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The Perils of Complete Regulation

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Key Points

- The Texas Insurance Code "completely regulates" the business of title insurance.
- With traditional avenues of competition closed, many within the title insurance industry have turned toward illegal kickbacks to solicit business.
- Consumers benefit the least from complete regulation and are often harmed by higher prices and poor service.
- Lawmakers should introduce competition into Texas' title insurance market and thereby eliminate the incentives that foster bad business practices.

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Introduction

Looking at the economy as a whole, the Texas Legislature has put Texas on a path toward dynamic economic growth with bold, free-market reforms in the electricity and telecommunications markets that have broken down state-imposed monopolies. Similar reforms, such as the transition of homeowners insurance to a file and use system, have introduced consumers to greater choices and more effective rates.

Through it all, however, the regulations surrounding title insurance have remained stubbornly tight-fisted. The Texas Department of Insurance, authorized by Title 11 of the Texas Insurance Code, decides what rates are charged by providers. It promulgates forms, dictating what services and coverage options are to be included in the final product. It even defines what is considered an appropriate division of premiums between title insurance companies and their agents. Purveyors of title insurance therefore enter the transaction with nearly every detail preset by the government, such that they have few opportunities through which to distinguish themselves from their rivals and compete directly for customers.

With traditional lines of competition closed to them, title insurance companies have turned their solicitation efforts to other participants in the transaction chain, namely the third-party intermediaries who direct clients their way. Although this type of "reverse competition" can work to the benefit of consumers from time to time, the practice also poses a serious risk of a conflict of interest if the third party acquires a financial stake in who receives the referral. In such a scenario, the interests of consumers take a backseat if they are considered at all. Consumers may even have to shoulder higher prices if the monetary consideration paid by title companies for referrals are absorbed into the promulgated rates.

Federal and state law consequently has prohibited kickbacks and other types of reimbursements for referrals, but the practice remains prevalent nonetheless. Investigators from multiple states, including Texas, have identified an unsettling trend where title insurance companies organize sham business relationships in order to hide illegal kickbacks and gain greater market share. The resulting environment makes it difficult for honest providers to refrain from pushing at legal boundaries since there are few legitimate outlets through which they can compete. They are in essence punished for their good behavior.

It has been argued that title insurance warrants complete regulation because it has steeper upfront costs compared to other types of insurance and plays a special role in the sale and investment of private property. Is that enough to justify a regime that incites illegal or morally ambiguous conduct, especially when the answer for almost every other market in Texas is a decided no? One way or another, companies will seek to acquire clients. If the law obstructs the straight and narrow path, all that remains is some back alley, far away from welfare of consumers.

A Peculiar Insurance Practice

Insurance has become an important part of the modern-day economy. Property ownership represents a recommended investment in one's long-term financial security, but it often requires a massive monetary commitment to purchase all while remaining vulnerable to the forces of bad luck. Insurance offers consumers a way of protecting that investment from ruin should the worst come to pass.

Most forms of property insurance guard policyholders from future risks, such as accidents, fires, natural disasters, or theft. Title insurance

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breaks from that mold. Title insurance is designed to cover events that occurred in the past, which may interfere with a buyer's claim of ownership. The insurance agent investigates the property's history and then, if no defects are unearthed, commits to defending those findings on the policyholder's behalf. Should an encumbrance on the property later be discovered, the insurer reimburses either the purchase price or the amount of the loan, depending on the identity of the payee. Property law permits owners to divide their bundle of rights in an untold number of fashions. Title insurance, along with the accompanying examination of public records, provides clarity to interested parties and gives them assurance that their investment in the land stands on firm ground. Any blemishes identified during the title search—easements, tax liens, unpaid judgments, and the like—are typically exempted from the policy if they cannot be corrected.

Title insurance also has other peculiar characteristics that set it apart from the typical insurance policy. For example, whereas most of the premiums in a casualty line are consumed by the losses incurred by the underwriter, the losses and loss adjustment expenses for a title company is actually quite small. According to the Texas Land and Title Association (TLTA), the "losses to premiums" ratio in Texas during the first three quarters of 2014 was only 1.5 percent (TLTA, 2). The U.S. Government Accountability Office (GAO) likewise calculated that losses in 2005 only accounted for 5 percent of the total premiums written nationwide (Williams 2007, 9). Most of the premiums are instead retained by the title agents since they perform most of the legwork leading up to the policy's issuance.

