Competition and Title Insurance Rates in California

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Summary

The title insurance industry has recently experienced one of the largest real estate booms in U.S. history. Since the industry is so closely tied to the fortunes of the volatile real estate sector it is necessary to take a long view to understand the true nature of competition. The data show that the title insurance industry in California is competitive and rates are not excessive. For the median priced home in California, the base price of a standard owner's title insurance policy per thousand dollars of coverage has declined significantly from $6.89 in 1962 to $3.06 in 2005. Prices for refinance loan policies have fallen even further. Title insurance prices in California are now among the lowest in any of the ten largest states. Competition among title insurance companies forces firms to provide more innovative products and services and to offer lower prices through modified pricing programs. If California instituted a more stringent form of rate regulation for title insurance it is likely that consumers would pay more for insurance and be denied the benefit of new, innovative insurance products.

I. Introduction

Most consumers buy a home relatively infrequently over their lifetimes so they are unfamiliar with title insurance and its features and pricing. Since the demand for title insurance is derived from home purchases it is not surprising to see a tight link between home sales and title industry operating revenue as shown in Exhibit 1. Extremely low interest rates during the past five years have fueled a rapid expansion of home sales, refinancings, and associated title revenues. But the real estate business in the U.S. is notoriously volatile and this affects the title industry as well. Over the last 25 years, title industry revenues have dropped by significant amounts during several periods of downturns in home sales and prices, e.g., the mid 1990s. In order to understand the economic performance of the title industry it is necessary to take a long view, spanning several housing cycles rather than focusing on a narrow window of time, such as the recent boom in housing prices, construction, and refinancings. It would be wrong to base major public policy changes on the peak experience of the past few years since industry conditions are likely to change.

Title insurance protects property owners and mortgage lenders from losses resulting from defects in the title to real estate, or claims against a property that were not discovered in the title search. Owners' policies are typically purchased by homebuyers and remain in effect as long as the buyer owns the property. Loan policies, which are required by virtually all lenders in order to obtain a mortgage, remain in effect until the loan is paid off. Development of standardized title insurance coverage has been a major contributor to the availability of mortgage financing and the resulting increase in home ownership since the 1950s. In part due to the growth of the secondary mortgage market, the development of which was facilitated by the availability of title insurance, national home ownership stood at 69 percent in 2005, the highest level ever.

An important difference between title insurance and other forms of insurance is that the title insurance premium is paid only once when the policy is issued. Most other types of insurance, such as homeowner's insurance, require that premiums be paid periodically over the term of coverage. Exhibit 2 compares the total premium over the full term of ownership for title insurance with that of homeowner's insurance for the median priced home in California in 2004. Over a typical 14.1 year period of ownership, the premiums for homeowners insurance total over $31,000 compared to just $1,552 for title insurance. By this benchmark, the price of title insurance is relatively modest.

II. The Issues and Findings

We were retained by Counsel for First American Title Insurance Company to examine competition in the title insurance business in California.[1] We were asked to study the extent of price competition, whether rates are excessive, the extent of product innovation, and whether profit rates in the title insurance industry indicate a lack of competition. We were also asked to evaluate whether having relatively few title insurers harms price competition, and whether marketing and distributing title insurance products to third parties, rather than directly to homeowners, harms consumers.

Our examination of the data reveals that title insurance prices in California have declined significantly as a percentage of a typical home's purchase price since the 1970s, and by a far larger amount since California home prices began their rapid rise in the year 2000. Title insurers frequently offer reduced price programs filed with the Department of Insurance at rates below filed base rates, demonstrating the existence of price competition. Similarly, filed rates vary across title insurance firms, providing price choices for buyers and further indicating price competition between providers. Prices in California are among the lowest available in any large state, including the states where prices are set under rigid state rate regulation, including Florida and Texas.

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[1] California Commissioner of Insurance John Garamendi funded a study on the extent of price competition among California title insurance companies. (Birny Birnbaum, Report to the California Insurance Commissioner, *An Analysis of Competition in the California Title Insurance and Escrow Industry*, December 2005. Hereafter "Report to the Commissioner.") The Report to the Commissioner concluded that price competition did not exist and that California home owners were being charged excessive prices for title insurance. Contributing to this alleged lack of competition, the Report to the Commissioner found that insurers were earning excessive profit rates, title insurance in California is controlled by a few firms which contributes to excessive prices, there is a large barrier to entry into the industry, prices have not changed in the last five years even through costs had declined, and marketing title insurance to third parties drives up costs and prices to homeowners. In an accompanying press release, Commissioner Garamendi concluded that prices had skyrocketed in recent years, consumers are systematically overcharged, and that title insurers refused to compete on price. (2005 Press Release, "Insurance Commissioner John Garamendi Blasts Title Insurers for Excessive Rates – vows to Lower Prices to Consumers," December 16, 2005.)

In addition to price declines, there has been extensive innovation in title insurance products offered to homeowners since the 1960s, providing greater value for the price. Profit rates for title insurance holding companies, which are generally equal to or less than those of property and casualty insurers, homebuilders, and the broader Standard & Poor's 500, indicate no lack of competition in title insurance markets. While consolidation in the industry has reduced the number of insurers, there is no necessary connection between the number of firms and price competition; many industries with only a few competitors are highly price competitive. More directly, the data indicate extensive price competition in California. We found no significant barriers to entry and expansion, indicating that if prices were excessive, entry could occur to hold down prices. Finally, criticisms of third party distribution are misguided as an alleged source of excessive costs and prices. If marketing directly to homeowners were more economical, competitive pressure would have led to the adoption of such distribution methods. Marketing to third parties has historically been the most economical channel to provide title insurance to homeowners, reducing costs.

III. Title Insurance Prices and Price Competition

A. Trends in prices. Have California's rates skyrocketed?

An accurate analysis reveals that filed rates for title insurance in California have declined substantially. Furthermore, price declines, which are evident in long-term price data, have accelerated in recent years. For example, as shown in Exhibit 3, in 1962, the price of First American's CLTA Standard Coverage owner's policy for the median priced home in California of $15,100 was $6.89 per thousand dollars of coverage. In the year 2000, the price for the same type of coverage for the median priced home of $241,350 was $4.11 per thousand dollars of coverage. By 2005, the price of coverage for the median priced home of $548,400 had fallen to $3.06 per thousand dollars of coverage. In the 38 years between 1962 and the year 2000, First American's price per thousand dollars of coverage to consumers for a median priced home declined by 40 percent, a compound annual decline of 1.4 percent. In just the last five years, the price per thousand dollars of coverage for a median priced home declined an additional 27 percent, a compound annual decline of 5.7 percent.

Price declines for loan policies issued for a refinancing have been even greater. The premium for First American's CLTA Standard Coverage loan policy in 1962 for a $10,000 refinance was $6.72 per thousand dollars of coverage. In 2005, for a $500,000 refinance it was $1.70 per thousand, which represents a price decrease of approximately 75 percent.[2]

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[2] Even if one were to rely on the biased data in the Report to the Commissioner, those data still provide evidence of falling title insurance prices. For example, using data in the Report of the Commissioner, we calculate that title insurance premiums as a percentage of home purchase prices declined in Los Angeles County from 0.44 percent of total purchase price in 1996 to 0.35 percent in 2005 and in Alameda County from 0.43 percent in 1999 to 0.35 percent of total purchase price in 2004. Report to the Commissioner, p. 87.

These calculations and the data in Exhibit 3 are based on filed base rates, even though, as discussed below, Californians now typically pay prices substantially below base rates, so the changes in base rates understate the actual decline in prices. Total premiums paid for title insurance have increased naturally as the price of homes and amount of coverage required in California have increased over time, but premiums have increased far less than the rise in home values, leading to a substantial decline in title insurance prices as a percentage of home value.

