

Statutory Issue Paper No. 57

Title Insurance

STATUS

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Type of Issue:

Property and Casualty

SUMMARY OF ISSUE

1. Current statutory guidance for premium revenue recognition, unpaid claims, losses, and loss adjustment expenses for title insurance contracts is contained in Appendix B of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual). This guidance states that title insurance premiums are fully earned on the date of policy issuance; however, most states require title insurance companies to establish and maintain an unearned premium or reinsurance reserve. This guidance also states that title insurance companies are not required to give recognition to Incurred But Not Reported (IBNR) losses as a liability in statutory reporting; however, disclosure of IBNR is required in Schedule P by the NAIC Annual Statement Instructions - Title (Annual Statement Instructions). Current statutory guidance for title plants is contained in Appendix B of the P & C Accounting Practices and Procedures Manual. This guidance states that title insurers are authorized to invest in title plants and to classify them as admitted assets, subject to certain valuation restrictions.
2. GAAP guidance for premium revenue recognition is found in paragraph 16 of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (FAS 60). GAAP guidance for claim cost recognition is found in paragraphs 17-20 of FAS 60. GAAP guidance for title plants is presented in FASB Statement No. 61, *Accounting for Title Plant* (FAS 61), as amended by FASB Statement No. 121, *Accounting for The Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FAS 121).
3. The purpose of this issue paper is to establish statutory accounting principles for title insurance that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. A variety of services are generally provided (either by the title insurance underwriter, its agent or others) in connection with the transfer of title to real estate. Title insurance rates frequently are determined in the rate making process based on the bundle of services provided, including some or all of title search and examination and closing or escrow fees, referred to as "Gross All-Inclusive" premiums. By statute or custom, certain states exclude title search and examination and closing or escrow fees from the rate-making process for title insurance premiums; referred to as "Gross Risk Rate" premiums. Premiums shall be recorded at the date of policy issuance, on either the Gross All-Inclusive or Gross Risk Rate premium basis, consistent with the rate-making method used. Amounts paid to or retained by agents shall be reported as an expense.
5. A liability shall be established for all known unpaid claims and loss adjustment expenses (known claims reserve), consistent with paragraph 23 of this issue paper, with a corresponding charge to income. The future payments associated with settling known unpaid claims and loss adjustment expenses meet the

definition of a liability as established in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5).

6. Premium revenue shall be deferred to the extent necessary to maintain a Statutory or Unearned Premium Reserve (SPR/UPR) determined in accordance with the reserve section detailed in paragraph 23 of this issue paper.

7. Additionally, a supplemental reserve shall be established consisting of any other reserves necessary, which when taken in combination with the reserves required by paragraphs 5 and 6 of this issue paper will be sufficient to cover the company's liabilities with respect to all known claims, IBNR claims, and loss adjustment expenses. The total of the known claims reserve, SPR/UPR, and the supplemental reserve shall not be less than the actuarially determined liability for the sum of known claims, IBNR claims, and loss adjustment expenses or the amount determined in accordance with paragraph 23 of this issue paper.

8. Consistent with the statutory objective of maintaining a SPR/UPR in an amount sufficient to purchase reinsurance, the criteria for revenue recognition in paragraphs 6 and 7 recognize the economics of the title insurance contract over the estimated period of exposure.

9. The actuarially determined liability for the sum of known claims reserve required in paragraph 5, and the IBNR claims and loss adjustment expenses required in paragraph 7 of this issue paper, shall be determined consistently with the guidance detailed in *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (Issue Paper No. 55), except that anticipated salvage and subrogation shall not be deducted from the liability for unpaid claims.

10. Assets acquired in settlement of claims (e.g., mortgages and real estate) shall be accounted for consistent with the guidance related to the asset acquired. For example, an impaired loan shall be accounted for in accordance with *Issue Paper No. 37—Mortgage Loans*, and real estate acquired in foreclosure shall be accounted for in accordance with *Issue Paper No. 40—Real Estate Investments*.

11. The financial statements or notes thereto shall disclose the following items for each period presented:

- a. The amount of premium revenue reported on the Gross All-Inclusive and on the Gross Risk Rate premium basis;
- b. The amount of the known claims reserve, SPR/UPR, and the supplemental reserve;
- c. Whether the insurer uses discounting in the calculation of its supplemental reserve, the method and rate used to determine the discount, and the amount of such discount.

12. Any material individual component of the reported expense categories shall be presented either on the face of the Summary of Operations or within the footnotes or related exhibits to the financial statements.

Title Plant

13. Title plants are an integrated and indexed collection of title records consisting of documents, maps, surveys, or entries affecting title to real property or any interest in or encumbrance on the property, which have been filed or recorded in the jurisdiction for which the title plant is established or maintained. They are tangible assets unique to the title insurance industry, and are the principal productive asset used to generate title insurance revenue and to mitigate the risk of claims. Title plant shall be reported as an admitted asset, subject to the following valuation restrictions:

- a. Costs incurred to construct a title plant, including the costs incurred to obtain, organize, and summarize historical information in an efficient and useful manner, shall be capitalized until the title plant can be used by the company to conduct title searches and issue title insurance policies. The capitalized costs shall be directly related to, and properly identified with, the activities necessary to construct the title plant.
 - b. Purchased title plants, including a purchased undivided interest in a title plant, shall be recorded at cost at the date of acquisition. For a title plant acquired separately, cost shall be measured by the fair market value of the consideration given. For title plant acquired as part of a group of assets, cost shall be measured by the fair value of the consideration given and then cost shall be allocated to the title plant based on its fair value in relation to the total fair value of the group of assets acquired. For title plants acquired as part of a purchase of assets or in a business combination, cost shall be determined in accordance with *Issue Paper No. 68—Business Combinations and Goodwill*.
 - c. After the construction or purchase of a title plant, a company may decide to purchase or construct a title plant that antedates the period of time covered by the existing title plant (backplant). Costs to construct a backplant must be properly identifiable to qualify for capitalization.
 - d. Costs incurred after a title plant is operational to (a) convert the information from one storage and retrieval system to another; or (b) modify or modernize the storage and retrieval system shall not be capitalized.
 - e. Costs incurred to maintain a title plant shall be expensed as incurred.
 - f. Costs incurred to perform title searches shall be expensed as incurred.
 - g. The aggregate carrying value of an investment in a title plant or plants shall not exceed the lesser of twenty percent (20%) of admitted assets or forty percent (40%) of surplus to policyholders.
14. Certain circumstances may indicate that the value of the title plant may be impaired and, thus, the carrying value of the asset may not be recoverable. If there is an indication of possible impairment of value, the title plant shall be evaluated for impairment and recorded in accordance with Issue Paper No. 5. The following are examples of circumstances that may indicate impairment:
- a. Effects of obsolescence, demand and other economic factors;
 - b. A significant change in the legal or business climate in the jurisdiction for which the title plant is established and maintained;
 - c. A current period operating or cash flow loss combined with a history of such losses or projections that indicate continued losses associated with the revenue produced by the title plant;
 - d. A lack of appropriate maintenance to keep the title plant up to date;
 - e. Abandonment of a title plant.
15. A properly maintained title plant has an indeterminate life and does not diminish in value with the passage of time, and accordingly, shall not be depreciated.

