WHAT WE’VE GOT HERE IS A FAILURE TO COMMUNICATE

How Traditional Financial Reporting Contributes to Misunderstanding of Title Insurance Loss Activity

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In 1967, Paul Newman starred in the movie *Cool Hand Luke*; however, it was veteran role actor Strother Martin, as the Captain of Road Prison 36, who uttered the comment, “What we’ve got here is a failure to communicate.” Nearly forty years later, the comment is applicable to the Title insurance industry. It pertains because there is a breakdown in communication as the Title industry attempts to explain itself to a constituency that is appreciably more familiar with the practices and procedures associated with Property and Casualty (P&C) insurance.

This article focuses on a specific financial reporting practice that has contributed to the Title insurance industry’s failure to communicate the unique characteristics associated with its loss containment activities. The author believes that communication can be enhanced if both parties, the Title industry and its regulators, address and acknowledge the impact of the rote application of certain financial reporting requirements and how Title underwriters do not fit the mold established for P&C companies.

### The Perception

Property and Casualty insurance loss and loss adjustment expense (L&LAE) ratios are traditionally at a level of 50%-60% or higher. This implies that 50% or more of the premium charged for insurance is ultimately utilized for settlement and payment of claims. In contrast, the Title insurance industry reports L&LAE ratios in the vicinity of 4%-6%. Based upon this simplistic comparison of the L&LAE ratios, there have been misperceptions that Title insurance rates are excessive. Similarly, comparisons of operating expenses between P&C and Title insurers can lead to inaccurate conclusions that Title underwriters have an excessive expense component. The comparisons of dissimilar coverages impedes communication between the Title insurance industry and regulators.

### The Reality

A Title insurance policy involves protection against historical events that were undiscovered and occurred prior to policy issuance. Typical language in a Title insurance policy states that:

> Subject to the exclusions from coverage, the exceptions from coverage contained in Schedule B and the conditions and stipulations, the Title insurance company, insures, as of the **Date of Policy** shown in Schedule A, against loss or damage... 

In contrast, a P&C insurance policy insures against undiscoverable future events that occur during the ensuing policy period. Typical language in a P&C insurance policy states that:

> In Consideration of the Provisions and Stipulations herein, this Property and Casualty Insurance Company, for the term of **this date** at 12:01 a.m. to **one year later** at 12:01 a.m. at the location of the property involved, does insure... 

While Title insurance coverage looks backward from a certain date, P&C insurance coverage looks forward, utilizing a finite future period, to evaluate liability. The timeframe of coverage and cost containment activities is a fundamental difference between Title and P&C coverages. This distinction for Title underwriters has not been properly reflected in at least one aspect of the financial reporting requirements. To explore this, one must understand that loss adjustment expense (LAE) is assigned to two broad categories:

1. **Adjusting and Other (A&O)**: A&O is a component of loss adjustment expense (LAE) that includes all claims adjusting expenses, whether internal or external to the Company. This component includes fees and salaries of those involved in a claim adjusting function, and other related expenses incurred in the determination of coverage. A&O expense is similar to what was previously known as unallocated loss adjustment expense (ULAE).

2. **Defense and Cost Containment (DCC)**: DCC includes defense, litigation and medical cost containment, whether internal or external to the Company. These expenses include, but are not limited to, accident investigation, surveillance, litigation management and fees of attorneys and others if working in defense of a claim. DCC expense is similar to what was previously known as allocated loss adjustment expense (ALAE).
These LAE categories, and the predecessor categories, ULAE and ALAE, have served the P&C insurance industry well. However, these definitions are implicitly designed to address traditional P&C policy characteristics, such as claims and cost containment expenses arising and manifesting after policy issuance and during a policy period. However, the Title industry has been required to report financial information utilizing these same categories, even though the characteristics of its claims and cost containment activities are fundamentally different. For instance, Title insurance coverage is designed to respond to undiscovered claims that existed prior to policy issuance. Similarly, the majority of the Title industry’s cost containment expense activities occurs prior to policy issuance and is associated with activities to discover and preemptively identify potential policy liabilities. The current LAE categories do not allow the Title industry to report these commensurate costs and activities. When information is assumed to be comparable even though it is not, the failure to communicate begins.