B. Price trends, product innovations and the level of service

Changes in product quality must be recognized when analyzing price trends or results may be biased. In the title insurance business, quality is reflected in several dimensions including the level of coverage incorporated in the title insurance policy and level of service provided to customers. Even if prices remained unchanged, if the quality of the product improves, then price in effect has declined because the price per unit of quality has declined. Just as the U.S. Bureau of Labor Statistics routinely adjusts products in the Consumer Price Index such as automobiles, computers, CDs, refrigerators, etc., for quality changes over time,[3] improvements in title insurance coverage must be taken into account when examining price trends over time.

Exhibit 4 shows changes in title insurance coverage features for owner's policies offered by First American in California since 1963.[4] The coverage applies to the policy that was most commonly issued in the year reported. As coverage for basic policies has grown substantially over time, the effective price per unit of coverage has thus declined. The price comparisons between different periods reported above thus understate the price decline because greater coverage, i.e., a superior product, is currently provided relative to past periods.

C. Product offerings at prices below base prices

The price of a CLTA Standard Coverage policy is sometimes used as a reference price or "base rate" when comparing prices for title insurance across firms. Base rates can be thought of as "list prices" rather than actual transaction prices. An analysis of price competition that relies on list prices is fundamentally flawed and can be misleading because most consumers do not purchase title insurance at these prices.[5] For example,

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[3] See seminal article by Zvi Griliches, "Hedonic Price Indexes for Automobiles: An Econometric Analysis of Quality Change," in *The Price Statistics of the Federal Government,* General Series No. 73, New York: Columbia University Press for the National Bureau of Economic Research, pp. 137-196. For current BLS methods see: National Academy of Sciences [2002], <u>At What Price? Conceptualizing and Measuring the Cost-of-Living and Price Indexes</u> , Panel on Conceptual, Measurement and Other Statistical Issues in Developing Cost-of-Living Indexes, C. Schultze and C. Mackie, eds., Committee on National Statistics, National Research Council.

[4] In addition, all basic loan policy coverages have likewise increased.

[5] The pricing analysis in the Report to the Commissioner is fundamentally flawed in at least three respects: first, it only includes base rates or list prices, second, it does not account for title insurance quality changes, and third, it does not account for inflation.

First American estimates that in 2005 the majority of owner's policies issued by First American in California were at rates different than the base rate.

Instead of paying the base rate, many consumers, or lenders on their behalf, purchase title insurance at lower prices through modified pricing programs and policy forms that have been filed for use with the Department of Insurance. The effective rates for title insurance have declined over time as these reduced price programs have been introduced and expanded, even though base rates may not have changed.[6] Many of the new products and pricing programs offered by First American included prices that were lower than the base rate that existed at that time. The following are examples of reduced price programs in California.

> Short term rates: Title insurers offer prices lower than base rates on policies for which an earlier policy had recently been issued. When first introduced in 1965, First American's short term rate provided a discount of 15 percent on one-to-four family properties if another policy had been issued within one year of the current policy. This program has been expanded on several occasions so that now reductions of 20 percent are available on all property types if a policy has been issued within five years of the current policy.
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> Affordable home ownership programs: Discount programs for low to moderate income families are available. First American's Affordable Home Ownership Settlement Package ("AHOSP"), introduced in 2003, offers qualifying families a discount of approximately 25 percent when purchasing a package of settlement services that includes title insurance.
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> First time buyers and seniors: As of 2004 some title insurers offered discounts of 10 percent or more for qualified first time buyers and seniors.
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> New lower priced policy forms: Insurers have introduced a number of new policy forms that are offered at prices lower than base rates. For example, First American's EagleEDGE policy, introduced in 2002, provides all of the protections afforded under the CLTA/ALTA Homeowner's Policy of Title Insurance at a price reduction of 20 percent. This reduction is available in addition to the short term rate mentioned above.
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> Automated issuance: Insurers offer a number of lower priced products to lenders that submit a high volume of orders electronically. For example, in 2001 First American introduced the FACT Master Loan Policy, a limited coverage title insurance policy for equity loans up to $250,000. The premium for $250,000 in coverage under this program is just $65, compared to the $350 base rate for the refinance loan policy used in the Report to the Commissioner.

In addition to reduced rate pricing programs and new lower priced product offerings, significant reductions in rates for refinance loan policies were also introduced

[6] As discussed below, rates for loan refinance policies were reduced by various insurers in 2005.

in 2005. For example, the rate charged by First American for a $350,000 refinance loan policy was reduced from $880 in 2004 to $550 in 2005, a reduction of over 37 percent. Other insurers also responded by filing base rate reductions for refinance loan policies in 2005, although the percent reductions were not as large as those of First American.

Reduced rate pricing programs, new lower priced products, and reductions in rates all provide clear evidence of price competition in California's title insurance industry.[7] Policy makers should not rely on any purported analysis of price competition that does not consider product improvements or the actual prices paid by consumers for title insurance.

D. Are California's rates excessive? California rates versus other states

Comparing title insurance prices across states (and in some cases within states) is complicated by at least two facts: 1) the level of insurance coverage may vary due to regulation or other factors, and 2) the set of services included in the title insurance product may differ.[8] A meaningful comparison of prices must consider potential differences in both of these effects.

In California, the level of coverage available to consumers is among the greatest of any state. Similarly, the bundle of services available in California is among the most comprehensive available in any state. In addition to these two factors, prices may vary for a number of other reasons including differences in the cost of inputs such as labor, the quality of title records, the expected loss ratio, the degree of regulation, and the level of demand, to name just a few.[9]

Policy rates for home owners in most large states are higher than in California. Exhibit 5 compares current prices of title insurance for the median priced home in the U.S. in the ten most populous states. California is the third lowest priced state in this group.[10]

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[7] We generally tend to favor using the term "competition" rather than attempting to separately identify various forms of competition such as price, non-price, service, quality, and new product or innovation, etc. Our reading of the California Insurance Code (section 12401.3) is that it speaks to "a reasonable degree of competition" without trying to specify what form of competition should exist.

[8] Title insurance consists of two distinct elements: 1) the search, examination and abstracting of title records and 2) the underwriting of insurance risk and issuance of a title insurance policy. In some states, separate fees are still charged for each element.

[9] Price is determined by more than just cost. Demand must also be accounted for in determining the expected level of prices. It is a fundamental concept of economics that price is determined by the interaction of both supply and demand. Other things equal, if demand increases, prices will be expected to increase. Thus, in a competitive market with declining cost, price could easily increase if demand increases. The demand for title insurance has certainly increased in recent years with the rise in home sales and lower interest rates leading to large scale refinancing. Without accounting for both cost and demand changes, sweeping conclusions about whether price changes in title insurance are consistent with price competition have no economic credibility.

[10] This analysis is based on the price of the median priced home in the U.S. To the extent that prices for homes are higher in California than in other states, the actual cost per dollar of coverage in California will be lower because prices per dollar of coverage fall as the dollar level of coverage increases.

Of the states shown in Exhibit 5, two have lower prices than California: Georgia and Illinois. Lower prices in Georgia are explained by the fact that the two elements of title insurance (discussed above in footnote 2) are priced separately in Georgia. This means that the price shown in the exhibit includes only the price of insurance risk. In short, the title insurance rate available in Georgia is not all-inclusive and therefore not comparable to title insurance rates in California and other states.