16. A title insurer may (a) sell its title plant and relinquish all rights to its future use; (b) sell an undivided ownership interest in its title plant; or (c) sell a copy of its title plant or the right to use it. Accounting and presentation for each type of sale noted shall be as follows:

- a. When a title insurer sells its title plant and relinquishes all rights to its future use, consideration received shall be presented as a separate component of revenue net of the carrying value of the title plant sold.
- b. When a title insurer sells an undivided ownership interest in its title plant, consideration received shall be presented as a separate component of revenue net of the pro rata portion of the carrying value of the title plant.
- c. When a title insurer sells a copy of its title plant or the right to use it, consideration received shall be presented as a separate component of revenue and the carrying value of the title plant shall not be reduced.

DISCUSSION

17. The P & C Accounting Practices and Procedures Manual states that title insurance premiums are fully earned on the date of policy issuance; however, title insurance companies are required to establish and maintain an unearned premium or reinsurance reserve. The primary objective of the SPR/UPR is to maintain at all times a reserve amount which is sufficient to purchase reinsurance for the IBNR claims and related loss adjustment expenses. Consistent with this objective, the statutory principles in paragraph 6 of this issue paper retain current statutory guidance, which requires that changes in the amount of the SPR/UPR be reflected as an adjustment to premium revenue. Additionally, the supplemental reserve required in paragraph 7 of this issue paper is analogous to the concept of a premium deficiency reserve as discussed in *Issue Paper No. 53—Property and Casualty Contracts – Premiums* (Issue Paper No. 53). Consistent with Issue Paper No. 53, anticipated investment income may be used as a factor in the supplemental reserve calculation.

18. The conclusions reached in this issue paper are consistent with current statutory guidance except as follows with the exception that this issue paper requires consideration of IBNR claims and related loss adjustment expenses in evaluating the sufficiency of the SPR/UPR in order to conform with the Title Insurers Model Act. The Model Act requires the reporting entity's state of domicile to determine the appropriate unearned premium reserve to be set aside. This issue paper also requires the unearned premium reserve to be determined by the reporting entity's state of domicile. The determination by the state of domicile of this reserve is considered necessary given the nature of this product. This issue paper also requires that the liability for known claims reserves be calculated in accordance with Issue Paper No. 55, except that anticipated salvage and subrogation shall not be deducted from the liability for unpaid claims. Issue Paper No. 55 permits, but does not require, anticipated salvage and subrogation recoverables to be deducted from the liability for unpaid claims; whereas current statutory guidance for title insurers does not permit case basis loss and loss adjustment expense reserves to be reduced for anticipated salvage and subrogation.

19. This issue paper modifies current statutory accounting for title plant to require the evaluation and write-off of impairment in value. This is consistent with Issue Paper No. 5. This issue paper adopts FAS 61, modified for carrying value restrictions, as amended by paragraph 29 of *FASB Statement No. 121 - Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FAS 121). Restrictions on the total carrying value of an investment in a title plant or plants have been set consistent with current statutory accounting outlined in the Title Insurers Model Act. FAS 121 is addressed in *Issue Paper No. 40—Real Estate Investments*.

20. The conclusions above reject FAS 60; however, it is considered appropriate to use the factors to be considered in the determination of the ultimate cost of settling claims included in FAS 60 when

establishing the reserves in accordance with paragraphs 5 and 7 of this issue paper. The concepts adopted above are consistent with GAAP literature except that GAAP requires immediate revenue recognition for title insurance contracts and the accrual of claims costs at the time title insurance premiums are recognized as revenue; whereas this issue paper requires that revenues be recognized consistent with the concepts discussed in paragraph 16.

21. The conclusions above are consistent with the regulatory objectives discussed in paragraph 17 of this issue paper and the concept of conservatism in the Statement of Concepts. The conclusions above are also consistent with the recognition and consistency concepts in the Statement of Concepts. Pertinent excerpts follow:

Conservatism

Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

Recognition

Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed.

SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners.

Consistency

The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

Drafting Notes/Comments

- Segregated funds held for others (i.e., escrow funds) will be addressed in *Issue Paper No. 77—Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures*.
- Review of state statutes of not less than 38 states indicates the use of a SPR/UPR, we are not aware of any states without such a requirement.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

22. Amended guidance for title insurance was adopted by the Accounting Practices and Procedures (EX4) Task Force at its October 1, 1996 meeting.

TITLE INSURANCE ACCOUNTING PRINCIPLES SUPPLEMENT

INTRODUCTION

Title insurance insures up to the date of policy issuance that the insured has title to the insured property on a certain title estate, subject to exceptions and exclusions in the policy. Also, a title policy, when issued, has a one time charge to the insured under the policy and reserves are set aside by the title insurance company that issues said policy.

The business of title insurance differs from that of property and casualty insurance in that its basic goal is risk elimination and not loss reimbursement. This risk elimination function results in significantly lower losses than that of other lines of insurance. Because of this fact, the title insurance business is organized and functions differently and its accounting for revenues, losses and loss adjustment expenses, unearned premium reserves, title plants, and escrow funds differs.

This supplement is intended to present the most commonly used practices and procedures as to those differences. Otherwise, title insurance accounting is in agreement with those described elsewhere in this manual.

Title insurers perform many services in connection with the transfer of real estate; however, their principal function involves insuring, guaranteeing, or indemnifying owners of real property or the holders of liens or encumbrances thereon against loss or damage suffered by reason of defective titles, liens or encumbrances or, in most states, the unmarketability of the title.

A one-time nonrefundable charge is due on the effective date of the insurance. This is described in more detail in the section on title insurance revenue. The term of the policy is indefinite in that the policyholder is insured for as long as he or his heirs or devisees have an interest in the property.

Before a title insurance policy is issued, skilled personnel must search and examine a variety of public records concerning the ownership, liens, and encumbrances on the subject real estate together with information relating to persons having an interest in the real property as well as maps and other records to determine that title to the property is insurable, or defects can be overcome.

In addition to insuring against defective records or examination of those records, an insurer insures against "non-record defects" such as:

- Forgeries
- Fraud
- Confusion of name in change of title
- Incompetency (minor or persons of unsound mind)
- Mistakes in public records
- Undisclosed or missing heirs
- Instruments executed under a fabricated or expired power of attorney
- Deeds delivered after death of grantor or grantee or without the consent of the grantor
- Deeds by persons supposedly single but actually married
- Wills not probated
- Liens against property (mechanic's liens, tax liens, etc.)
- Falsified records

TITLE PLANTS

Title plants are an integrated and indexed collection of title records covering parcels of real estate within a county. They are tangible assets unique to the title insurance industry and are the principal productive asset used to generate title insurance revenue.

