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Inside America's Richest Insurance Racket

Title insurance firms rake in $18 billion a year for a product that is outdated, largely unneeded—and protected by law | By Scott Woolley

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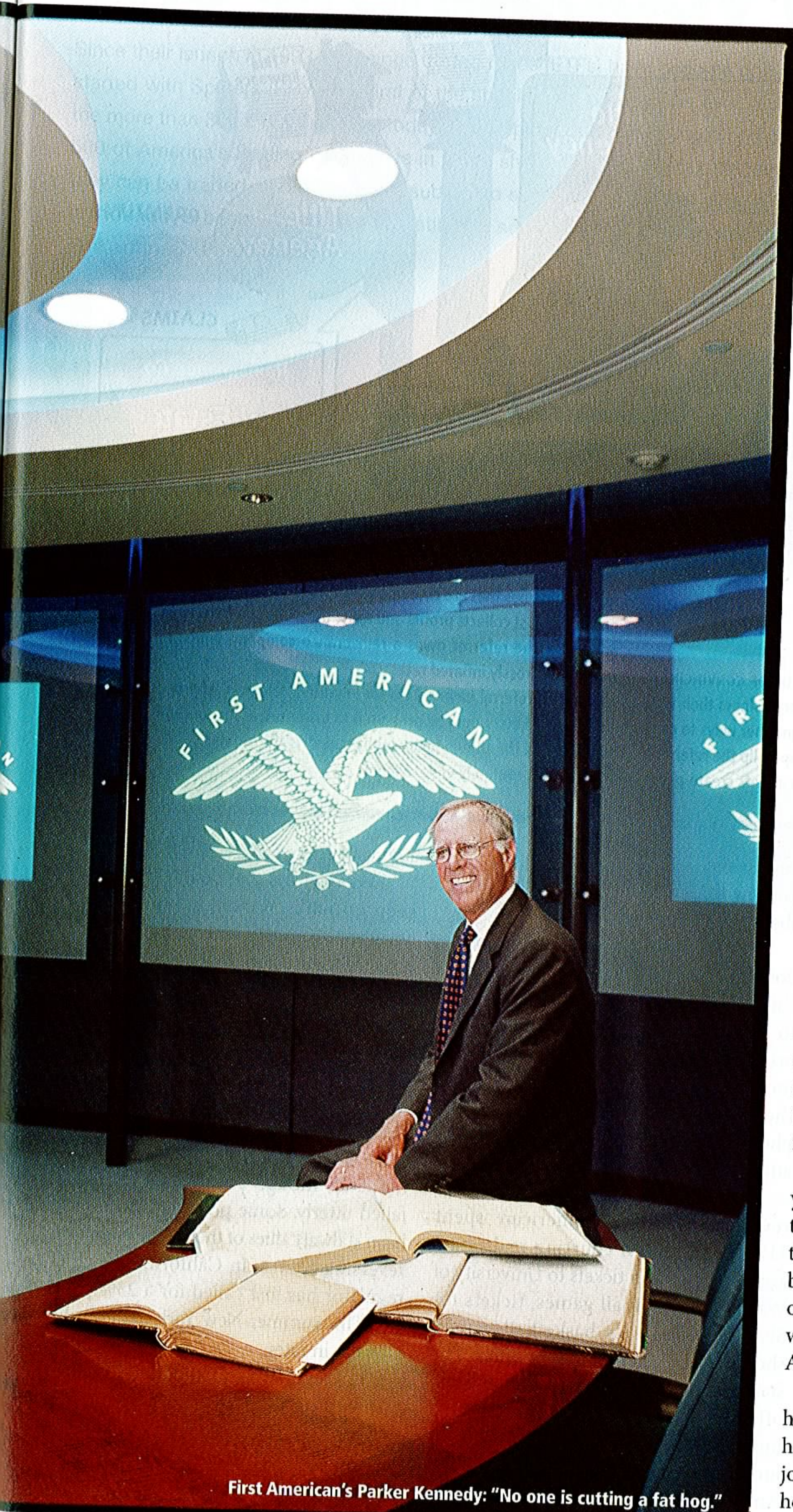


First American's Parker Kennedy: "No one is cutting a fat hog."