The Title underwriter’s determination of coverage, elimination of ambiguity and other litigation management efforts are summarized in Schedule B of the Title policy, and memorialized when the policy is issued. Schedule B - Exceptions From Coverage notes that “This policy does not insure against loss or damage (and the Company will not pay costs, attorneys’ fees or expenses) which arise by reason of …” These efforts by Title underwriters to eliminate ambiguity and manage future litigation should be viewed in the same light as P&C cost containment activities. The distinction rests solely with the characteristics of the coverage timeframe.

By way of analogy, assume that a P&C insurer expended time, effort and expense to evaluate facts related to a covered incident on the behalf of an insured. Further, assume the P&C insurer mitigated the potential claim costs by ultimately determining that no liability existed. Would anyone consider allocating this time, effort and cost to the P&C insurer’s operating expense? Of course not. This type of activity would be loss adjustment expense. However, comparable activities by a Title underwriter, working on behalf of an insured to preemptively resolve potential coverage exposure related to a policy continues to be allocated to operating expense even though commensurate cost containment activities occurred. Until the difference between the coverage timeframe and ensuing cost containment activities for Title insurance (retrospective) and P&C insurance (prospective) has been addressed through revised financial reporting requirements, a comparison of P&C and Title L&LAE ratios is not appropriate.
What We’ve Got Here Is a Failure to Communicate -
How Traditional Financial Reporting Contributes to Misunderstanding of Title Insurance Loss Activity (CONTINUED)

**Better Understanding through Better Communication**

Due to the predominant familiarity with P&C insurance reporting, a head-to-head comparison of Title versus P&C L&LAE ratios is inevitably part of the communication and dialogue between the industry and its regulators. However, the current financial reporting standards do not properly consider characteristics unique to Title insurance. This understates Title underwriters’ true L&LAE ratios. There exists a material component of Title LAE that must be accounted for and properly allocated in order to compare Title and P&C L&LAE ratios. Adjusted financial reporting procedures would transfer loss containment activities from the expense ratio to the L&LAE ratio for Title underwriters.

The Title industry’s L&LAE ratio of 4%-6% does not provide an accurate reflection of the expenses associated with coverage, investigation, litigation management and cost containment. A P&C L&LAE ratio reflects all such expense elements. The result for Title underwriters understates L&LAE ratios, overstates operating activities and expense ratios, and also hinders analysis of the appropriateness of the Title insurance rates. The fact that the Title insurance industry’s combined ratio will not change might be one of the reasons that these adjustments have not yet received the attention they are due.

Utilizing the current financial reporting guidelines, a typical P&C insurance company with a 60% L&LAE ratio and a 35% operating expense ratio would report a 95% combined ratio. A typical Title underwriter might report a 5% L&LAE ratio with a 90% operating expense ratio, for a 95% combined ratio.

Financial reporting procedures that broaden the P&C definitions of DCC and A&O with consideration of Title insurance characteristics might result in a Title underwriter reporting a 45% L&LAE ratio, a 50% operating expense ratio, and the same 95% combined ratio. These steps to properly categorize cost containment activities mitigate, perhaps even eliminate, the differences in P&C and Title coverage characteristics as it relates to financial reporting of L&LAE.

**Conclusion**

The author respectfully submits that the fundamental difference between Title and P&C coverage characteristics can create financial reporting anomalies. Current financial reporting requirements have DCC and A&O expense definitions focused on and designed for P&C coverage characteristics, yet these same definitions are imposed on Title insurance coverage, which has fundamentally different timeframe and loss containment considerations.

If Title and P&C L&LAE ratios are to be directly compared, which is inevitable, the Title insurance industry and regulators should work to develop financial reporting rules that prepare similarly categorized costs and activities. This could be accomplished without impacting P&C financial reporting by appropriately broadening the definition of A&O and DCC expenses to consider Title insurance characteristics and industry activities.

Until the coverage timeframe and subsequent cost containment activities for the respective insurance contracts are appropriately reflected in financial reporting requirements, industry-to-industry comparisons will continue to result in misperceptions and misunderstanding. Proper contextual understanding or revised reporting definitions are required for accurate Title and P&C comparisons. Until then, what we’ve got here is a failure to communicate.
ABOUT DEMOTECH, INC.