A title plant consists of (a) indexed and catalogued information for a period of time concerning the ownership of, and the encumbrance on, real estate, (b) information relating to persons having an interest in real property, (c) maps, plats, and so forth, (d) copies of prior title insurance policies and reports, and (e) other documents and records. In summary, a title plant constitutes a historical record of matters affecting title to parcels of land in a particular geographic area. The number of years covered by a title plant varies, depending on regulatory requirements and management decisions concerning the minimum information period needed to issue title insurance policies efficiently. Title plants are updated on a daily or other frequent basis by the addition of copies of documents on the status of title to specific parcels of real estate.

Authorization and Limitations

Title insurers are authorized to invest in title plants and to classify them as admitted assets in their financial statements subject to valuation restrictions which vary from state to state. Insurers' investments in title plants are detailed in Schedule "H" of the annual statement.

Valuation

Costs incurred to construct a title plant, including the costs incurred to obtain, organize and summarize historical information in an efficient and useful manner, should be capitalized until the title plant can be used by the company to conduct title searches and issue title insurance policies. The capitalized costs should be directly related to, and properly identified with, the activities necessary to construct the title plant.

After the construction or purchase of a title plant, a company may decide to purchase or construct a title plant (backplant) that antedates the period of time covered by the existing title plant. Costs to construct a backplant must be properly identifiable to qualify for capitalization.

Purchased title plants, including a purchased undivided interest in a title plant, should be recorded at cost at the date of acquisition. For a title plant acquired separately, cost should be measured by the fair market value of the consideration given. Title plants purchased as part of a group of assets or as part of a business combination accounted for as a purchase, should be accounted for in accordance with APB Opinion 16, "Business Combinations."

Costs incurred after a title plant is operational to (a) convert the information from one storage and retrieval system to another or (b) modify or modernize the storage and retrieval system should not be added to the carrying amount of the title plant. Such costs may be capitalized separately as Title Plant Improvements and charged to expense in a systematic and rational manner in accordance with Statement of Financial Accounting Standards No. 61, "Accounting for Title Plant."

Ordinarily, a title plant has an indeterminate life and does not diminish in value with the passage of time and accordingly should not be depreciated. However, in certain circumstances, evidence may exist that the value of a title plant has been impaired. Evidence of impairment includes the following:

- a) a change in legal requirements or statutory practices,
- b) effects of obsolescence, demand, and other economic factors,
- c) actions of competitors and others that may affect competitive advantages,
- d) failure to maintain the title plant properly on a current basis, or,
- e) abandonment of a title plant or other circumstances that indicate obsolescence.

If such evidence exists, title plant values should be adjusted to the lower of carrying value or current fair values in accordance with Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of."

Maintenance of Title Plant

Costs incurred to maintain a title plant should be expensed as incurred. Title plant maintenance involves the updating of the title plant on a daily basis or other frequent basis by adding (a) reports on the current status of title to specific parcels of real estate and (b) other documents such as records relating to security or other ownership interests.

Cost of Title Searches

Costs incurred to perform title searches should be expensed as incurred. Title searches involve the process of searching through records for all recorded documents or updating information summarized in the most recently issued title report.

Sale of Title Plant

A title insurance company may (a) sell its title plant and relinquish all rights to its future use, (b) sell an undivided ownership interest in its title plant, that is, the right to its joint use, or (c) sell a copy of its title plant or the right to use it. If the company sells its title plant and relinquishes all future rights to its use, the amount received as consideration for the sale should be presented as a separate component of revenue, net of the carrying amount of the title plant. If the company sells an undivided ownership interest in its title plant, the amount received as consideration should be presented as a separate component of revenue, net of the pro rata portion of the carrying amount of the title plant. If the company sells a copy of its title plant or the right to use it, the amount received should be presented as a separate component of revenue. Ordinarily no cost should be allocated to the sale of a copy or the right to use a title plant.

STATUTORY PREMIUM RESERVE

The premium related to a title insurance policy is due upon the effective date of the insurance and is not refundable. The term of a title insurance policy is indefinite in that the policyholder is insured for as long as he or his heirs or devisees have an interest in the property. Since title insurance premiums are fully earned on the date of policy issuance, there are no unearned premiums for title insurers.

Most states require title insurance companies to establish and maintain a statutory premium reserve. Generally, the title insurance company must establish this statutorily required deferred income account based upon the law of its domiciliary state. The computation is based upon either premium revenue, number of policies issued, liability assumed, or combinations thereof. The reserve is drawn down in accordance with recovery or amortization formulas as prescribed by state law.

Generally, title insurance companies are required to hold, maintain and segregate investments in marketable admitted assets of a particular type and quality as prescribed by certain states' statutes in an amount at least equal to the statutory premium reserve. When applicable, such assets are summarized by investment type in a footnote to the "Assets" page of the annual statement.

TITLE INSURANCE REVENUE

The variety of services performed by a title insurance company in connection with the insurance of a real estate title may vary substantially according to local statutes, regulations or practices. This causes a substantial variance in the classification of these services on financial statements of title insurers. While all such services are an integral part of the transfer of title to real estate, services may in some markets be performed by title insurance companies, separately in competition with title insurance agents, or insurers may subcontract some functions to agents or others.

Where title insurance companies perform these services, it is often not possible to allocate specific revenue or costs to a separate function such as search, examination, closing, or escrow services with any precision. Many joint costs of the insurer cannot be adequately allocated to a specific function, and some functional elements of title insurance costs tend to overlap into other areas, e.g., a portion of search and escrow costs performed by a title insurance company could be partially allocated to an underwriting function.

In order to provide for consistency in reporting financial data in the annual statement, all title insurers must strictly follow the guidelines stated in this instruction. The NAIC has dictated that title insurance revenues reported in the annual statement be differentiated as to (1) two generally acceptable premium rate types, and (2) the distribution network for direct premiums written.

However, the NAIC has recognized that the data reported in Schedule "T" of the annual statement is not intended to be used for the calculation of the amount of premium tax due. In the event the basis used for the calculation of premium tax differs from the basis required for reporting in the annual statement, the company should submit to the respective state insurance department or other premium tax collection agency a separate schedule to support its premium tax calculation.