PARKER KENNEDY'S ROOTS run deep in the California company his family founded 112 years ago. Through four generations the clan (unrelated to the Massachusetts political dynasty) has run what today is First American, the largest title-insurance company in the nation. It collects $5.8 billion a year selling this age-old mainstay of homeownership.

All that cash—for an outdated product that should have been all but wiped out by digital technology.

Title companies appeared a century ago, helping to protect home buyers from being swindled by crooks who sold properties they didn't own. A title insurance policy protects the buyer in case the deed turns out to be defective but the seller cannot be collared to refund the purchase price. It is far less necessary in these days of computerized records, online searches and rare instances of title fraud or hidden liens.

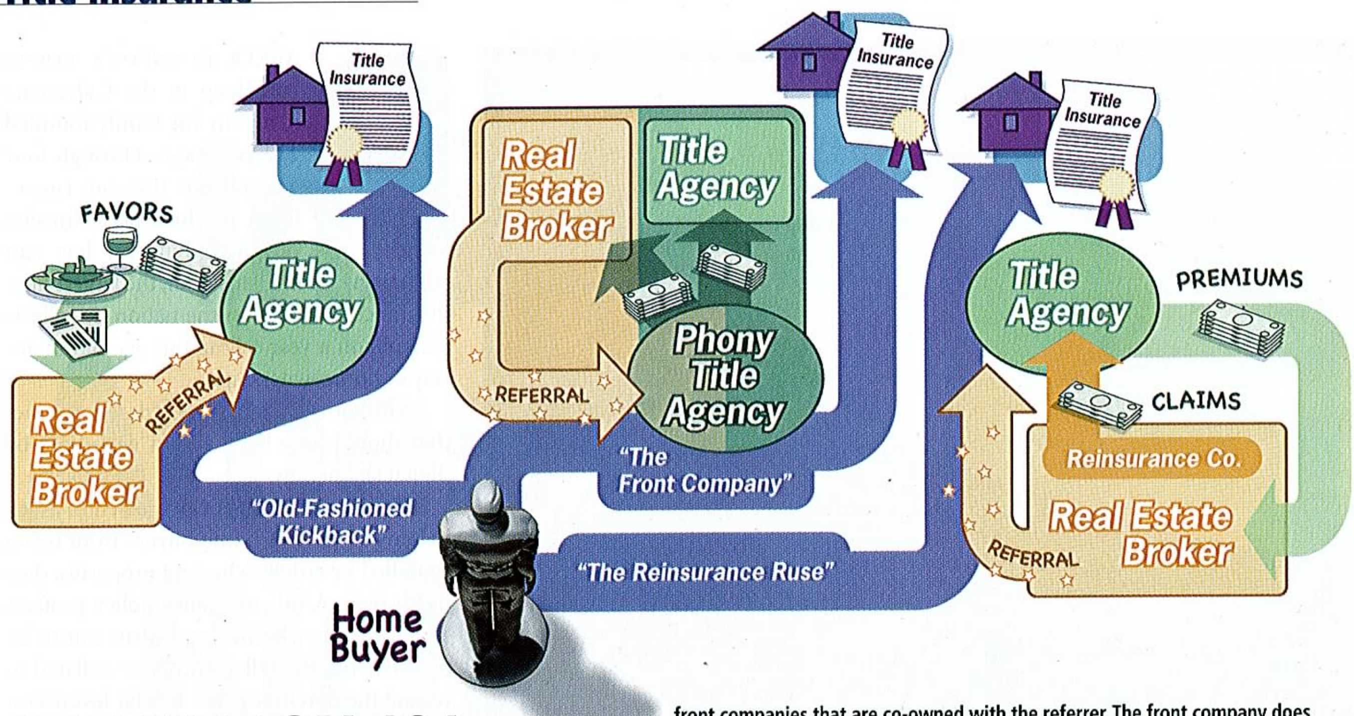
Yet First American and its two main rivals—number two Fidelity National (no relation to Fidelity mutual funds) and third-ranked LandAmerica—are fat and thriving in an $18-billion-a-year business that has quadrupled in ten years.

First American has doubled its prices in a decade, to an average charge of $1,472 per home for a title search and insurance. Meanwhile, thanks to computerized record-keeping, the cost of searching for a home's ownership records online has fallen to as low as $25. Technology also has helped make mistakes rarer; now only $74 of each policy goes to pay claims—that is, make home buyers with defective deeds whole. That leaves a $1,373 spread for overhead and for profit.