Illinois is the only state among the nine other most populous states in which prices for title insurance are lower than prices in California. This is of particular interest because Illinois is the only state shown in Exhibit 5, besides Georgia, in which title insurance rates are not regulated.[11] In contrast, there are two states shown in Exhibit 5 – Florida and Texas – in which rates are explicitly set by the state insurance commissioner, the most onerous form of rate regulation. As noted in Exhibit 5, rates to homeowners in these two states are substantially higher than rates in California (i.e. 56 percent higher in Texas than California and 17 percent higher in Florida than California).[12]

The data presented above indicate that prices of title insurance in California are not excessive when compared to prices in other states. In fact, prices in California are among the lowest available in any large state. Further, the data suggest that prices tend to be higher in states with greater regulation and lower in states where title insurance rates are unregulated.

E. Profit rates as a measure of price competition

We were asked to evaluate whether the profit levels earned by title insurance holding companies indicate a lack of competition in title insurance markets. A comparison of title insurance profits to profits earned by companies in other industries reveals that title insurers' profitability has generally been below that of other benchmark industries.[13]

Exhibit 6 compares profit margins of publicly traded title insurance holding companies with those of three benchmark comparators: 1) homebuilders that, like title insurers, are tied closely to the real estate sector, 2) property and casualty insurers that, like title insurers, offer insurance products, and 3) the Standard and Poor's 500 ("S&P 500), a broadly diversified index of public companies. Results are compared for the ten years from 1995 through 2004, the last year for which data are currently available. Because title insurer profits are tied so closely to the volatile real estate sector,

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[11] Title insurance rates are also not regulated in Georgia; however price comparisons with Georgia are meaningless because the rate available there is not all-inclusive as discussed above.
[12] In one other state not shown in Exhibit 5 – New Mexico – rates are also set by the state insurance commissioner. As in Florida and Texas, rates in New Mexico are also substantially higher than rates in California.
[13] The analysis that follows is based upon nationwide results for title insurance companies, not just within California. Overall profitability may not be indicative of profitability of title insurance within California due to differences across states in prices, operating costs, levels of coverage, loss ratios, and the inclusion of other business segments.

comparisons must be made over relatively long periods that capture both peaks and troughs in the real estate cycle.[14] The margins presented in Exhibit 6 show profits as a percentage of sales. Over this period, the operating profit margins earned by title insurance holding companies averaged 8.9 percent, below the average margins for all three benchmark groups which ranged from 9.0 percent for homebuilders to 14.5 percent for the S&P 500. Over the same period, the net income margin for title insurance holding companies averaged 5.1 percent, below the average margins of 8.5 percent for property and casualty insurers and 6.1 percent for the S&P 500, and slightly above the average margin of 5.0 percent for homebuilders.

Return on equity is another measure of profitability in which after-tax profits are expressed as a percentage of the book value of stockholder's equity.[15] As shown in Exhibit 7, this measure also does not provide evidence of excessive profits for title insurance holding companies. Title insurance holding companies earned an average return on equity of 12.8 percent, below the average of 16.8 percent for homebuilders and 13.7 percent for the S&P 500, and above the average of 11.1 for property and casualty insurers.

The comparisons in Exhibits 6 and 7 likely overstate the profitability of title insurance because title insurance holding companies have diversified into other lines of business and these new lines are on average more profitable than the older core business of title insurance. For example, based upon the SEC filings of publicly traded title insurance holding companies in 2004, profit margins on the title insurance business segment averaged 10.8 percent compared to 16.2 percent in all other business segments.[16]

The comparison of the profitability of title insurance holding companies with profits earned in other industries supports the conclusion that the markets for title insurance are competitive.

IV. Competition and Market Structure

In evaluating the degree of competition in a given market, a range of factors that may affect the ability of suppliers to raise prices above the competitive level must be considered. While the starting point of such an analysis may be the number and size distribution of sellers in a market, this is only a preliminary consideration. It is well

[14] For this reason, as well as others, the analysis of the profitability of California underwritten title companies included in the Report of the Commissioner, which considers only 2003 and 2004 results, is biased and unreliable.
[15] Accounting rates of return on equity are generally considered by professional economists to be of little relevance in evaluating competition, in part because they are calculated using the depreciated historical cost of assets rather than their replacement values.
[16] Results are based on business segment profit margins for Fidelity National Financial, First American Corporation, Stewart Information Services and LandAmerica Financial excluding the segment "corporate and other." Title insurance was less profitable than other segments even in 2004, when profits for title insurance would be expected to be near their peak as home sales and refinancing activity were at or near all time highs.

established among professional economists that high concentration alone does not result in a lack of price competition.[17] A host of other factors, including the ease with which new suppliers can enter the relevant market or existing suppliers can expand output, must be considered.

While the number of national title insurance companies has declined over the past twenty five years as a result of mergers, this trend has also been evident in many other industries, including retail banking, investment banking, and automobiles, in which there is a high degree of price competition. Further, mergers in the title insurance business must be approved by both federal antitrust authorities and state insurance commissions so as to protect consumers. If the analyses conducted at the times of these mergers had caused regulators to expect adverse effects on competition, then the prior mergers would not have been approved.

While the number of national firms has declined, the number of underwritten title companies ("UTCs") in California has increased recently. For example, between 2004 and 2005 the number of UTCs licensed to do business in the state increased from 83 to 91.[18] The entry of new suppliers, during a period of exceptional profits, is one more indication of competition in the California title industry.

A. Few firms as a measure of competition

The notion that a market supplied by few firms provides the basis for predicting an absence of price competition is at odds with real world markets and, moreover, has little basis in economics. First, the number of firms in a market is not determined by accident. Few firms compete in certain markets because of fundamental, underlying economic conditions. Market structure, the number and size distribution of firms in an industry, is largely conditioned by the costs of production and distribution relative to the size of the market. Where there are large economies of scale relative to the size of the market, fewer firms can profitably compete. A large minimum efficient scale must be reached to attain profitability, and the size of the market limits the number of firms when large scale is required for efficient operation. However, that does not mean that the surviving firms will not compete aggressively on price and product quality for customers.

The real world offers many examples of industries with few firms and intense price competition, indicating that the existence of few firms does not necessarily predict an absence of price competition. Everyday examples include aircraft, beer, and soft drinks. In large commercial aircraft there are only two rivals worldwide, Boeing and Airbus, who are well known for battling each other for months on price discounts to win orders for new aircraft. Aircraft buyers play one manufacturer off against the other to extract a competitive price. Anheuser-Busch, Coors, and Miller account for most beer sales in the U.S. and market aggressively against one another. The industry has been investigated numerous times by the government and price collusion has never been

[17] See for example U.S. Department of Justice and the Federal Trade Commission, *Horizontal Merger Guidelines,* 1997.
[18] California Department of Insurace.

detected. Coca-Cola and Pepsi have long accounted for most soft drink sales in the U.S. and regularly undercut each other's prices in supermarket sales. Other examples of few firm industries engaged in intense price competition include household detergents and cleaners, and household paper products. Economics has long known that two firms are sufficient for competitive pricing to flourish.

Attempting to infer price competition from the number of sellers is also misleading because it ignores the buyers' side of the market. When there are large buyers in a market supplied by relatively few sellers, buyers provide a countervailing force that blocks prices from being raised above the competitive level. In this case, title insurance providers must compete for large lenders, like Citibank, Chase, and Bank of America. These are large scale, highly knowledgeable and sophisticated buyers, who demand the lowest prices available. The threat of such large buyers moving their business to rival title insurance firms prevents pricing above the competitive level.

B. Barriers to entry and expansion

A barrier to entry or to the expansion of existing firms is some unique factor that allows incumbents to sustain above competitive prices in the long run. Historically, the need for insurance companies to establish and maintain title plants was considered a barrier to entering the industry.[19] More recently, the development of "joint plants" and easy access to title information for a modest subscription fee has effectively removed this factor as a barrier to entry.