For the purpose of reporting in Schedule "T" and other schedules or exhibits in the annual statement, the amount of title insurance premiums to be reported by premium rate type shall be guided by the following definitions of the methods of reporting "Direct Premiums Written":

1. Gross All-Inclusive Premiums - Under this method of reporting direct premiums written, the title insurer and its title agent generally perform all the functions necessary to insure the risk and to issue a title insurance policy. The title insurer reports 100% of the premiums charged either through its branch office or its title agents. Direct premiums written reported under this method generally contemplates some or all of the following factors in the rate-making process:

- a. Cost of title search and examination
- b. Policy issuing cost
- c. Amount retained by agents/abstractors/attorneys
- d. Overhead and miscellaneous expenses
- e. Expected losses and LAE from underwriting the risk
- f. Profit margin.
- g. Additional activities (such as closing) may also be included in specific states.

2. Gross Risk Rate Premiums - This method of reporting direct premiums written generally applies to states where either by statute or custom the charge for title search and examination are excluded or charged for separately from the title insurance premiums. The cost factors contemplated in the rate-making process include the proportionate share of all of the factors listed in the "Gross All-Inclusive Premiums" except for the "Cost of the title search and examination."

The applicable premium rate type in effect for each state (either gross all-inclusive or gross risk rate) is reported in the "Premium Rate" column of Schedule "T."

Generally, the direct premiums written reported in the annual statement should fall within the definitions of either Gross All-Inclusive Premiums or Gross Risk Rate Premiums. The net risk or net remittance method is not an acceptable method of reporting premiums written. In the event the company uses another method, this method must be designated as "Other" in the "Premium Rate" column of Schedule "T" for each state and must be footnoted to define the basis for varying from either the Gross All-Inclusive or Gross Risk Rate method.

In addition to designating the premium rate type in effect for each state for direct premiums written in Schedule "T," title insurance companies must report direct premiums written by the distribution network within each state. The NAIC has designated three distribution networks, with

direct premiums written reported in separate columns of Schedule "T," as well as in other schedules or exhibits of the annual statement, as follows:

1. Direct Operations - Includes direct premiums written at home office and branch office operations of the title insurer. No amounts attributable to agency operations (even wholly owned agencies) are to be included in this category.
2. Non-affiliated Agency Operations - Includes direct premiums written by non-affiliated agency operations. The standard for reporting as a non-affiliated agency is the affiliation standard established under the holding company laws of the domestic state jurisdiction.
3. Affiliated Agency Operations - Includes direct premiums written by affiliated agency operations, including wholly-owned agencies. The standard for reporting as an affiliated agency is the affiliation standard established under the holding company laws of the domestic state jurisdiction.

Revenues received for services performed by a title insurance company, other than premium, are to be reported under the "Other Income" category of Schedule "T."

EXPENSES

In the title insurance industry, there are expenses incurred in establishing and maintaining the distribution networks involved in acquiring and underwriting policies and servicing policyholders and third party claimants. Expenses are important elements of the company's operations and accurate statistics are needed for comparisons and control. The instructions for uniform classification of expenses are a part of the NAIC Examiners Handbook - Volume 1.

Expense Group Classifications

Expenses for title insurance companies are listed in the "Operations and Investment Exhibit, Part 4, Expenses" of the annual statement. Expenses are specifically identified or allocated and reported for the following groups:

1. Title and Escrow Operating Expenses - Title and escrow operating expenses consist of all expenses incurred in relation to engaging in the business of title insurance, including costs associated with the following: issuing or offering to issue a title insurance policy; soliciting or negotiating the issuance of a title insurance policy; guaranteeing, warranting or otherwise insuring the correctness of title searches affecting title to real property; handling of escrows, settlements or closings; executing title insurance policies; effecting contracts of reinsurance and abstracting, searching or examining titles. Also included are specifically identifiable and allocated expenses relating to the following activities: supervision and training of employees and agents; operating costs for branch offices or agencies; underwriting activities; receiving and paying of premiums and commissions; maintaining general and detailed records; data processing; advertising and publicity; clerical, secretarial, office maintenance, supervisory and executive duties; postage and delivery; and all other functions reasonably associated with the business of title insurance. Title and escrow operating expenses do not include losses, loss adjustment expenses (allocated or unallocated), expense of other operations or investment expenses. The expenses include only amounts incurred directly by the company, and do not include expenses incurred by any agents (regardless of ownership interest).
2. Unallocated Loss Adjustment Expenses - Unallocated loss adjustment expenses ("ULAE") are those indirect costs incurred by a title insurer, typically internal to the company, which are necessary to process claims or manage the claims settlement function and which are not incurred on a claim-specific basis. ULAE should include all costs of outside parties involved in claims adjusting services, but should not include any costs incurred by agents in settlement of title or other claims.

3. Other Operations - The amounts shown for this category represent the expenses incurred by the company in operations other than title and escrow, loss adjustment or investment activities.

4. Investment Expenses - Investment expenses are those expenses incurred in the investing of funds and the pursuit of investment income, including specifically identifiable and allocated expenses related to such activities as: initiating or handling orders and recommendations for investments; research; pricing; appraising and valuing; disbursing funds and collecting income; safekeeping of securities and valuable papers; maintaining general and detailed records; data processing; general clerical, secretarial, office maintenance, supervisory and executive duties; supplies, postage, and the like; and all other functions reasonably attributable to the investment of funds.

A company that pays management fees to an affiliate shall allocate these costs to the appropriate expense classification item (salaries, rent, postage, etc.) as if these costs had been borne directly by the company. Management or similar fees should not be reported as a one-line expense. It is appropriate for the company to estimate these expense allocations based on a formula or other reasonable basis.

Title and Escrow Operating Expenses are further broken down in the annual statement by the distribution network that gives rise to the expense incurrence. Accordingly, expenses are specifically identified or allocated (in accordance with reasonable allocation procedures consistently applied) to either Direct Operations, Non-affiliated Agency Operations or Affiliated Agency Operations. Some general guidelines for allocating these expenses to the appropriate distribution network are shown in the following table. The expense classification item (salaries, rent, postage, etc.) are those in the annual statement.

TABLE 1

General Guidelines for Classifying Expenses

Expenses to be Allocated to Distribution Network	Principal Basis for Allocation
Personnel costs:	
Salaries	Studies of employee activities
Employee relations and welfare	Pro rate on salary ratios
Payroll taxes	Pro rate on salary ratios
Other personnel costs	Pro rate on salary ratios
Amounts paid to or retained by title agents	Direct charge to non-affiliated or affiliated agents
Production services (purchased outside)	Study of company practices
Advertising	Pro rate on basis of Part 2A revenue distribution
Boards, bureaus and associations	Pro rate on basis of Part 2A revenue distribution
Title plant rent and maintenance	Study of company practices
Amounts charged off, net of recoveries	Direct charge by source of business
Marketing and promotional expenses	Pro rate on basis of Part 2A revenue distribution

Insurance	Pro rate on salary ratios
Directors' fees	Pro rate on salary ratios
Travel and travel items	Study of company practices
Rent and rent items	Pro rate on salary ratios
Equipment	Pro rate on salary ratios
Printing, stationery, books and periodicals	Pro rate on salary ratios
Postage, telephone, messengers and express	Pro rate on salary ratios
Legal and auditing	Study of company practices
Taxes, licenses and fees	Study of company practices

Any other basis of allocation should be used if it yields more precise results than expenses allocated on the salaries or revenue distribution basis.