Fancy this: racetracks that keep 93% of your money and return only 5% in winning tickets. They wouldn't last long, not unless they could somehow rig the rules to both forbid price competition and make the purchase of race bets mandatory. That's more or less what the title insurance industry has done to American homeowners.

Kennedy attributes his profits to the long housing boom and the efforts his company has made to deploy technology and move jobs offshore. "Nobody's cutting a fat hog," he says.

But the title industry's halcyon days owe



CORRUPTION 101

AS TITLE AGENTS' PROFITS HAVE SOARED, SO HAS THE VALUE OF CONVINCING A real state broker (or mortgage broker or builder) to steer business their way. Paying for such referrals is illegal, so title agencies design other ways to camouflage kickbacks. In an old-fashioned kickback they simply slip the referrer a free meal or other favor. To pass along bigger sums title agents create phony front companies that are co-owned with the referrer. The front company does no work, it just collects profits and splits them with the referrer. In the reinsurance ruse, the referrer owns a reinsurance company, which reinsures title policies at grossly inflated rates.

If cash referral payments were legalized, referrers, who operate in competitive markets, would be pressured to lower prices for consumers. So it's no surprise that the title industry lobby supports the antikickback laws, even as its members routinely violate them.

much to antiquated state laws that thwart new competition, allow prices to soar despite declining costs and force almost every home buyer to pay for insurance that most of them will never need. In all but a handful of states, laws bar insurance giants in other fields, such as AIG or State Farm, from offering title insurance and undercutting incumbents' prices. It also is illegal for anyone to offer guarantees that provide the same protection as title insurance.

Home buyers can't get mortgages without buying title insurance; nor can banks themselves legally offer it as part of a loan. (Otherwise, the banks could demand high-volume discounts.) A handful of states set prices title firms may charge; others regulate prices and rubber-stamp the prices title firms request.

The industry has boomed on such you-gotta-have-it conditions—especially in the refinancing craze of recent years. In 2000 some 2 million refinancings went through; that grew to 7 million in 2005. A homeowner refinancing a mortgage pays for new title insurance, despite the utter absence of any new risk in the deed.

The title industry's perennial protectionism has had a predictable side effect: corruption. Shielded by law from having to compete on price, insurers resort to bribes and gifts to real estate agents and mortgage brokers for steering business their way, deceptive front companies, phony "reinsurance" deals and other creative chicanery *(see above).*

Regulators in Washington State just revealed that First American spent $120,000 a month courting real estate agents with season tickets to University of Washington football games, tickets for Seattle Supersonics basketball games, shopping sprees and other goodies. The state report says the firm was "the worst offender" and committed more than a hundred violations a month in the 18-month period studied. It adds: "First American offers a prime example of how illegal inducements can help a company attain superior market share."

Kennedy says that despite pressure to keep up with crooked competitors he never approves such schemes: "All you can do is try to hire honest people."

Now some forces are working to rein in this rapacious industry. Officials in dozens of counties are working to standardize homeownership for digital access by the public. The U.S. Department of Housing & Urban Development is mulling ways to force more competition on the industry, though previous efforts have failed utterly. Some politicians who have been stalwart allies of the business now are reversing course. In California the chief regulator has just called for a 23% price cut. This summer New York mandated a 15% cut in rates.

Yet regulators in most states have blithely acquiesced as consumers bills have risen. This, despite insurers' low risk of payouts and the tech-fueled decline in costs. Sifting through property records to ensure that a title is clear of old claims

JOHN KOCON FOR FORBES

costs them all of $25 to $125 if the records are digitized.

The industry's high-tech muscle is flexed at First American's offices in Santa Ana, Calif., a few miles from where Parker Kennedy's great-grandfather, Charles Parker, started the company. A cavernous data center overflows with details on property in counties encompassing 98% of the U.S. population. Packed with supercomputers and suspended on massive pylons to keep them running in an earthquake, the facility soon will hold data on virtually every building in the country, Kennedy vows.

When Kennedy's great-grandfather started out in 1894 he would hire stenographers to go to the county courthouse and copy ownership records by hand into ledgers and then deliver that information to clients by horse and buggy. People who didn't have the desire, time or knowledge to do it themselves happily paid for these title surveys. In 1924 he guaranteed his copies were accurate, turning his product into title insurance.