It has been suggested that the need to overcome established relationships between title insurance providers and the network of contacts that direct homeowners seeking title insurance represents a large barrier to entry.[20] Gaining sales by encouraging customers to switch from rival firms is a problem facing new entrants in any industry, and it is a cost of business that incumbents faced when they entered. Moreover, battling for customers is an every day cost of doing business in all industries. Such a ubiquitous cost is not a barrier to entry or expansion as the term is used by professional economists.

In industries where prices are above the competitive level, new entrants could attempt to overcome established relationships by offering title insurance at competitive prices. Nothing prevents new entrants from marketing their services to lenders, homebuilders, and real estate agents. If incumbents are earning relatively high profit rates (i.e. above risk adjusted competitive returns), then there are strong incentives for new entry. However, entry may be limited in the case of title insurance if, as noted earlier, there are large economies of scale relative to the size of the market, which would restrict the number of firms that can profitably compete.

[19] A title plant is a compilation of records affecting the title to real property maintained by title insurance companies.
[20] Report to the Commissioner, pp. 68-69.

V. Do Middlemen Drive up the Cost of Title Insurance?

We were asked to evaluate whether the common practice of marketing and distributing title insurance products through third parties such as realtors, lenders, and other settlement providers, rather than directly to homeowners, harms consumers. It has been suggested that these so called "middlemen" serve merely to drive up title insurance prices.

But middlemen serve a useful purpose in many markets. They serve to lower the cost of distribution and exchange of economic goods and services. They can provide price and quality information and facilitate the matching of customers to providers. Middlemen often reduce search costs for both buyers and sellers. The ultimate success story for middlemen is currently eBay, which has greatly reduced the cost of bringing together millions of buyers and sellers.

In the 1970s the term "reverse competition" was applied to the title insurance industry to describe the way that title insurance is marketed to homeowners.[21] Providers of title insurance market their products to real estate agents, mortgage brokers, lenders, and developers to secure recommendations (sometimes called referrals) to home owners. Proponents of the concept of reverse competition viewed this avenue of marketing as harmful to consumers because it purportedly raised the cost of gaining business and the costs were passed on to consumers. In effect, expenses for marketing and distribution, normal activities in all markets, were seen as harmful in title insurance because of the cost to consumers. The implication was that title insurance providers should market directly to home owners, rather than use third parties for referrals.

But marketing directly to home owners entails costs as well, such as advertising and other means of reaching potential customers, and price, in the end, must cover costs for a company to remain in business. A range of negative and anti-competitive connotations were originally attached to the term, reverse competition. Since that time, many profound changes have occurred in the real estate and banking industries coupled with a revolution in information technology such that it is not at all clear that "reverse competition" adequately describes the title industry as of 2006.

There are numerous industries where middlemen operate, where ultimate consumers may not be well informed about quality or price, and where recommendations are a normal and acceptable business practice. For example, the marketing of prescription drugs was historically most often directed to physicians rather than final consumers, until it became legal for drug companies to advertise to consumers.[22]

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[21] See U.S. Department of Justice, "The Pricing and Marketing of Insurance," January 1977.

[22] The pharmaceutical industry provides an informative example of the cost of marketing directly to consumers. Historically, the marketing efforts of pharmaceutical companies were directed toward the physicians who prescribed medications. Changes in regulations of the Food and Drug Administration in the 1990s expanded the ability of pharmaceutical companies to advertise directly to consumers. In the ten years since 1995, direct to consumer advertising by pharmaceutical companies has increased over 13 fold from approximately $300 million to over $4 billion. Francis B. Palumbo and C. Daniel Mullins, "The

Similarly, professional services such as consulting, architectural and legal services are often acquired via referrals rather than direct marketing to the end consumer, in part because this method is cost effective.

In a residential real estate closing, a consumer will be confronted with dozens of legal forms to read and sign. Numerous checks may be exchanged between buyer and seller. It would be unrealistic to think that a typical buyer would want to do a separate price and quality assessment on every line item on the HUD-1 Form. Rather, the consumer places their trust in the real estate agent or banker, expecting that they have recommended reliable vendors for each of the various closing services. Consider the analogy of home construction. Suppose someone was considering renovating their kitchen and adding a new family room. Most people would search for a reliable contractor, perhaps interview several, ask for bids, and make a final selection possibly after talking to other satisfied customers. The contractor that is retained may need to separately hire subcontractors for plumbing, electrical, flooring, tiles, etc. It would be unrealistic for the homeowner to have the knowledge to manage all of the subcontractors. It is the general contractor's responsibility to monitor the price and quality of the work done by the various subcontractors.

In applying this analogy to the title insurance industry, many of the same conditions apply. Many residential customers do not have the experience necessary to make a fully informed choice about title insurance. Just as it is generally uneconomical for homeowners to search for each required subcontractor when undertaking a major home remodeling project, it is uneconomic for a single home owner to search the market for title insurance, mortgage insurance, escrow services, appraisers, inspectors and all other services required for home financing. Many home owners would prefer to rely on the expertise of the realtor or banker who is a specialist dealing with these issues as a regular part of their trade. As long as RESPA[23] is complied with, lenders and realtors have no incentive to see their customers pay more for title insurance or any other closing costs. Realtors and lenders want to create good will and encourage their customers to return to their firm when they are looking to sell their home or refinance their mortgage, and to recommend the realtor and lender to their friends.

For those claiming that marketing title insurance directly to homeowners is more beneficial to consumers than through third parties for recommendations, the evidence is to the contrary. Competition pushes markets to adopt the most efficient forms of production as well as distribution. If there were more economical methods to market title insurance directly to consumers, title insurance firms would be doing so, in order to reduce costs. The fact that they market to third parties demonstrates that it is the most efficient way to attract business from home owners.

Development of Direct-to-Consumer Prescription Drug Advertising Regulation," *Food and Drug Law Journal*, 2002; The IMS Health Report-Pressure Zone," *Medical Marketing & Media*, May 2005.
[23] RESPA stands for Real Estate Settlement Procedures Act.

VI. Rate Regulation

Title insurance is subject to a variety of different forms of rate regulation in the U.S. Some states such as Illinois and Indiana have very little or no rate regulation. California is a so-called "file and use" state meaning that title insurance companies must file proposed rates with the Department of Insurance and wait thirty days before implementing them. Stricter forms of regulation exist in so called "prior approval" states. Finally, in Texas, Florida and New Mexico there is the most onerous rate regulation where the insurance commissioner "promulgates" the rates that insurers can charge for title insurance. As noted earlier, premiums for title insurance in Texas and Florida are considerably higher than in California. To make matters worse, in Texas and New Mexico there is absolutely no product innovation because every firm is required to sell exactly the same product. Consequently, as one example, First American does not offer in Texas a variety of its products that it considers of higher quality.

If the nature of regulation in California were to change so that title insurance rates were promulgated by the Department of Insurance Commissioner, it is likely that the following effects would ensue. First, the extensive number of reduced price offerings would diminish and perhaps ultimately vanish. Second, firms would no longer have an incentive to innovate with new products. Third, tremendous resources would be brought to bear on formal rate hearings, with companies hiring lawyers, accountants, and rate specialists, and government departments expanding similarly with equivalent expertise to hold rate hearings where the companies and the Department of Insurance would argue about the cost of capital and approved investments. Fourth, price competition would end, and consumers would be paying a higher price for an inferior product. Blocked from competing for customers on price, providers would resort to greater expenditures on marketing efforts to third parties, exactly the behavior the Report to the Commissioner finds harmful to consumers.

There is ample information available to suggest that more stringent regulation of title insurance in California in the form of explicit rate regulation would produce a poor outcome for consumers, with higher prices and fewer product offerings.