NOTES:

Claim adjustment services are all attributable to the Unallocated Loss Adjustment Expenses group.

Real estate expenses and real estate taxes are all attributable to the Investment Expenses group.

Expenses should be specifically identified or allocated to the Unallocated Loss Adjustment Expenses group or Other Operations group based on a study of company practices and employee activities.

AMOUNTS PAID TO OR RETAINED BY TITLE AGENTS

Unlike agents representing other lines of insurance whose primary function is to sell the policy and receive a sales commission, title insurance agents also perform various functions in connection with the issuance of a title insurance policy. These functions can include search and examination, abstracting, certain underwriting and closing services. Typically, the agent collects the entire charge for the title insurance transaction, retains a portion for his services, and forwards the insurer's portion in accordance with individual agency contracts.

LOSSES AND LOSS ADJUSTMENT EXPENSES/RESERVES

Unlike most other forms of insurance, losses do not generally represent the largest liability or expense for title insurance companies. The emphasis is upon loss prevention and the duty to defend, rather than on reimbursement of losses. Therefore, title insurance companies incur large expenses in labor, equipment, etc. in maintaining title records and in searching and examining the titles to real estate and in curing defects found prior to the issuance of the policy and closing or escrow services.

The liability for unpaid losses is composed of (1) the loss reserve, net of recoveries, for undetermined title and other losses of which notice has been received (known claims reserve), (2) the statutory premium reserve, and (3) the excess of Schedule "P" reserves over statutory reserves (supplemental reserve).

Definitions

Allocated Loss Adjustment Expenses

Allocated loss adjustment expenses are those expenses that can be related to specific claims and include fees, salaries, overhead and expenses of lawyers for legal service in defense, trial or appeal of suit, other legal services rendered in connection with title claims, and general court costs and fees together with appeal costs and expenses. Allocated loss adjustment expenses should include all costs associated with attorneys involved in litigation of specific claims whether such attorneys are engaged as outside counsel or salaried employees of an insurer. The inclusion of “salaried employees” in the definition of allocated loss adjustment expenses is effective January 1, 1996. Allocated loss adjustment expenses also include any fee or expense, other than claim adjuster services, which is directly attributable to the defense of a particular claim. See definition of Unallocated Loss Adjustment Expenses below.

Incurred But Not Reported Reserve

The incurred but not reported reserve (“IBNR”) is an amount estimated to cover all unpaid losses, claims and allocated loss adjustment expenses arising under title insurance policies, guaranteed certificates of title, guaranteed searches and guaranteed abstracts of title, and all unpaid losses, claims and allocated loss adjustment expenses for which the title insurer may be liable and for which the insurer has not received notice by or on behalf of the insured, holder of a guarantee or escrow or security depositor. Title insurance companies are not required to give recognition to IBNR losses in statutory reporting unless a “supplemental reserve” is required. See the definition of Supplemental Reserve below.

Known Claims Reserve

The known claims reserve (referred to as the “loss reserve for undetermined title and other losses of which notice has been received”) is the amount estimated to be sufficient to cover all unpaid losses, claims and allocated loss adjustment expenses arising under title insurance policies, guaranteed certificates of title, guaranteed searches and guaranteed abstracts of title, and all unpaid losses, claims and allocated loss adjustment expenses for which the title insurer may be liable and for which the insurer has received notice by or on behalf of the insured, holder of a guarantee or escrow or security depositor. The known claims reserve also includes “bulk” reserves, if any - a provision for subsequent development on known claims.

Statutory Premium Reserve

See the “Statutory Premium Reserve” section above. The Statutory Premium Reserve (“SPR”) is considered a liquidation reserve and is equivalent to a property and casualty company’s IBNR reserve. Certain states’ statutes also require insurance companies to segregate investments in an amount at least equal to the SPR. If a title insurer becomes insolvent, the segregated assets are used to pay future claims or purchase reinsurance to settle future claims. In addition, the SPR is intended to provide a reserve for unallocated loss adjustment expenses on all claims.

Supplemental Reserve

The supplemental reserve is the excess of Schedule “P” reserves over statutory reserves (i.e., the excess of the known claims reserve + IBNR reserve + ULAE reserve [total Schedule “P” reserves] over the known claims reserve + SPR [statutory reserves]). The supplemental reserve requirement is effective January 1, 1996. Also see “Actuarial Opinion” below.

Title Insurance Losses

Title insurance losses should include all losses on any transaction for which a title insurance premium, rate or charge was made or contemplated. Escrow losses for which the company is

contractually obligated should be included. Losses arising from defalcations for which the company is contractually obligated should also be included.

Unallocated Loss Adjustment Expenses

Unallocated loss adjustment expenses (“ULAE”) are those expenses other than allocated loss adjustment expenses that are assigned to the expense group “loss adjustment expenses” (i.e. all other expenses, typically internal, necessary to process claims or manage the claims settlement function and which are not incurred on a claim-specific basis). ULAE should include all costs of outside parties involved in claims adjusting services. Schedule “P” reserves include an Unallocated Loss Expense Unpaid component, a reserve estimated to cover all unpaid unallocated loss adjustment expenses on all claims and losses provided for in the known claims reserve and the IBNR reserve. As noted above, the SPR is intended to provide a balance sheet reserve for ULAE on all claims. The requirement to separately report ULAE in the Operating and Investment Exhibit (Part 4 - Expenses) and the ULAE reserve in Schedule “P” is effective January 1, 1996.

Loss Reserving Requirements

Valuation

A company is required to determine what the value of its claims will be when they are ultimately settled, including inflation. Therefore, in general, loss and loss adjustment expense reserves are to be presented on a non-discounted basis. Also see “Loss Reserve Discounting” below.

Known Claims Reserves

The reserve for known claims is generally determined using established reasonable baseline reserves developed by tracking and analyzing historical claims data. These estimates are reviewed and adjusted as necessary.

Incurred But Not Reported Losses and Unallocated Loss Expense Unpaid

In addition to reserving for known claims, a title insurance company must also provide a liability for losses that are incurred but not reported and for unpaid ULAE in Schedule “P,” effective January 1, 1996. Various methods are used for estimating these reserves. Whatever methods are selected for establishing unpaid losses, the goal should always be reserve adequacy. Also see “Actuarial Opinion” below.

Loss Reserve Discounting

Discounting of loss and loss adjustment expense reserves is allowed only if expressly permitted by the state insurance department to which the annual statement is being filed. If discounting of loss and loss adjustment expense reserves is reflected in an insurer’s balance sheet liabilities as included in the annual statement, then the insurer must complete a reconciliation of the discounted liability to the whole dollar value of the reserves in Schedule “P.” The insurer should also complete a note to the annual statement - Discounting of Unpaid Losses or Unpaid Loss Adjustment Expenses - as required by the annual statement instructions.

