100,000 house. As the insured value of the property increases, the insured event (e.g. a fire) can destroy a much more valuable property and give rise to a much larger claim.

In contrast, title insurers provide protection against *pre-existing* title problems. If they miss a recorded tax lien of $10,000, their risk of loss is $10,000 regardless of whether that lien is against a $100,000 or $1,000,000 property. Also, the amount of work to search the title is not necessarily related to the value of the insured property. As premiums go up along with rising property prices, the margins for title insurers expand favorably, doing wonders for their reported earnings.

Title insurers should also benefit from a higher-margin profit mix going forward, as lower-margin refinance transactions are replaced by higher-margin purchase transactions. In a report released in October 2012, the Mortgage Bankers Association (MBA) projected $1.3 trillion mortgage originations for 2013. While down from the estimated $1.7 trillion of total mortgage originations for 2012, MBA expects purchase transactions will grow in place of refinance transactions.

More purchase transactions favor title insurers because the title insurance premium for a purchase transaction is generally much higher than for a refinance transaction, which often enjoys discounted rates. While the discounts and eligibility requirements vary from state to state and insurer to insurer, the average discount for insuring a refinance transaction is 50 to 60 percent, according to

Realtor.org.

Benefits from operating leverage

A big part of a title insurer's costs is fixed. Such fixed costs and the cyclical nature of a title company's business spell trouble during real estate downturns. This negative operating leverage means that profits are often decimated during difficult times, such as the recent housing depression. On the flip side, the fixed costs do not increase proportionately to revenue growth during real estate up-cycles. Consequently, operating leverage will drive higher earnings for the title insurers in the coming years as the housing market recovery brings about larger order volume and higher revenues.

We can already see this operating leverage at work in favor of the title insurers. As Fitch Ratings stated in its November 27, 2012 press release, GAAP operating margins for Fitch's title company universe rose to 10.3% in the first nine months of 2012, up from 6.1% in the prior year. Earnings for all insurers improved, and title revenues through the first nine months of 2012 increased by over 15%, due to refinance activities outpacing expectations and housing markets stabilizing. In the third quarter of 2012, open title order counts jumped 20% from the same period a year ago, according to a DSNews article dated November 27, 2012 citing Fitch Ratings.

As the title insurance industry moves further along in cycling through the large claim losses from the most recent housing downturn, and absent adverse economic conditions that hinder the current housing market recovery, the prospects of further premiums and earnings growth are looking very promising for title insurers. Further, some title companies have substantial tax loss carryover accumulated during the past few years which should help lower their taxes in the coming years as earnings improve.

Limited loss from robo-signing

Despite all the favorable trends benefitting the title companies, you might still wonder whether they are attractive investments in light of possible exposure from the robo-signing fiasco. When the robo-signing scandal broke in late 2010, questions were raised about the validity of the title to properties that had been improperly foreclosed and resold. This led to concerns that title insurers might be faced with crippling claims. Reports from the media speculated that the robo-signing scandal would turn into a nightmare for the title insurers.

As it turned out, concerns about the robo-signing's impact on the title insurers were overblown. After a brief hiatus from issuing policies while they analyzed the situation, the title insurers resumed their operations. The title insurance industry determined that the risk of loss from robo-signing and shoddy foreclosure procedures would be manageable for a number of reasons:

- Common law and state statutes provide protection to bona fide purchasers – purchasers who bought a real property in good faith for value and without notice of any claim or interest of a third party. Good faith purchasers of real estate owned properties (REO) for value have very strong legal defenses against rescission claims based on faulty foreclosures.

- Even if a rescission claim succeeded, the REO purchaser would get the purchase price back, mitigating or eliminating loss under the title policy issued to the REO purchaser.

- The title companies acknowledged that litigation defense costs presented a risk, which they considered manageable.

- The suspension and scrutiny of foreclosure practices since the robo-signing situation first broke have reduced the risk of shoddy foreclosures.

- In connection with issuing owner's and lender's policies for purchases of REO, title companies have in some cases required indemnification from the lenders that owned the REO with respect to faulty foreclosures.

- As a practical matter, the person most likely to argue rescission would be the homeowner who lost his home. In addition to the formidable defenses available to the bona fide purchaser of REO, it costs money for the foreclosed-upon borrower to bring a lawsuit for rescission. Even if he prevails, he gets his house back, subject to a mortgage he likely cannot afford.

- The title companies have no exposure to the owner who lost his house (i.e. defaulting owner) because the original title policy insured title against defects that existed prior to the time when the defaulting owner first bought the house, while any faulty foreclosure proceedings by definition occur after the original house purchase by the defaulting borrower.

- For a lender who is the purchaser at foreclosure via a credit bid and takes the property as REO, the pre-existing lender's policy would not protect against faulty foreclosures and a new owner's policy in favor of the foreclosing lender would exempt the title company from any loss due to a faulty foreclosure by the same lender.

Be Selective

There are currently only 4 publicly traded title insurance companies, following a period of industry consolidation. As the housing market rebounds, the rising tide should lift all boats. However, title insurers have already seen their stocks rally strongly this year, so you should be mindful of how much you are willing to pay for their improving business prospects.

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