In addition, premiums for a title insurance policy are not reoccurring. Most types of insurers collect premiums at fixed intervals in return for providing continual coverage. Title insurance companies, conversely, receive one upfront payment at the policy's start. The companies have a single chance to recoup their operational expenses and their liability exposure as well as make a profit (Williams 2007, 8-9). In other words, a key distinguishing feature of title insurance, outside of its retrospective gaze, is that the bulk of the industry's costs—the title search—and the possibility for profit—the premium—both occur in rapid succession at the beginning of the transaction rather than through the lifespan of the policy. It has been contended that this makes title insurance companies' rate of return much more volatile (Davis and McCarthy, 1,7,&10; OPPAGA, 1) and therefore in need of regulatory protections not afforded to other lines of insurance (Rosenberg, 202; Roberts, 24) or considered in harmony with Texas' customary commitment to free enterprise. The result is a regulatory regime responsible for the most peculiar characteristic associated with Texas' title insurance market: a lack of competition.

Regulation Blocks Legitimate Competition

"Competition does not and cannot exist in the title insurance market in Texas under the current[] regulatory structure," concludes the Lyndon B. Johnson School of Public Affairs (Eaton, 63). The state statutory code that governs the industry, Title 11 of the Texas Insurance Code, explicitly states that its purpose is to "*completely regulate* the business of title insurance on real property" (§2501.002). The language is absolute. It conceives of no ceiling on the government's authority to interfere in the market and in fact pledges to infiltrate every corner.

Compare this to the Utilities Code, which describes its own purpose as "to establish a comprehensive and adequate regulatory system," (Tex. Util. Code §11.002) yet specifically instructs elsewhere in the code that:

> "[r]egulatory authorities . . . *shall authorize or order competitive rather than regulatory methods*

> *to achieve the goals of this chapter* to the greatest extent feasible and shall adopt rules and issue orders that are both practical and limited so as to impose the least impact on competition" (Tex. Util. Code §39.001(d) (emphasis added)).

There are a couple of lessons here. First, while the purpose of the Utilities Code is broad, by including the terms "comprehensive" and "adequate," the state implicitly acknowledges that there is a realm of economic decisions left to private actors on which the government should not tread. Second, even when it pursues a regulatory model on a crucial commercial service, the Texas Legislature has relied on "competitive rather than regulatory methods" to achieve its goals. The provision's language orders regulatory authorities in plain terms to "impose the least impact on competition."

Title 11 lacks the basic modesty embodied in the Utilities Code. It adopts a blanket presumption that the title insurance industry cannot function to the benefit of either consumers or providers without the government stipulating all the transaction details usually left to the market. Thus, title insurance prices are promulgated by the government, whereas the prices of electric services remain under the control of "customer choices and the normal forces of competition," despite that service's bearing on the economy (Tex. Util. Code §39.001(a)). Both codes have the same objective, to protect market participants, but the method could not be any more different.

The Texas Department of Insurance (TDI), for instance, promulgates both the amount that a consumer will pay for a given title insurance policy as well as what services and coverage the consumer will receive as part of the contract (Tex Ins. Code, §2703.002, §2703.051, and §2703.151; Basic Manual, 289, 325-26). Texas is a so-called "comprehensive" or "all-inclusive" state because all four principal services associated with title insurance are built into the final rate: the basic risk premium, the title search, the title examination, and closing costs. The Lyndon B. Johnson School of Public Affairs, in its 2011 policy report, noted that Texas had the distinction of being one of only three states to promulgate rates and the only "comprehensive" state to do so (Eaton, 6, 8). The report then accredits the fixed pricing scale as the primary reason Texas customers pay the highest rate in the country, observing that "regulation appears to reduce price competition" and "the more comprehensive the degree of regulation, the higher the insurance rates" (Eaton, 24).

