

A.M. Best's Title Insurance Rating Methodology

Introduction to A.M. Best Ratings Process

A .M. Best's rating process for title insurance companies is intended to evaluate a company's ability to meet its ongoing obligations to policyholders. The criteria to evaluate a company's financial strength and credit quality are based on an in-depth analysis of both quantitative and qualitative measures, including balance-sheet strength, operating performance and business profile. These three criteria then are compared with A.M. Best's quantitative benchmarks and qualitative standards to determine the financial strength (FSR) and issuer credit (ICR) ratings (see Sidebar: Financial Strength Ratings Scale and Translation to Credit Market Scale or Issuer Credit Ratings).

A.M. Best's rating opinions are prospective, in that they evaluate not only a company's current financial position, but also how that position is likely to evolve in the future. While the evaluation of financial strength and credit quality is specific to the quantitative results of the company being analyzed, such measures also are compared with the industry composite. These composite benchmarks are based on the capitalization and operating performance of most insurers within the title insurance industry.

The three criteria listed above can be viewed as components of a ratings "pyramid" that parallels the ratings scale. Balance-sheet strength, which forms the base of the pyramid, is the most important criterion in the rating evaluation, since the level and quality of capitalization are the foundation of a company's ability to meet ongoing obligations to policyholders. Operating performance, which forms the next layer of the pyramid, then determines how balance-sheet strength is maintained, enhanced or eroded over time. The upper layer of the pyramid is composed of a company's business profile, which encompasses the extent of a company's market power depending upon

its historical presence in a given market and in the industry as a whole; the loyalty to its brand among customers and agents; and its scale, which impacts its ability to influence pricing and market trends. The very apex of the pyramid represents management quality, which itself is a component of business profile. While balance-sheet strength is the foundation of the rating, the other components of the pyramid gradually assume more importance as a company's position on the rating scale increases (see Sidebar: Pyramid of Key Rating Components).

The rating evaluation also takes into account the risk component of the company's balance-sheet strength, operating performance and business profile. It evaluates all sources of risk, including financial leverage, which may involve evaluation of any debt that is carried at a parent or holding-company level; underwriting leverage, including direct premium leverage and dependence on reinsurance; loss-reserve leverage; investment leverage and its impact on liquidity; and risks relating to geographic concentration, the regulatory environment and changing economic and market conditions.

Finally, the A.M. Best rating process is interactive, which involves meeting with company management; analysis of publicly available financial data; requests for data from companies that are not publicly available; compilation and analysis of all company-provided data; and ongoing monitoring of a company's financial position. A.M. Best believes that such an interactive process results in a more credible and transparent rating opinion.

Benefits of a Rating From A.M. Best

- Validates the financial strength of a title insurance company
- Facilitates debt issuance
- Enhances access to residential and commercial markets
- Promotes credibility with regulators, policyholders and stockholders
- Offers benchmarking standards
- Facilitates expansion into international markets

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Uniqueness of Title Industry and Impact on Rating Process

A.M. Best recognizes that while its rating process generally is applicable to the rating of all insurance companies and groups, the evaluation of title insurance companies must take into account the key differences of title from other lines of insurance and the role that title insurance plays in the overall economy, as well as the susceptibility of title underwriting performance to interest-rate swings and real estate cycles.

Industry Overview

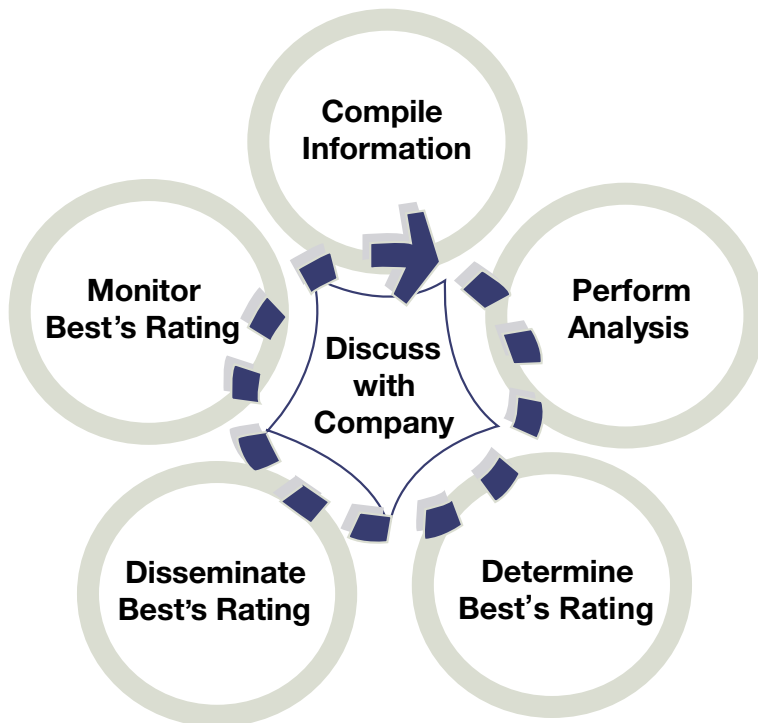
The title industry plays a critical role in the U.S. economy by facilitating the growth of the secondary mortgage market, as the process of insuring the proper transfer of real estate from seller to buyer is critical to the real estate transfer process. At any real estate closing, the parties involved must be assured that the title of the subject real property is as represented.

The functions of search and examination of title concerning the legal interest affecting the title to real property compose the title insurance underwriting process. The search-and-examination process very often includes

the curing of defects to title necessary to complete the transaction. Since there are few properties with perfect title conditions, title insurance was developed to guarantee the current status of title. The title search and examination can require the search of numerous public documents, including tax, court judgment, deed, encumbrances, etc. Despite increasing automation, this process is often quite labor intensive. Title insurance policies are meant to indemnify an owner's or lender's financial interest in real property for any covered loss caused by a defect in title that existed as of the effective date of the policy.