Actuarial Opinion

Effective January 1, 1996, the Schedule “P” reserves must be supported by an actuarial opinion from a qualified actuary who is a member in good standing of the American Academy of Actuaries, setting forth an opinion as to the adequacy of all loss reserves (known claims reserve, including bulk reserves (if any), + IBNR reserve + ULAE reserve).

Supplemental Reserve Computation - Schedule "P"

As noted above, the supplemental reserve, if any, is the excess of Schedule "P" reserves over statutory reserves. If a supplemental reserve is required, it shall be phased in as follows: twenty-five percent (25%) of the otherwise applicable supplemental reserve will be required until December 31, 1997; fifty percent (50%) of the otherwise applicable supplemental reserve will be required until December 31, 1998; seventy-five percent (75%) of the otherwise applicable supplemental reserve will be required until December 31, 1999; and, one hundred percent (100%) thereafter.

Recoveries from Salvage and Subrogation

Salvage and subrogation should be reflected using the following rules:

1. Paid losses must be reported net of realized, but not anticipated, salvage and subrogation. Case basis loss and loss adjustment expense reserves must not be reduced on account of anticipated salvage and subrogation.
2. Paid salvage and subrogation is not realized until a salvage asset or an actual payment pursuant to a subrogation right is in the direct control of the insurer and is admissible as an asset for statutory reporting purposes in its own right.
3. Salvage assets and payments pursuant to a subrogation right are to be booked at current market value. Current market value of real estate is to be established through an appraisal conducted by a qualified independent appraiser.
4. If a salvage asset is sold or revalued by the insurer within twelve months of realization for an amount less than the value at which it was originally placed on the books of the insurer, then the loss on disposition is to be treated as a decrease in paid salvage (same effect as an addition to the paid loss) on the corresponding claim. After twelve months, such salvage revaluation will be treated as a loss on disposition or change in value of an asset, and is not to be deducted from the salvage on the corresponding claim.
5. If a salvage asset is sold or revalued by the insurer within twelve months of realization for an amount greater than the value at which it was originally placed on the books of the insurer, then the gain on disposition is to be treated as an increase in paid salvage (same effect as a deduction to the paid loss) on the corresponding claim. After twelve months, such salvage revaluation will be treated as a gain on disposition or change in value of an asset, and is not to be added to the salvage on the corresponding claim.
6. IBNR reserves may make a provision for the expected value of future salvage and subrogation on open claims and IBNR claims. This provision must be actuarially determined and should not be based upon current case estimates.

TITLE REINSURANCE

Reinsurance is a contract whereby the reinsurer, for consideration received, agrees to indemnify the ceder or policy-issuing company in whole or in part against loss or liability which the ceder may sustain or incur under a separate and original contract of insurance ("policy") with the original insured owner, lender or lessee. The ceder or ceding company is the company which writes the policy insuring the owner, lender or lessee and cedes, lays off, or transfers to the reinsurer all or a portion of its policy risk or exposure which the reinsurer assumes or acquires under the reinsurance agreement or contract.

The principal functions of reinsurance are to provide insurers with capacity enabling them to write policies in larger amounts than could otherwise be written; to spread the risk of a potential loss in order to protect the insured's interest on very large transactions; and to protect the policy issuing company from insolvency in the event of a catastrophic loss.

Reinsurance is necessary when a title insurance company is limited to a certain amount of liability on a policy or transaction risk by either the insurer's self-imposed limitation, statutory limitation or the insured's limitation. Each title insurer internally sets a self-imposed limit where reinsurance is obtained when a policy is issued above that limit. Many states have limitations as to qualifications of insurers relating to single risk liability on risks issued on property in that state. In addition, the insureds on a title policy may also have restrictive liability limits pursuant to their own detailed analysis of a title insurer's financial strength and ability to pay a claim. These limitations are sometimes lower or more restrictive than state statutory limits or a title insurer's self-imposed limits. Therefore, on a certain risk which has all three types of limitations present, whichever limitation is lowest will determine how much reinsurance is necessary on a particular transaction. When reinsurance is purchased, the ceding company may reduce its net retained liability for the risk ceded. The reinsuring company would then be responsible for the appropriate reserves pertaining to its assumed liability or premium, subject to applicable rules and regulations of the state where the insured property is located.

Title insurance utilizes two main types of reinsurance. The most common type is facultative reinsurance that pertains to one individual, particular risk or transaction. The ceder may offer all or any part of a risk to one or more other title insurers or reinsurers who may either accept or reject that particular risk. The facultative reinsurance agreements utilized in the title industry have been developed by the American Land Title Association. The most common form utilized today is the 1994 ALTA Facultative Reinsurance Agreement. This agreement contains conditions and stipulations regarding ceder's cession and warranty, reinsurer's assumption, direct access, notices, investigation and settlement of claims, payment of losses, insolvency of ceder, recoupment and subrogation, rights of insured not prejudiced, laws applicable, actions by or on behalf of ceder, severability, notices-where sent and effective date.

Facultative reinsurance allows some flexibility in the spreading of the risk in which the ceder normally retains the primary risk and a share of the secondary level risk, which secondary level is structured on a coordinate and proportionate share among the secondary participants. There may also be other levels of reinsurance which are mainly utilized to induce reinsurers to accept more liability on larger than usual risks. These levels are called the tertiary, quaternary and quinary levels and they are each coordinate and proportionate as to each level. In other words, a reinsurer's secondary share is based on that reinsurer's secondary liability assumption divided by the total amount of secondary allocation of liability. If the ceding company retained a \$5,000,000 primary, then they are responsible for 100% of the first level or primary retention retained. If the loss exceeds the primary into the secondary level, then the reinsurers as well as the ceder must pay off per their coordinate and proportionate share of that level until the secondary level is exhausted. If there is a tertiary level, the coordinate and proportionate tertiary percentage shares as to the total tertiary level control the payment of loss. And so on as to each level of liability.

The other type of reinsurance utilized in the title industry is called treaty reinsurance. This is mainly utilized by smaller companies that have a much smaller self-imposed or statutory limit and do not have the personnel to handle individual facultative agreements on each policy written over their threshold liability limit. This is usually done on an excess of loss basis where a treaty contract is negotiated where ceder is indemnified against loss in excess of a specified retention, normally subject to a specified limit, with respect to each risk covered by the treaty. Normally, the treaty contract specifies contingencies in the event the risk is greater than the treaty contract terms and therefore not covered under the treaty. Either the ceder may have to purchase facultative reinsurance, or the treaty reinsurer would assume all liability under the risk subject to the treaty ceder's primary retention and purchase its own facultative reinsurance on the liability in excess of the treaty limitations.