About the Authors

Analysis Group, Inc. provides economic, financial, and business strategy consulting to law firms, corporations, and government agencies. We assist law firms with all aspects of litigation, including pretrial discovery, development of economic and financial models, preparation of testimony, and critique of opposing experts. We advise corporate and government clients on a range of business issues that require expert interpretation of economic and financial data, including financial planning, tax and transfer pricing issues, company and asset valuations, cost-effectiveness analyses, market analyses, and evaluation of mergers and acquisitions. We also help organizations create strategies for growth by analyzing market dynamics and organizational capabilities, enhancing innovation in current products and services, and identifying new market opportunities. Since the company's founding in 1981, our professional staff, which now numbers 300, has worked closely with an extensive network of experts at leading universities who help us develop state-of-the-art analyses and compelling insights for our clients.

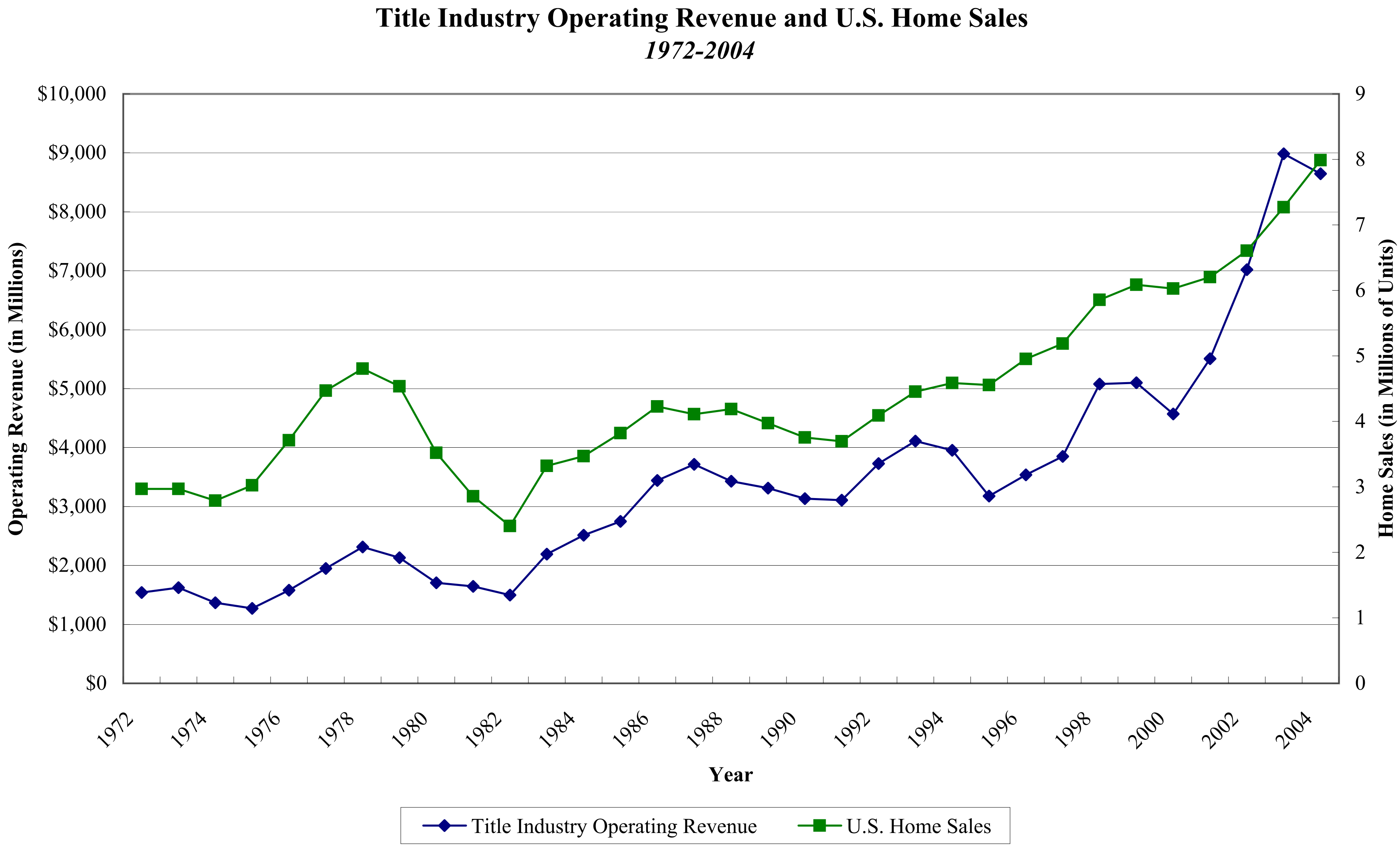
Bruce E. Stangle, Chairman; *Ph.D. in Applied Economics and M.S. in Management, Sloan School of Management, Massachusetts Institute of Technology; B.A., Bates College*

A co-founder of Analysis Group, Dr. Stangle has more than 25 years experience directing large research and consulting projects in numerous industries, in such areas as antitrust, regulation, intellectual property, and damages. He has provided testimony on market definition, entry conditions, competitive effects, security valuation, and damages. Dr. Stangle serves as a member of the Board of Trustees of Bates College, the Visiting Committee for the Economics Department at MIT, and the Board of Directors of Wellington Trust Company, a subsidiary of the private money management firm Wellington Management Company. He has also served as a member of the Board of Directors of a venture capital firm.

Bruce A. Strombom, Managing Principal; *Ph.D. in Economics, University of California, Irvine, B.A. in Economics, San Jose State University.*

Dr. Strombom is an expert in applied microeconomics, industrial organization and finance. For the past 13 years he has served as a consulting and testifying expert in both commercial litigation and public policy matters. He has conducted economic analyses and damages assessments involving antitrust, intellectual property, fraud, securities valuation, employment, and contract disputes. His clients include private and public companies and government agencies including the California State Auditor, the Securities and Exchange Commission and the Department of Justice.