That process hadn't changed much by the time Parker Kennedy joined First American in 1977. He had been working as a lawyer when his father, Donald, chief executive at the time, persuaded him to join the family business. Parker would trek to courthouses and assessor offices in southern California and tediously page through musty volumes of property records; a single title search could take all day.

Kennedy, now 58, rose to chief executive in 2003, though he began steering the company into the digital age a decade ago. The tech overhaul has let him close 48 of 50 offices in his home state of California in five years, replacing people and paper with databases and offshore data entry clerks. The online automation also has reduced errors. If the title searcher misses a contractor's lien and the builder who should have paid cannot be made to pay, the insurance steps in. It's a rarity.

"We get a little more automated every day," Kennedy says. "In the old days, if you wanted to double your business you had to double your people. Now you can double your business and increase your staff maybe 10%."

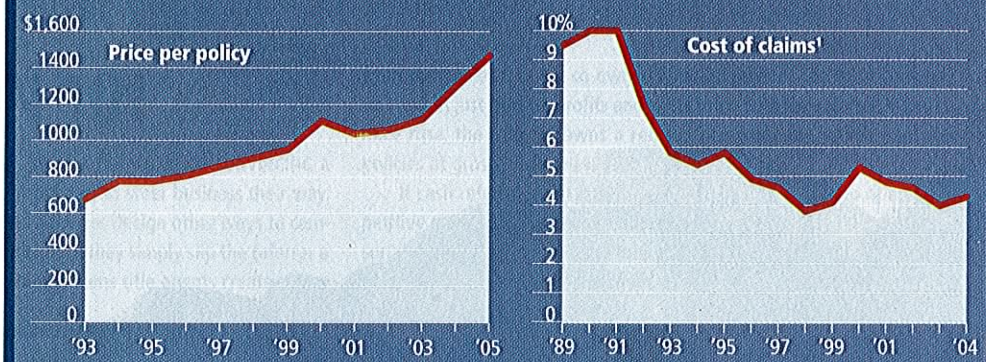
The tech push must continue, he says, because one day economic rationality and digital reality will catch up to the title industry. Real estate ownership records, always open to the public, are going online, alongside all sorts of other data. Today anyone can instantly learn a property's square footage, its sales price history, even view satellite photos, at virtually no cost. If records are instantly accessible and accurate, the need for title insurance will fade away. "Eventually insurance won't be an important component of the product," he allows.

So Kennedy hopes to harness digital technology to create a new business. Rather than broker one piece of information for an exorbitant cost, he hopes to collect all manner of real estate skinny and sell it to banks, insurers, real estate agents and direct marketers.

Title insurance accounts for 70% of First America's $8 billion in annual revenue, with newer and unregulated services providing the rest. Kennedy says that this unregulated part of the business will be as lucrative as the legally armored one he now runs. "When I look out 5, 10, 20 years, I just see data becoming a very powerful thing to own."

Out of Whack

The price the average First American customer pays for title insurance has doubled in the past decade to $1,472—but why? Mistakes (like an overlooked lien on a house) are rarer in the automated age, so title insurers pay fewer claims. The cost of searching property records can't account for the discrepancy. Today even a pricey online search costs just $125; many cost just $25.



Source: SEC filings.

[1]Claims paid per premium dollar. Source: A.M. Best Company.

It wasn't until after the Great Depression that big insurers started eyeing title-industry profits, and the title firms found a clever way to fight back—not by lowering prices but with state laws that walled off the industry from outside competition.

Laws ostensibly designed to help consumers instead outlawed competition.

They invoked consumer protection: In the Depression many insurers had gone bust, including a few that also offered title insurance. The title industry, and many regulators, argued that insurers that also sold life or car insurance were more likely to go broke and stick their customers with unpaid title claims.

Most states responded by passing laws dictating that only dedicated title insurers could sell home buyers title policies. Decades later many of the banned multi-line insurers are far more financially secure than most title insurers in the eyes of credit-rating agencies, but the states haven't done much to raze the barriers.

Private insurers have become so overpriced that Iowa, the one state government to not only maintain property records but guarantee their accuracy, can offer a vastly better deal. The typical Iowan pays the state $110 for title insurance when buying a home, 92% less than the average First American customer's bill.

