

Understanding Title Insurance

What Is Title Insurance?

Title insurance is used by homebuyers and lenders for protection against back taxes, undisclosed liens, legal judgments, forgeries, fraud and a host of other potential legal/financial problems that can arise when purchasing or refinancing property. Title companies perform upon an exhaustive search of the public record to identify and correct liens and encumbrances on property. Most of the title insurance premium goes towards identifying and eliminating these potential problems before the close of escrow. Consumers pay only once for title insurance – there are no monthly premiums – for coverage that lasts as long as they own the property.

Both buyers and lenders in real estate transactions need title insurance. Both want to know that the property they are involved with is insured against certain title defects. Title companies provide this needed insurance coverage subject to the terms of the policy. The seller, buyer and lender all benefit from the insurance provided by title companies. Title companies routinely issue two types of policies: An “owner’s” policy that insures the homebuyer for as long they own their home; and a “lender’s” policy that insures the priority of the lender’s security interest over the claims that others may have in the property.

Title Insurance Protects Against Title Defects

Title insurance offers protection against various legal and financial defects (as set out in the policy) that may exist in the title to a specific parcel of real property, effective on the issue date of the policy. For example, a person might claim to have a deed or lease giving them ownership or the right to possess someone’s property. Another person could claim to hold an easement giving them a right of access across a person’s land. Yet another person may claim that they have a lien against an owner’s property securing the repayment of a debt. That property may be an empty lot or it may hold a 50-story office tower. Title companies work with all types of real property.

A title insurance policy contains provisions for the payment of the legal fees in defense of a claim which is covered under the policy. It also contains provisions for indemnification against losses that result from a covered claim.

According to data from the American Land Title Association, more than one-third of all residential real estate transactions have issues with the title – issues that are resolved by title companies before the closing of escrow. This emphasis on risk elimination and loss prevention results in fewer claims paid by title insurers compared to other lines of insurance. However, loss prevention and clearing title issues is a labor-intensive process and constitutes the vast majority of a title company’s operating budget.

Eliminating Risk & Solving Problems

Title insurers work in advance of issuing a policy to identify and cure potential legal and financial problems that may exist. This is fundamentally different than property & casualty insurers that assume risks. Property & casualty insurance companies realize that a certain number of losses will occur each year in a given category (auto, fire, etc.). These insurers collect premiums monthly or annually from the policy holders to establish reserve funds in order to pay out claims. Title insurance, on the other hand, emphasizes loss prevention on the front end by resolving potential problems that arise from past events.

Unlike other lines of insurance, the majority of the title insurance premium dollar goes towards identifying and eliminating potential problems for consumers before they occur – rather than paying claims after the fact. Erin Toll, the former Deputy Commissioner of Insurance for Colorado, summarized this best by stating: “...loss ratios for title insurance should be at or near zero...The real cost of title insurance is the title search, not claims payment...The core value of title insurance is ensuring clear title.” (*Testimony of Erin Toll, former Deputy Commissioner of Insurance, Colorado, Hearing before the Subcommittee on Housing and Community Opportunity of the House Committee on Financial Services, April 26, 2006*)

This “risk elimination” process requires enormous fixed costs to build and maintain title plants, gather and index property records and other information reaching back hundreds of years, acquire sophisticated technology systems and, most importantly, retain the skilled personnel who make sure that consumers don’t face financial or legal problems when buying property. During the 20-year period from 1985 to 2004, the expense ratio (i.e. the costs of all operating expenses) for the title industry averaged 92 percent, while the expense ratio for property & casualty companies averaged less than 30 percent. Conversely, during the same time period, loss ratios (i.e. claims paid) in the title industry averaged less than 7%, while property & casualty companies had loss ratios of about 80% (“*Clouds on the Horizon After Title Industry’s Bright Year,*” *AM Best, October 2005*)

Because title companies are risk eliminators, the probability of a claim is low. In spite of every effort to eliminate title problems, however, the title industry nationwide still paid over \$782 million in claims during 2006. (*ALTA 2006 Title Insurance Industry Statistical Analysis*)