Exhibit 1

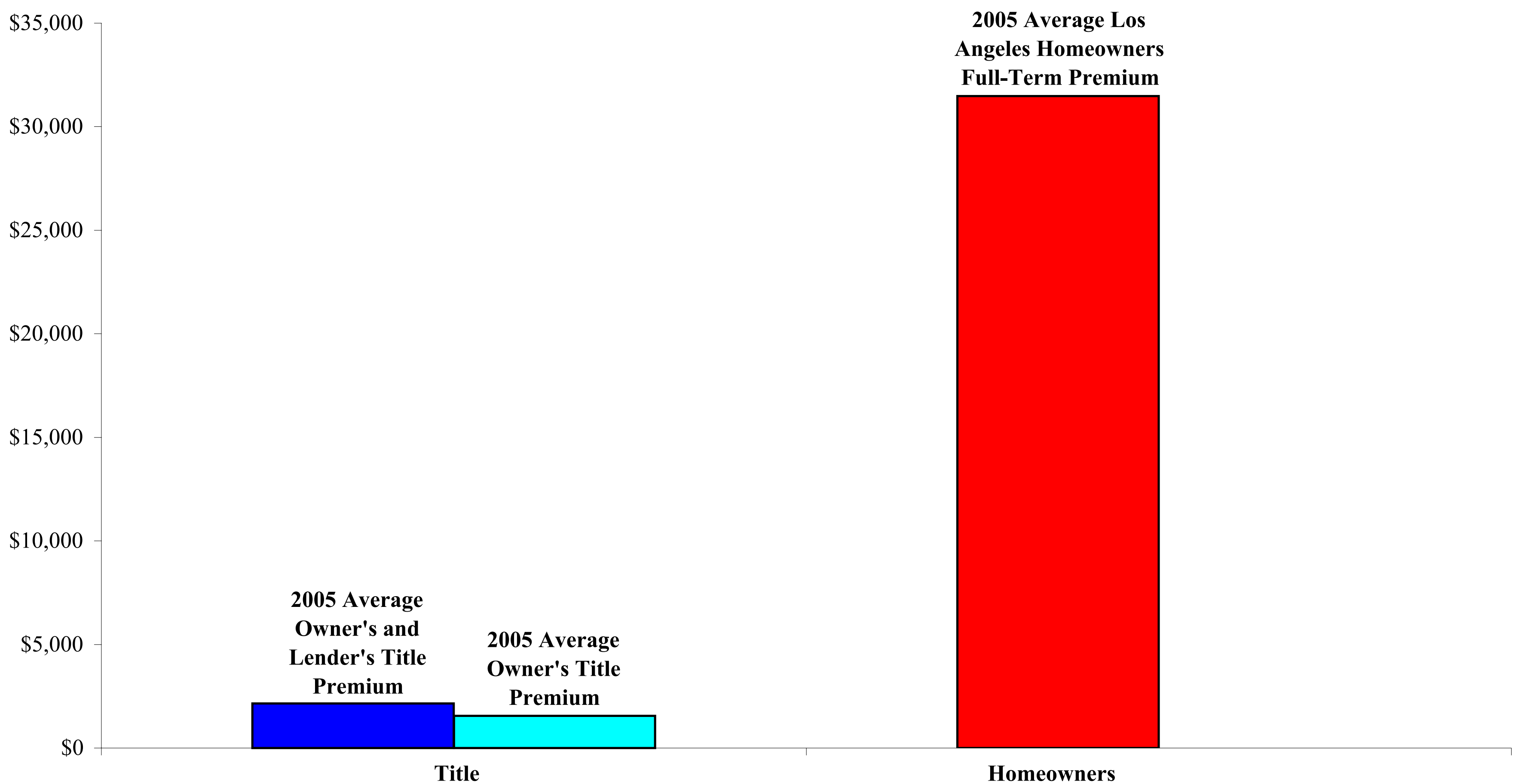


Notes: 1. Operating Revenue is adjusted for inflation using the CPI Index (base year is 1982-84).
2. The correlation between Operating Revenues and Home Sales is 92%.

Sources: A.M. Best Special Report: Clouds on Horizon After Title Industry's Bright Year, October 2005 (Exh. 5), Bureau of Labor and Statistics.

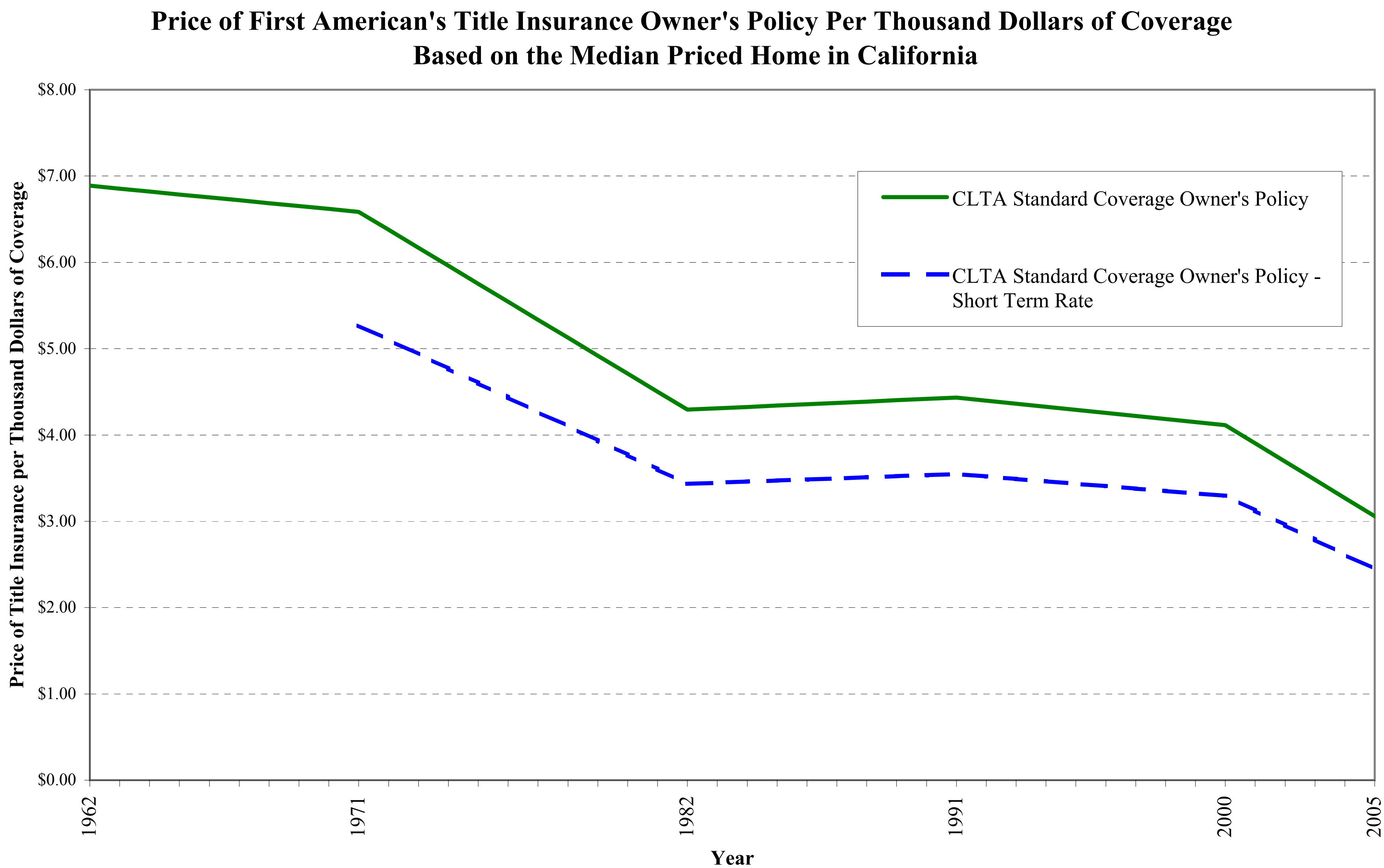
Exhibit 2

Comparison of Full-Term Premiums on Median Priced Home Purchases for Title and Homeowners Insurance in California



Notes:
Median home price for CA in 2004 was $450,990. Average term length is assumed to be 14.1 years, based on Birnbaum report. 2005 average title premiums, from First American online rate calculator, are an average of Basic and Eagle premiums for non-foreclosure home/land purchases that have not been insured within 5 years. 2005 average Los Angeles premium from CDI survey of rates for 7-15 year-old $500K homes in central Los Angeles, adjusted by value of home.

Exhibit 3



Notes: The price of the median priced home increased from $15,100 in 1960 to $548,400 in 2005. The median priced home during the month of November 2005 was used as the median priced home in 2005. The median priced home in 1960 was used as the median priced home in 1962.

Sources: RealEstate ABC, California Historical Title Rates by First American Title Insurance Company, U.S. Census Bureau.