Industry representatives contest the report's findings, arguing that the Texas' title insurance rates include supplemental fees that are paid separately in other states but remain necessary to close the transaction regardless of the jurisdiction. Their account, however, fails to explain national trends where the prices charged in risk premium states—in other words, those with the narrowest policy services—sometimes exceeded the prices in states with comprehensive title insurance. Pointedly, both Florida and New Mexico were among that number, as was New Jersey (Eaton, 15). Florida and New Mexico had the distinction of being the only two states with promulgated rates other than Texas—since the data was collected, New Mexico moved to a promulgated rate ceiling—while New Jersey employs a prior approval system, the second most stringent form of rate control (Eaton, 8). In each instance, the expense borne by the customer did not stem from a heftier product; nor did it arise so much because of variable market conditions. Rather there is significant evidence to suggest that the expense correlated with each state's willingness to meddle with the equilibrium that would otherwise be reached by the market.

Texas' high title insurance rates therefore are a symptom of the state's heavy-handed regulatory regime and, more specifically, the dearth of competition within the industry that has followed since. Title insurance companies are prohibited from reducing rates. Likewise, they cannot offer clients a spectrum of coverage that matches their clients' risk of exposure or suits the differing depths of their clients' pockets. Participants have their choice of one product at one price. On top of that, the manner in which consumers purchase title insurance ensures that they enter the transaction with minimal bargaining power since consumers buy title insurance infrequently and typically rely on the expertise of third parties, such as real estate and mortgage professionals, to refer them to a quality provider. Title insurance companies thus confront minimal market pressure to find cost-cutting measures and have fewer options still to pass any discovered savings along to the consumer. Prices come to reflect the persuasiveness of the parties before Texas' legislative and regulatory bodies. As countrywide price rankings show, the title insurance industry has proved quite adept at representing their interests. Whether consumers have fared just as well remains far less certain.

The Problem of Reverse Competition

Completely regulating Texas' title insurance market does not eliminate the need for insurers and agents to compete. It merely redirects their competitive efforts away from the betterment of consumers. Insurance providers must abide by a very strict set of rules, but the dynamics of the game are not such that a pure monopoly exists. There are enough participants jockeying for market share that companies must locate a means of

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distinguishing themselves from their fellows if they are to retain or grow their business. With Title 11 foreclosing the traditional options, namely price competition and tailored coverage plans, title insurance providers have turned to the third-party intermediaries from whom they receive customer referrals to make their pitch. Economists refer to this pattern of soliciting business as "reverse competition" (White, 309; Nev. Rev. Stat. §691C.220).

To the extent that the interests of the intermediaries are aligned with those who trust in their judgment, the arrangements that result from reverse competition can work to the benefit of everybody. A bad experience with a title insurance company, after all, should reflect back on the customer's relationship with one who referred him. Since neither the insurer nor the real estate professional wants their business relationships to sour, each has a strong interest, at least in theory, in providing a quality service that meets the expectations and needs of the consumer. If all unfolds as it should, then consumers can adopt the intermediaries' greater bargaining position for their own.

The theory of reverse competition works better than the practice of it. As the GAO report was quick to note, reverse competition can give third-party intermediaries a financial stake in which provider the consumer ultimately employs merits (Williams 2007, 25-26). This conflict of interest can then pressure the third party to break the charge entrusted to them and advise the consumer to hire an insurer based on how well it will benefit the third party rather than an honest opinion of the insurer's qualifications and merits (Williams 2007, 25-26). In such a scenario, the consumer does not gain vicarious access to a better bargaining position as anticipated. He is instead shut out from the negotiation and his interests become an object to barter if not exploit. Authors of the GAO report thought that reverse competition "raise[d] questions" about "the prices paid by consumers," seeing how any improper expenditures would have been included in the rate calculation (Williams 2007, 27). The New York State Governor's Office agreed, lamenting that the arrangements had "saddled New York consumers with excessive title insurance premiums for years" (Cuomo). Multiple states have echoed these remarks.

Because of the potential conflict of interest, both federal and state law prohibit title insurance companies from giving anything of value in exchange for a customer referral. The federal provisions, established under the Real Estate Settlement Procedures Act (RESPA), even went so far as to permit the imposition of criminal and civil penalties. In a criminal case, a person found in violation may be fined up to $10,000 and/or imprisoned up to one year. In a private suit, that person has joint and several liability for "an amount equal to three times the amount of any charge paid" for the service. Texas' restrictions are a bit more modest, in that a violation of Section 2502.051, Texas Insurance Code, does not immediately trigger criminal liability. But otherwise Texas' restrictions resemble the standards set forth in RESPA, authorizing a monetary forfeiture up to three times the value of the payment and clarifying that the ban only pertains to the referral of customers (§2502.056). Title insurance companies are still allowed to reimburse third-party intermediaries for services actually performed (§2502.053). Experience shows that even that small leeway is enough to disguise improper behavior.