Schedule "F" of the annual statement summarizes relevant information for both assumed and ceded reinsurance.

SEGREGATED FUNDS HELD FOR OTHERS

Title insurers provide services in which they have custody and are accountable for cash and other assets belonging to others. Generally these services relate to real estate settlement services in which closing "escrow" funds are received and disbursed and note and contract collection services in which payments of principal and interest are received and disbursed. In addition, title insurers may hold cash or other assets as security for indemnity agreements with the company and others relating to title matters.

These "custodial" funds are set apart in special accounts and are excluded from title insurer's assets and liabilities in the statutory statement. However, the title insurer's accountability for these "custodial" funds is reported in a footnote and the detail of segregated deposits of these funds in banks, trust companies, and savings and loan associations are reported in Schedule "E" of the annual statement.

23. The Title Insurers Model Act was adopted by the Title Insurance Working Group of the Special Insurance Issues (E) Committee on December 4, 1995 and was adopted by the full membership of the NAIC at the March, 1996 Plenary Session (only the pertinent excerpts are included below):

Section 3. Definitions

W. "Title Plant" means a set of records consisting of documents, maps, surveys or entries affecting title to real property or any interest in or encumbrance on the property, which have been filed or recorded in the jurisdiction for which the title plant is established or maintained.

Section 9. Admitted Asset Standards

In determining the financial condition of a title insurer doing business under this Act, the general investment provisions of [insert reference to applicable provision of the insurance code governing investments] shall apply, except that an investment in a title plant or plants in an amount equal to the actual cost shall be allowed as an admitted asset for title insurers. The aggregate amount of the investment shall not exceed the lesser of twenty percent (20%) of admitted assets or forty percent (40%) of surplus to policyholders, as shown on the most recent annual statement of the title insurer on file with the commissioner.

Section 10. Reserves

In determining the financial condition of a title insurer doing business under this Act, the general provisions of the insurance code requiring the establishment of reserves sufficient to cover all known and unknown liabilities including allocated and unallocated loss adjustment expense, shall apply, except that a title insurer shall establish and maintain:

- A A known claim reserve in an amount estimated to be sufficient to cover all unpaid losses, claims and allocated loss adjustment expenses arising under title insurance policies, guaranteed certificates of title, guaranteed searches and guaranteed abstracts of title, and all unpaid losses, claims and allocated loss adjustment expenses for which the title insurer may be liable, and for which the insurer has received notice by or on behalf of the insured, holder of a guarantee or escrow or security depositor.
- B. A Statutory or Unearned Premium Reserve consisting of:
 - (1) The amount of statutory or unearned premium reserve required by the laws of the domiciliary state of the insurer if the insurer is a foreign or non-U.S. title insurer; or
 - (2) If the insurer is a domestic insurer of this state, a statutory or unearned premium reserve consisting of:

- (a) The amount of the statutory or unearned premium or reinsurance reserve on the effective date of this Act, which balance shall be released in accordance with the law in effect at the time such sums were added to the reserve; and
- (b) Out of total charges for policies of title insurance written or assumed commencing with the effective date of this Act, and until December 31, 1997, a title insurer shall add to and set aside in this reserve an amount equal to [insert amount] of the sum of the following items set forth in the title insurer's most recent annual statement on file with the commissioner:
 - (i) Direct premiums written;
 - (ii) Escrow and settlement service fees;
 - (iii) Other title fees and service charges including fees for closing protection letters; and
 - (iv) Premiums for reinsurance assumed less premiums for reinsurance ceded during year.
- (c) Additions to the reserve after January 1, 1998 shall be made out of total charges for title insurance policies and guarantees written, equal to the sum of the following items, as set forth in the title insurer's most recent annual statement on file with the commissioner:
 - (i) For each title insurance policy on a single risk written or assumed after January 1, 1998, [insert amount] per \$1,000 of net retained liability for policies under \$500,000 and [insert amount] per \$1,000 of net retained liability for policies of \$500,000 or greater; and
 - (ii) [Insert amount] of escrow, settlement and closing fees collected in contemplation of the issuance of title insurance policies or guarantees.
- (d) The aggregate of the amounts set aside in this reserve in any calendar year pursuant to Subsections B(2)(b) and B(2)(c) shall be released from the reserve and restored to net profits over a period of twenty (20) years pursuant to the following formula: thirty-five percent (35%) of the aggregate sum on July 1 of the year next succeeding the year of addition; fifteen percent (15%) of the aggregate sum on July 1 of each of the succeeding two (2) years; ten percent (10%) of the aggregate sum on July 1 of the next succeeding year; three percent (3%) of the aggregate sum on July 1 of each of the next three (3) succeeding years; two percent (2%) of the aggregate sum on July 1 of each of the next three (3) succeeding years; and one percent (1%) of the aggregate sum on July 1 of each of the next succeeding ten (10) years.
- (e) The insurer shall calculate an adjusted statutory or unearned premium reserve as of the effective date of this Act. The adjusted reserve shall be calculated as if Subsections B(2)(b) through (B(2)(d) of this section had been in effect for all years beginning twenty (20) years prior to the effective date of this Act. For purposes of this calculation, the balance of the reserve as of

that date shall be deemed to be zero. If the adjusted reserve so calculated exceeds the aggregate amount set aside for statutory or unearned premiums in the insurer's annual statement on file with the commissioner on the effective date of this Act, the insurer shall, out of total charges for policies of title insurance, increase its statutory or unearned premium reserve by an amount equal to one-sixth of that excess in each of the succeeding six years, commencing with the calendar year that includes the effective date of this Act, until the entire excess has been added.

- (f) The aggregate of the amounts set aside in this reserve in any calendar year as adjustments to the insurer's statutory or unearned premium reserve pursuant to Subsection B(2)(e) shall be released from the reserve and restored to net profits, or equity if the additions required by Subsection B(2)(e) of this section reduced equity directly, over a period not exceeding ten (10) years pursuant to the following table:

Year of Addition	Release
Year 1*	Equally over 10 years
Year 2	Equally over 9 years
Year 3	Equally over 8 years
Year 4	Equally over 7 years
Year 5	Equally over 6 years
Year 6	Equally over 5 years

* (The calendar year following the effective date of this Act).

- C. A supplemental reserve shall be established consisting of any other reserves necessary, when taken in combination with the reserves required by Subsections A and B of this section, to cover the company's liabilities with respect to all losses, claims and loss adjusted expenses.
- D. Each title insurer subject to the provisions of this Act shall file with its annual statement required under [insert section] a certification by a member in good standing of the American Academy of Actuaries. The actuarial certification required of a title insurer must conform to the National Association of Insurance Commissioners' annual statement instructions for title insurers.
- E. [Temporary Provision] The supplemental reserve required under Subsection C of this section shall be phased in as follows: twenty-five percent (25%) of the otherwise applicable supplemental reserve will be required until December 31, 1997; fifty percent (50%) of the otherwise applicable supplemental reserve will be required until December 31, 1998; and, seventy-five percent (75%) of the otherwise applicable supplemental reserve will be required until December 31, 1999.