Exhibit 4

Change in Coverage for California Residential Title Insurance Policies Issued by First American

Coverage	1963	1973	1975	1980	1987	1997	1998
Coverage continues forever							X
Insured parties further expanded to include beneficiaries of a trust and owner/ex-spouse after divorce							X
Type of improvement and address coverage							X
Building set-back encroachment coverage							X
Boundary wall and fence encroachment coverage							X
Forced remedial coverage for zoning violations							X
Forced remedial coverage for building permit violations							X
Access further expanded to provide actual access							X
Coverage for defects in title created post policy							X
Post policy limitation of use of land							X
Coverage for easements created post policy							X
Post policy coverage for identity theft (impersonation) affecting title							X
Coverage for post policy leases, contracts or options							X
Coverage for third parties claiming a post policy interest in the title							X
Insured parties expanded to cover a post policy trust created by named insured						X	X
Map discrepancy coverage						X	X
Post policy structural modification mineral surface entry coverage						X	X
Subdivision Map Act violation coverage						X	X
Post policy encroachment coverage						X	X
Enhanced unmarketability coverage for C, C & R violations (for pre policy violation)						X	X
Expanded C, C & R violation coverage (for pre policy violation)						X	X
Title reversion coverage for C, C & R violations (for pre policy violation)						X	X
Building permit violation coverage						X	X
Access expanded for legal right of pedestrian and vehicular access						X	X
Post policy forgery						X	X
Single family residence use coverage				X	X	X	X
Forced removal enhanced C, C & R violation coverage (for pre policy violation)				X	X	X	X
Coverage for loss of use because of zoning violations				X	X	X	X
Substitute property rental benefit during claims period coverage				X	X	X	X
Automatic inflation coverage				X	FA 11.1	X	X
Unrecorded easement claims				X	X	X	X
Unrecorded defects, liens and encumbrance claims				X	X	X	X
Unrecorded adverse ownership claims				X	X	X	X
Document execution coverage				X	X	X	X
Mineral right surface entry coverage			X			X	X
Zoning coverage (regulating area, width and depth of the land)			X	X	X	X	X
Basic C, C & R violation coverage (for pre policy violation)			X	X	X	X	X
Unrecorded encroachment coverage			X	X	X	X	X
Unrecorded mechanics' lien coverage			X	X	X	X	X
Basic access		X	X	X	X	X	X
Recorded ownership (vesting)		X	X	X	X	X	X
Unmarketability of title	X	X	X	X	X	X	X
Recorded defects, liens or encumbrances not shown as an exception	X	X	X	X	X	X	X

Year

Exhibit 4

Notes:

1. The coverages shown pertain to the owner's policy version indicated by year which was commonly issued for residential transactions from 1963 to present.
2. These coverages, in most instances, were also included in corresponding loan policies in addition to specific insuring clauses in those loan policies having to do with the insured mortgage.

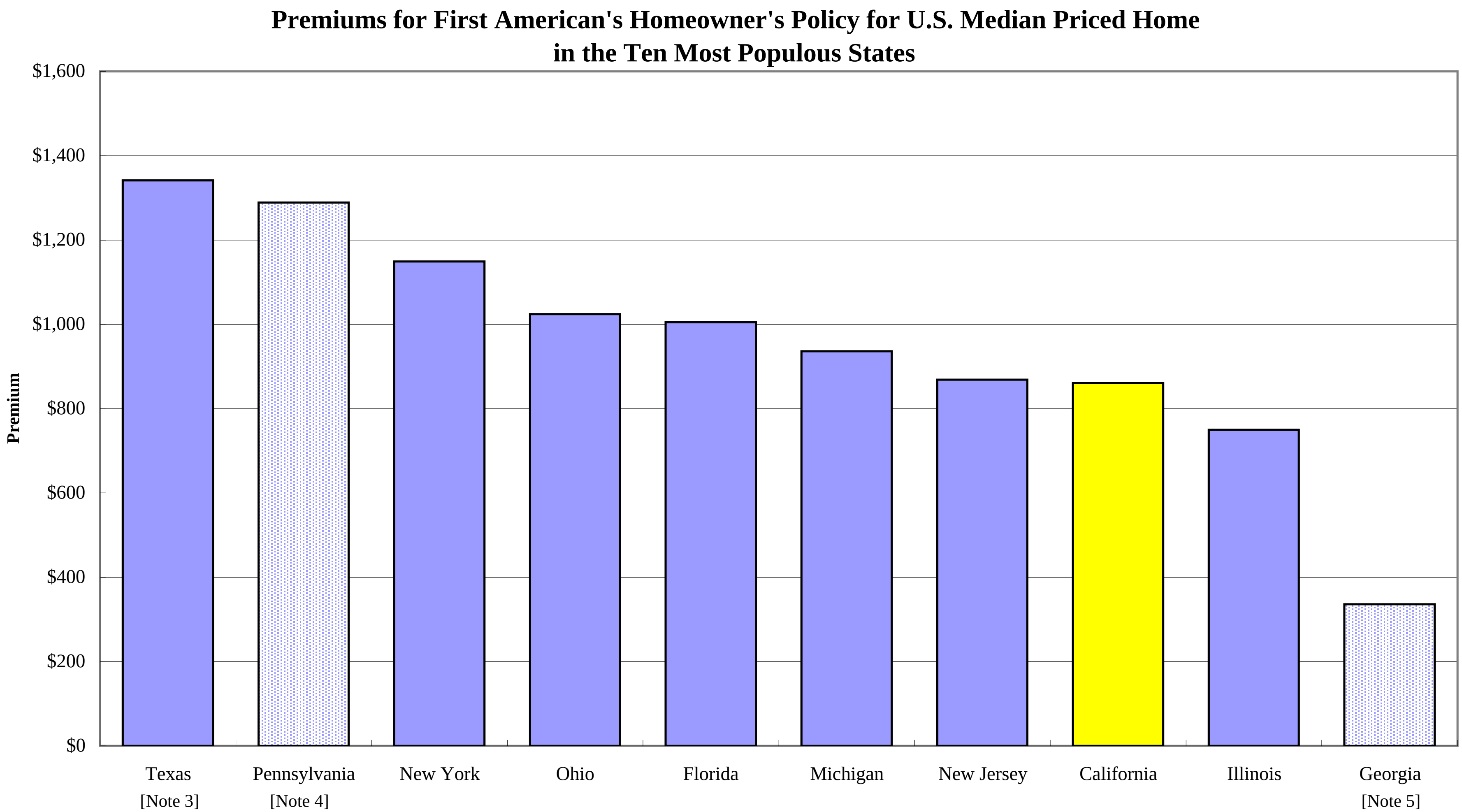
Legend:

1963 - CLTA
1973 - CLTA
1975 - CLTA with 126 endorsement (issued automatically for no additional charge)
1980 - ALTA Plain Language
1987 - ALTA Plain Language with 11.1 endorsement (issued automatically for no additional charge)
1997 - ALTA Plain Language with EAGLE Protection added "EAGLE Policy"
1998 - CLTA/ALTA Homeowner's Policy of Title Insurance "2nd Generation EAGLE Policy"

Source:

First American

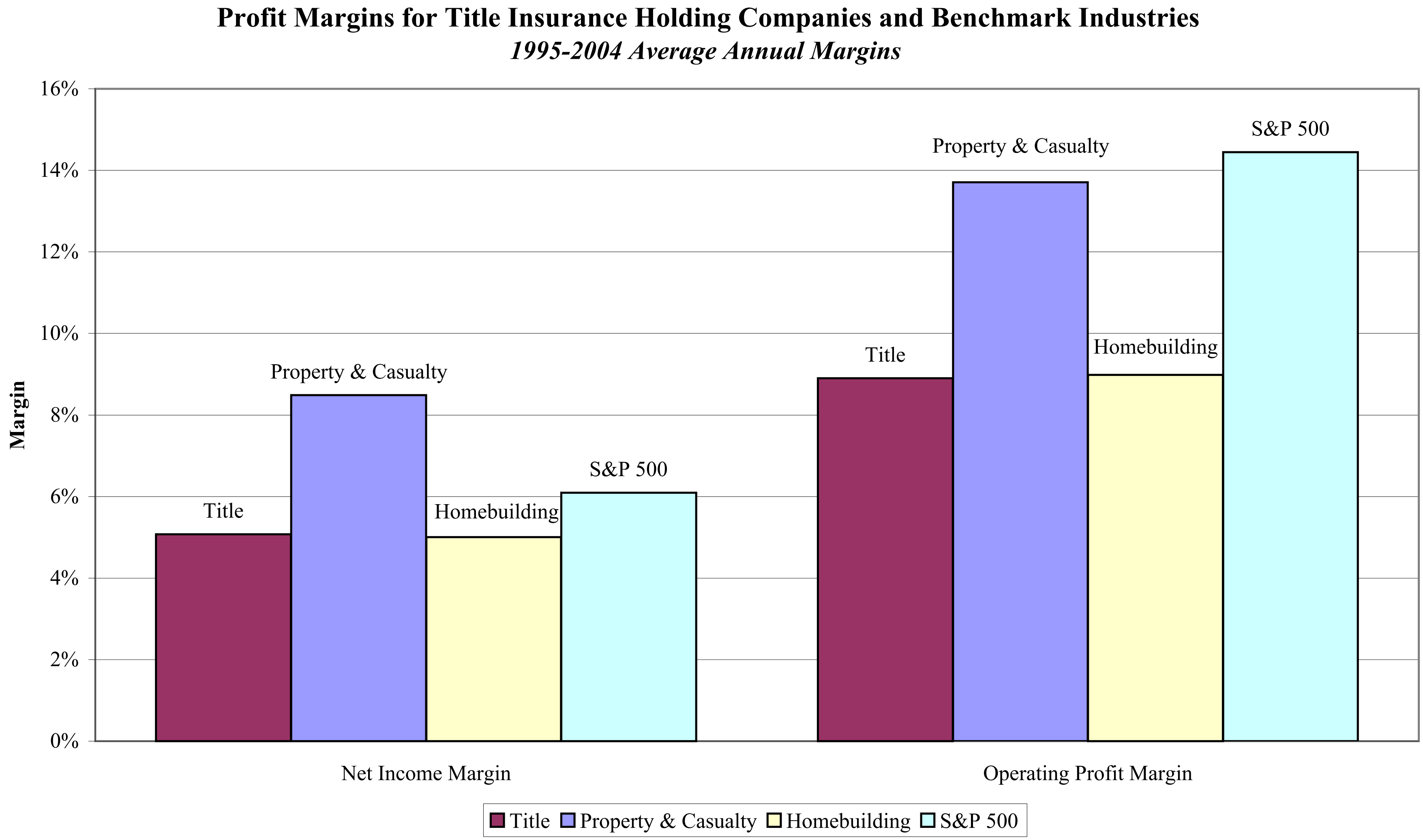
Exhibit 5



Notes: 1. 2004 median home price in the U.S. was $185,200.
2. Top ten states by July 1, 2005 population estimates.
3. Level of coverage in Texas is less than that available in California.
4. Pennsylvania may not be comparable to other states because premium includes escrow fees.
5. Georgia may not be comparable to other states because premium is not all-inclusive.

Sources: First American, US Census Bureau

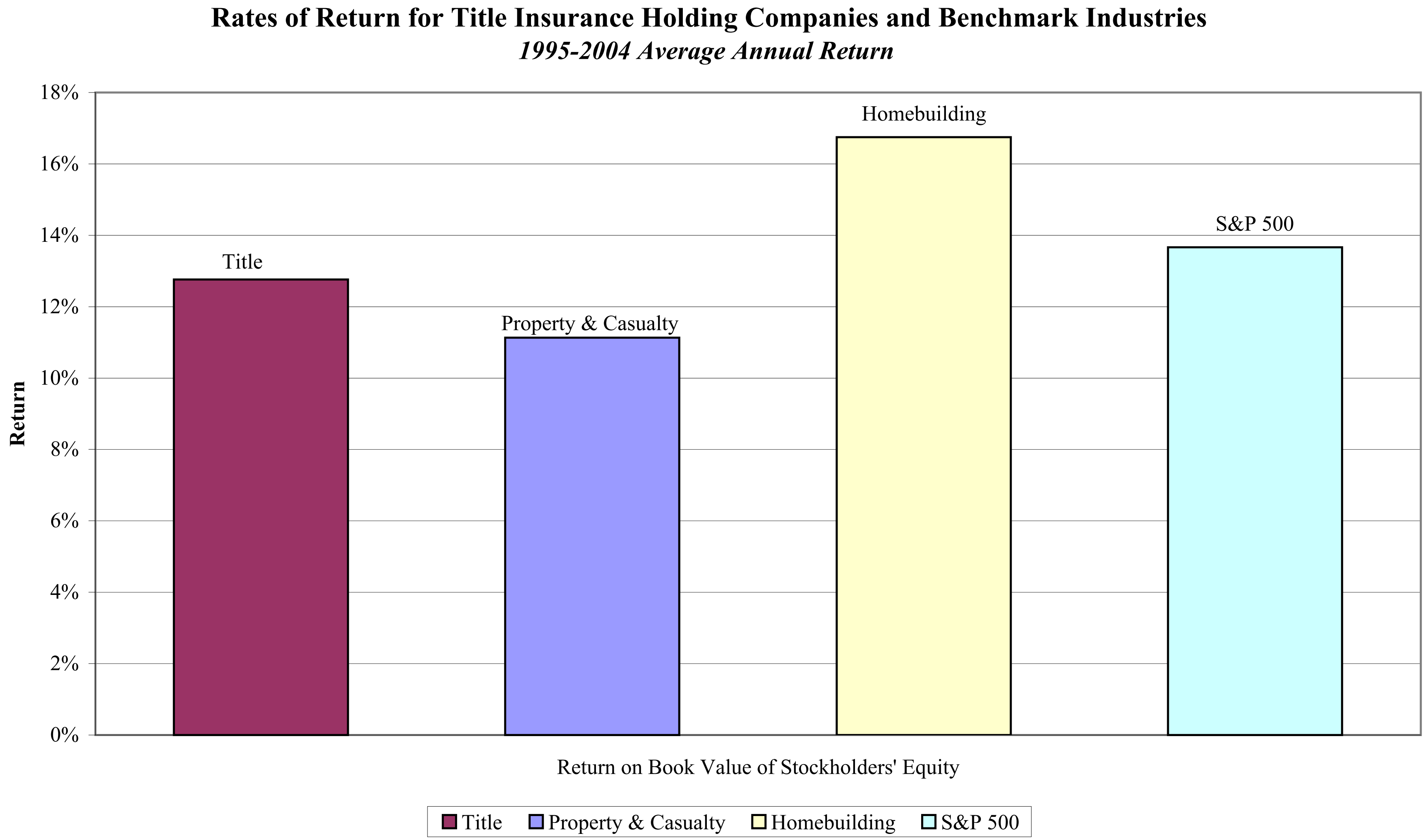
Exhibit 6



Notes: Title includes the 10 publicly-traded companies in SIC 6361, Title Insurance, that provide title insurance in various years between 1995 and 2004 (Capital Title Group, Fidelity National Financial, First American Corp., Investors Title Co., LandAmerica Financial Group, Stewart Information Services, Firstmark Corp., Chicago Title Corp., Alleghany, and ANFI, Inc.). Chicago Title Corp. was spun-off from Alleghany in 1997. Fidelity National Financial acquired Chicago Title Corp. in 2000 and ANFI, Inc. in 2003. Property & Casualty includes companies in the S&P 500 Property & Casualty Index. Homebuilding includes companies in the S&P 500 Homebuilding Index.

Sources: Compustat and Bloomberg.

Exhibit 7



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Sources: Compustat and Bloomberg.