Illegal and Ambiguous Practices

Public investigations have identified several common practices of reverse competition across the country that flirt with, or in some cases defy, the line etched by RESPA and the Texas Insurance Code.

Kickbacks

The first is a simple "kickback," defined as a fee or benefit offered by a company in return for directing business its way. As the definition implies, a kickback is in clear breach of RESPA and the Texas Insurance Code. Kickbacks, however, are not always easy for public watchdogs to identify. Not only can they take the form of nonmonetary incentives, such as shopping sprees, spa trips, tickets to sporting events, and the like, but companies also can disguise the kickback as a payment for some other service (Caulfield; Woolley). All the business practices discussed hereafter are a type of kickback; what differs is the manner in which the money or benefit is being funneled.

Affiliated Business Arrangements

One way in which participants disguise a kickback is by entering into an affiliated business arrangement, which gives third-party intermediaries an ownership interest in the title agency.

What is important to keep in mind is that in most instances there is nothing untoward about an affiliated business arrangement. They fall on the right side of federal and state law assuming certain disclosure requirements are met. They also can provide a benefit to consumers when used correctly given that many homebuyers appreciate having a one-stop shop when closing on a property.

The problem with affiliated business arrangements is that they blur the distinction between reimbursing a referral and reimbursing a service actually rendered. This characteristic makes them an ideal tool for the less fastidious in finding a workaround to the ban on paid referrals. Investigators from multiple states, as well as the U.S. Department of Housing and Urban Development (HUD) and more recently the Consumer Financial Protection Bureau (CFPB), have identified a pattern of abuse, where title insurance groups would filter money through a network of sham corporations that either did not exist or whose services fell far short of the compensation offered (CFPB 2015; CFPB 2013; Garrison; Lane; Swanson; Toll, 8-10). On multiple occasions, the shell companies were even found to lack a physical location, employees, or assets.

Captive Reinsurance

Captive reinsurance is another good example of how the illusion of a legitimate settlement service is used to hide illegal behavior. Under this arrangement, a title insurance company pays a portion of the collected premiums to a group of third-party intermediaries, who then agree to "reinsure" the company's policies in the event that a title defect is found and damages must be offered. The transaction is justified under the rationale that the group now shares in the risk incumbent to the policy, but as stated above, the risk of loss in a title insurance policy is actually quite small. Most of the costs involved sit on the front end of the transaction, particularly the title search and examination. By the industry's own reckoning, the "losses to premiums" ratio in Texas during the first three quarters of 2014 was only 1.5 percent (TLTA, 2). Additionally, when asking for a rate increase, TLTA effectively estimated that its members would endure a 4.8 percent loss ratio in the years ahead (Texas Title Insurance Rate Hearing, 5).

For this reason, investigators have come to believe that the arrangements are nothing more than a vehicle established to deliver kickbacks—to the extent that HUD has repeatedly stated, "there is almost never any *bona fide* business purpose for title reinsurance on a single-family residence" (Cunningham 5). Both HUD and CFPB have spent a significant amount of resources over the last decade investigating companies for captive reinsurance arrangements that violate RESPA, holding that such practices "are deserving of close scrutiny" (Cunningham 5). Nevertheless, despite the disfavor shown, the practice of captive reinsurance is quite prevalent throughout the industry.

Conclusion

Every industry suffers from the occasional bad actor. The title insurance industry is no different in that regard. Most market participants pursue their job with the utmost integrity, motivated by the simple desire to exchange a quality service at a fair price. What distinguishes the title insurance industry from others is that the regulatory system set up here in Texas incentives questionable business conduct. The law leaves title insurance companies with almost no viable avenues through which to compete for customers directly. The companies instead must direct their attentions at third-party intermediaries, who refer them business.

Introducing direct competition into the title insurance market will not fully rid the industry of anticompetitive activity immediately, but it will begin to force the industry to cater to consumers in fairly short order. In nearly every industry outside of title insurance, Texas recognizes that competition, innovation, and free negotiation with consumers represent the most effective means of keeping participants honest and considerate of the interests of everyone else involved. Title insurance is a peculiar practice but its participants respond to incentives just like everyone else.

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