Having insulated themselves from outside rivals, the title companies then won state support to limit competition among themselves. A small number of states passed laws fixing prices of title insurance. Other states enacted a pastiche of rate regulations that let insurers set their own rates, routinely granting them increases.

Spared from having to compete on price, title firms large and small vied for customer referrals from real estate agents, mortgage brokers and builders by bribing them, in violation of federal law. The insurance agents who woo the customers are also compensated handsomely. Of the cash First American collects for title searches and accompanying insurance, it hands 80% to its own agents and to independents.

In the old days title agents looking to attract more business paid kickbacks that were modest and in-kind—baseball tickets, spa trips, free meals, luxury boxes at concerts (the type of favors that First American continues to hand out, in violation of state and federal rules). But in recent years, as the gross profit per customer topped $1,200 in many cases, title agents have devised new ways to sluice larger sums to the partners that send business their way.

LandAmerica, the number three title company in the U.S., allegedly arranged for sales agents, mortgage brokers and developers around the country to start their own "reinsurance" companies. Then, every time one of them sent a customer to LandAmerica, it would pay his newly formed shop to reinsure the policy, a subtle and tidy little kickback. In one type of arrangement LandAmerica paid them 35% of its revenue to assume half the risk; yet the newly minted "reinsurers" were never asked to pay up in the rare instances when a title search missed an old claim, Colorado state regulators say. LandAmerica says the deals were legal, but it agreed to halt the practice last year.

Rivals copied LandAmerica's premium-sharing scheme. First American followed suit, though some state regulators say it is the least dirty of a bad bunch. "They were the last company to engage in these practices, the first to stop and the most cooperative," says Erin Toll, Colorado's former deputy commissioner of insurance, who investigated the industry.

In Minnesota police stumbled upon another scam after a burglar alarm kept ringing in one shell company's office building. No one was there to shut it off, the cops eventually realized, because no one was ever there. Such fronts typically are run by the large title companies but are co-owned by real estate agents and mortgage brokers, who get a cut of the profits.

Elsewhere many title insurance fronts don't even bother to create a real office. When investigators in Colorado recently sent out letters to the state's 500 title agencies, more than a hundred came back stamped "no such address."

First American participated in such scams, too, though to a lesser degree. Last year HUD accused the firm of creating nine sham outfits that were owned by real estate brokers and lending agents but which did no work. The company closed the fronts and paid a $680,000 fine.

But attempts at more fundamental reform have faltered. In 2002 a company called Radian concocted a clever new product it dubbed "lien protection." The firm targeted refinancings of homes that already had title insurance and aimed the product not at home buyers but at their mortgage lenders, looking to cut prices in half and still make a good profit.

But California's state insurance commissioner, John Garamendi, leaped to the title industry's defense, banning lien protection in his state. Garamendi says he had no choice: "I have no option but to enforce those laws even though I think they are wrong and should be changed."

"I have to enforce these laws, even though they are wrong and should be changed."

The leaders of Radian were stung, says the company's former general counsel, Howard Yaruss. The old "monoline" law ostensibly had been designed to protect consumers; yet Radian's product was to be sold to Bank of America and its ilk.

In July Garamendi himself took on the title industry, proposing cuts in title insurers' regulated prices of 23%. He says it will save California homeowners $1 billion a year. A better solution would be to throw open the market to products like the one Radian offered, he admits, but he doesn't see that as likely. "The title insurance industry is very politically powerful. It has tens of thousands of agents in California," he sighs.

In 2004 the title industry stared down another threat, this one in Washington, D.C. HUD had pushed for rules that would allow lenders to package title insurance with a mortgage, something federal law currently forbids. The title industry, fearing the power of banks to negotiate lower title insurance rates, was violently opposed to the rules and found a key ally in Senator Richard Shelby, the Alabama Republican who is chairman of the Senate Banking, Housing & Urban Affairs Committee—and who owns the Tuscaloosa Title Co. (A Shelby spokesman says the senator's attitude toward HUD's proposals is unrelated to his sideline business.) HUD is now considering other options for reforming the industry.

Yet another movement for change comes from efforts by the nation's county recorders to agree on a uniform way to store property records online, which could severely curtail the need for title insurers. But even if they succeed, most state legislatures would have to lift a thicket of creaky old laws that have enriched the title industry for decades—and bilked home buyers out of billions of dollars. **F**