24. The Annual Statement Instructions for Schedule P include the following guidance (only the pertinent excerpts are included below):

Discounting of loss and loss adjustment expense reserves is allowed only if expressly permitted by the state insurance department to which this annual statement is being filed. If discounting of loss and loss adjustment expense reserves is reflected on Page 3 of this annual statement, a reconciliation is provided in Schedule P, Part 1. Work papers relating to any discount amounts must be available for examination upon request.

Generally Accepted Accounting Principles

25. FAS 60 provides the following guidance related to premium revenue recognition on long-duration contracts:

15. Premiums from long-duration contracts, such as whole-life contracts (including limited-payment and single-premium life contracts), guaranteed renewable term life contracts, endowment contracts, annuity contracts, and title insurance contracts, shall be recognized as revenue when due from policyholders.

16. Premiums from title insurance contracts shall be considered due from policyholders and, accordingly, recognized as revenue on the effective date of the insurance contract. However, the binder date (the date a commitment to issue a policy is given) is appropriate if the insurance enterprise is legally or contractually entitled to the premium on the binder date. If reasonably estimable, premium revenue and cost relating to title insurance contracts issued by agents shall be recognized when the agents are legally or contractually entitled to the premiums, using estimates based on past experience and other sources. If not reasonably estimable, premium revenue and costs shall be recognized when agents report the issuance of title insurance contracts.

26. FAS 60 provides the following guidance related to claim cost recognition:

17. A liability for unpaid claim costs relating to insurance contracts other than title insurance contracts, including estimates of costs relating to incurred but not reported claims, shall be accrued when insured events occur. A liability for estimated claim costs relating to title insurance contracts, including estimates of costs relating to incurred but not reported claims, shall be accrued when title insurance premiums are recognized as revenue (paragraphs 15 and 16).

18. The liability for unpaid claims shall be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience.⁴ Changes in estimates of claim costs resulting from the continuous review process and differences between estimates and payments for claims shall be recognized in income of the period in which the estimates are changed or payments are made. Estimated recoveries on unsettled claims, such as salvage, subrogation, or a potential ownership interest in real estate, shall be evaluated in terms of their estimated realizable value and deducted from the liability for unpaid claims. Estimated recoveries on settled claims other than mortgage guaranty and title insurance claims also shall be deducted from the liability for unpaid claims.

⁴ Certain disclosures are required if the time value of money is considered in estimating liabilities for unpaid claims and claim adjustment expenses relating to short-duration contracts (paragraph 60.d.).

19. Real estate acquired in settling mortgage guaranty and title insurance claims shall be reported at fair value, that is, the amount that reasonably could be expected to be received in a current sale between a willing buyer and a willing seller. If no market price is available, the expected cash flows (anticipated sales price less maintenance and selling costs of the real estate) may aid in estimating fair value provided the cash flows are discounted at a rate commensurate with the risk involved. Real estate acquired in settling claims shall be separately reported in the balance sheet and shall not be classified as an investment. Subsequent reductions in the reported amount and realized gains and losses on the sale of real estate acquired in settling claims shall be recognized as an adjustment to claim costs incurred.

20. A liability for all costs expected to be incurred in connection with the settlement of unpaid claims (claim adjustment expenses) shall be accrued when the related liability for unpaid claims is accrued. Claim adjustment expenses include costs associated directly with specific claims paid or in the process of settlement, such as legal and adjusters' fees. Claim adjustment expenses

also include other costs that cannot be associated with specific claims but are related to claims paid or in the process of settlement, such as internal costs of the claims function.⁵

⁵ Title insurance internal claim adjustment expenses, which generally consist of fixed costs associated with a permanent staff handling a variety of functions including claim adjustment, ordinarily are expensed as period costs because the costs are insignificant.

27. Accounting for title plant is contained in FAS 61, as amended by FAS 121. Pertinent excerpts are as follows:

1. A title plant consists of (a) indexed and catalogued information for a period concerning the ownership of, and encumbrances on, parcels of land in a particular geographic area; (b) information relating to persons having an interest in real estate; (c) maps and plats; (d) copies of prior title insurance contracts and reports; and (e) other documents and records. In summary, a title plant constitutes a historical record of all matters affecting title to parcels of land in a particular geographic area. The number of years covered by a title plant varies, depending on regulatory requirements and the minimum information period considered necessary to issue title insurance policies efficiently. Title plants are updated on a daily or other frequent basis by adding copies of documents on the current status of title to specific parcels of real estate.

3. Costs incurred to construct a title plant, including the costs incurred to obtain, organize, and summarize historical information in an efficient and useful manner, shall be capitalized until the title plant can be used by the enterprise to do title searches. To qualify for capitalization, costs need to be directly related to, and properly identified with, the activities necessary to construct the title plant.

4. Purchased title plant, including a purchased undivided interest in title plant, shall be recorded at cost at the date of acquisition. For title plant acquired separately, cost shall be measured by the fair value of consideration given.

5. An enterprise may decide to construct or purchase a title plant that antedates the period covered by its existing title plant (backplant). Costs to construct a backplant need to be identifiable to qualify for capitalization.

6. Capitalized costs of title plant shall not be depreciated or charged to income unless circumstances indicate that the carrying amount of the title plant has been impaired.

7. Costs incurred to maintain a title plant and to do title searches shall be expensed as incurred. Title plant maintenance involves the updating of the title plant on a daily or other frequent basis by adding (a) reports on the current status of title to specific parcels of real estate and (b) other documents, such as records relating to security or other ownership interests. Title searches involve the process of searching through records for all recorded documents or updating information summarized in the most recently issued title report.

8. Costs incurred after a title plant is operational (a) to convert the information from one storage and retrieval to another or (b) to modify or modernize the storage and retrieval system shall not be capitalized as title plant. Those costs, however, may be capitalized separately and charged to expense in a systematic and rational manner.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy

- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 10, *Losses*, and Chapter 11, *Loss Adjustment Expenses*, Appendix B, *Title Insurance Accounting Principles Supplement*
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 37—Mortgage Loans*
- *Issue Paper No. 40—Real Estate Investments*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force*
- *Issue Paper No. 53—Property and Casualty Contracts - Premiums*
- *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*
- Title Insurers Model Act, dated April 1996
- NAIC Annual Statement Instructions Title

Generally Accepted Accounting Principles

- *FASB Statement No. 5, Accounting for Contingencies*
- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 61, Accounting for Title Plant*
- *FASB Statement No. 121, Accounting for The Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*

State Regulations

- Review of state regulations for 38 states with respect to premium reserves.