Since 1985, Demotech, Inc., a Columbus, Ohio based financial analysis and actuarial services firm, has been serving the insurance industry, providing independent opinions on the financial stability of Property and Casualty insurers and Title insurance underwriters.

Demotech offers services including actuarial opinions and pricing assistance, strategic market and product analysis, state filings assistance, as well as financial valuations. Demotech was the first company to have its rating process formally reviewed and accepted by Fannie Mae, Freddie Mac and HUD.

In 1992, Demotech became the first company to review the financial stability of the Title insurance industry and publish an independent opinion of underwriters' financial strength. Since 1992, Demotech has presented Financial Stability Ratings® for virtually all Title underwriters. No other organization reviews more underwriters or has been providing Financial Stability Ratings® longer.

About Demotech Performance of Title Insurance Companies

In 2003, Demotech purchased the exclusive publishing and distribution rights to the 2004 and all future editions of CDS Performance of Title Insurance Companies from Corporate Development Services, Inc. (CDS). The 2004, and all future editions, are published as Demotech Performance of Title Insurance Companies.

With the release of the 2006 edition of Demotech Performance of Title Insurance Companies, Demotech presents the latest edition of the Title industry's only independent and most comprehensive resource. The 2006 edition includes 90 Title underwriters, representing more than 99% of the industry's premium volume. This edition offers the traditional content as well as further publication refinements, such as electronic data collection and entry, improved recognition of intercompany consolidations, nearly 30 pages of expanded market share reports and expanded Quarterly Update content.

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1985  Founded by Joseph L. Petrelli and Sharon M. Romano to offer actuarial services.
1986  First to issue Financial Stability Ratings® (FSRs) for health maintenance organizations (HMOs).
1987  First to issue FSRs for public entity liability self-insured pools through the development of our Management Audit Process.
1989  First to have Property and Casualty insurance company rating process formally reviewed and accepted by Fannie Mae. An FSR of A or better eliminates the need for property insurance cut-through endorsements.
1990  First to have Property and Casualty insurance company rating process formally reviewed and accepted by Freddie Mac.
> Began offering Property and Casualty insurance companies and Title underwriters loss cost analysis and rate, rule and form filing assistance.
> Responded to the National Association of Insurance Commissioners (NAIC) requirements for Property and Casualty insurers to submit actuarial opinions related to loss and loss adjustment expense reserves concurrent with the 1990 Property and Casualty annual statement.
1992  First to issue FSRs for each Title underwriter.
1993  First to have Property and Casualty insurance company rating process formally reviewed and accepted by HUD.
1994  Fannie Mae issued Title underwriting guidelines, naming Demotech as an approved Title underwriter rating service.
1995  First to promulgate Commercial Real Estate Recommendations (CRERs) to provide additional financial due diligence of Title underwriters involved in larger real estate transactions.
1996  Contacted by the Florida Office of Insurance Regulation when the property insurance market encountered newly established insurers that did not meet traditional rating requirements. Working with the Florida Office of Insurance Regulation, Demotech developed evaluation procedures for the assignment of FSRs to newly formed Property and Casualty companies.
1999  Co-authored the Commerce Clearing House publication describing the evolution of the Canadian Title insurance industry.
2001  Completed the initial loss and loss adjustment expense review of the Iowa Finance Authority – Title Guaranty Division.
2002  Revitalized the Ohio Title Insurance Rating Bureau (OTIRB).
2003  Assisted the North Carolina Title Insurance Rating Bureau with the development and filing of a closing protection product.
> Assisted the OTIRB with its first rate revision since 1980.
> Purchased publishing rights for CDS Performance of Title Insurance Companies from Corporate Development Services, Inc. (CDS)
2004  Introduced Demotech Performance of Title Insurance Companies and Quarterly Updates, presenting consolidated statutory financial information based upon more than 99 percent of the Title insurance industry’s premium volume.
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> HUD approved Demotech’s rating process for professional liability insurance under HUD Notice H04-15, Professional Liability Insurance for Section 232 and 223(f) Programs.
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For eighteen years, Performance of Title Insurance Companies has been compiled and reviewed by independent financial analysts.

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- **2004** - Electronic consolidation of data in our Form 9 Database.
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