The title insurance industry is highly concentrated, with five national writers accounting for more than 90% of total industry premium. However, there are regional players with long-standing presence in local markets that do provide effective competition to the national writers. Another industry trend, especially

The Interactive Rating Process



A.M. Best Co.

Methodology

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Best's Ratings reflect the A.M. Best Company's opinion based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile and, where appropriate, the specific nature and details of a rated debt security. These ratings are not a warranty of an insurer's current or future ability to meet its contractual obligations, nor are they a recommendation to buy, sell or hold any security. Further, any and all information herein is provided "as is," without warranty of any kind, expressed or implied. A.M. Best Company receives compensation for its interactive financial strength ratings, from the insurance companies it rates. In compliance with the Securities Act of 1933, A.M. Best also discloses that it receives rating fees from most issuers of the debt securities it rates. Those fees fall within a range of \$ 7,500 to \$ 500,000.

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among some national writers, is the effort to diversify their revenue base by expanding into other real estate-related businesses such as mortgage and information processing, tax and credit reporting services.

Key Differences of Title Insurance From Property/Casualty Insurance

While similar to certain P/C lines such as surety and boiler and machinery in its loss-prevention characteristics, title insurance involves the acceptance of past transactional events rather than future occurrence events associated with all other property and casualty exposures. In addition, title insurance, unlike most other property/casualty exposures, has no termination date and no time limitation on filing claims.

While comparisons on an operating ratio basis yield similar results for both title and P/C companies, there are important differences for combined ratio and investment ratio, which are the major components of the operating ratio. Since title insurance usually involves the acceptance of prior transaction-related risk rather than future risk, the underwriting process in the title insurance industry differs markedly from the typical property/casualty underwriting process. The title underwriting process is based on loss prevention designed to limit risk exposure through a thorough search of the recorded documents affecting a particular property. Property/casualty underwriters are concerned with determining the probability of loss based on the characteristics of the insured, while title underwriters are concerned with reducing the possibility of loss by discovering as much information as possible about the past through extensive searches of public records and stringent examinations of title. This results in typical loss and loss-adjustment expense ratios of 4% to 10% for title insurers, compared with the 70% to 90% typical of the P/C industry.

The title industry is characterized by high fixed costs, with typical total underwriting expense ratios of 85% to 95%, unlike the P/C industry, where expense ratios are comparatively lower, ranging typically from 20% to 30%. This is because title insurers must physically produce policies, which is labor and system intensive. A typical property/casualty policy might involve filling out some blanks on a form, while the title policy might require the transcription of a complex legal description unique to the insured property, along with enumeration of often equally complex and unique terms of easements or other special property rights. In property and liability lines,

agents' commissions are generally in the range of approximately 5% to 25% of premium on policies that agents write. In title insurance, the agent retains a much larger proportion, generally 70% to 85% of the amount charged, depending on the state, which usually sets commission rates for title agents. Commissions for title insurance are more properly described as agent's retention or agent's labor or work charges. Agents' activities not only reflect a sales commission but incorporate underwriting, loss prevention and administration costs that title insurers would incur if policies were issued directly. These unique characteristics of the title insurance industry, combined with the necessity of maintaining a title plant or searching public records, contribute to the high fixed costs. The general underwriting examination and search requirements, coupled with the disarray and geographical dispersion of records, has fostered the development of privately owned, indexed databases or title plants. These title plants must be maintained regardless of the level of real estate activity during any given period. The cost to maintain the economic life of a title plant and continuously update the records is moderately high. This is one factor adding to the higher overall fixed-cost percentage for title insurers as compared with property/casualty insurers.

Title insurers also typically generate far lower investment income as compared with property/casualty companies because of low underwriting losses, and reserves are a far less significant component of the balance sheet than for P/C insurers. This results in lesser amounts of capital available for investments. The typical title insurer has an

Typical Rating Information Requested

1. Annual financial reports – latest five years preferably or credible projections for a less-experienced or start-up company
2. Audited financial statements for parent and subsidiary companies, if applicable
3. Actuarial reports, both internal and external
4. Corporate structure and history
5. Management structure and key executive committees
6. Biographical information on principal officers
7. Operating and business plans
8. Capital management strategies
9. Any other information management believes is relevant to the rating process
10. Any other reasonable information requested by A.M. Best, including but not limited to:
 - (a) Estimated impact (net and gross) from economic or other unusual events
 - (b) Details of changes in ownership, management, products or operations
 - (c) Projection of year-end results
 - (d) Plans to mitigate losses and/or to correct an identified problem
11. Pro forma projections for title insurer and parent, if applicable
12. History of losses and premiums
13. Organization structure for parent organization and subsidiaries
14. Additional data as needed

investment income ratio of 3% to 6%, compared with 8% to 15% for a P/C company. Thus, while individual components of the operating ratio differ significantly when comparing title with P/C companies, the 10-year average operating ratios are similar at approximately 92%.

The title industry generally operates on a much higher premium-to surplus ratio than does the average P/C insurer. This is due to the title industry's loss reserves, which are far more stable, have less adverse development and represent less exposure to the industry's surplus. Therefore, surplus required to protect against unexpected events is typically lower. This differs significantly from the experience of property/casualty companies, which require a relatively larger surplus cushion to protect property underwriters from catastrophes or casualty underwriters from adverse loss-reserve development. Reported net-premium-to-surplus ratios typically range from 4-1 to 6-1 for the title insurance industry, compared with 2-1 or significantly less for the P/C industry.

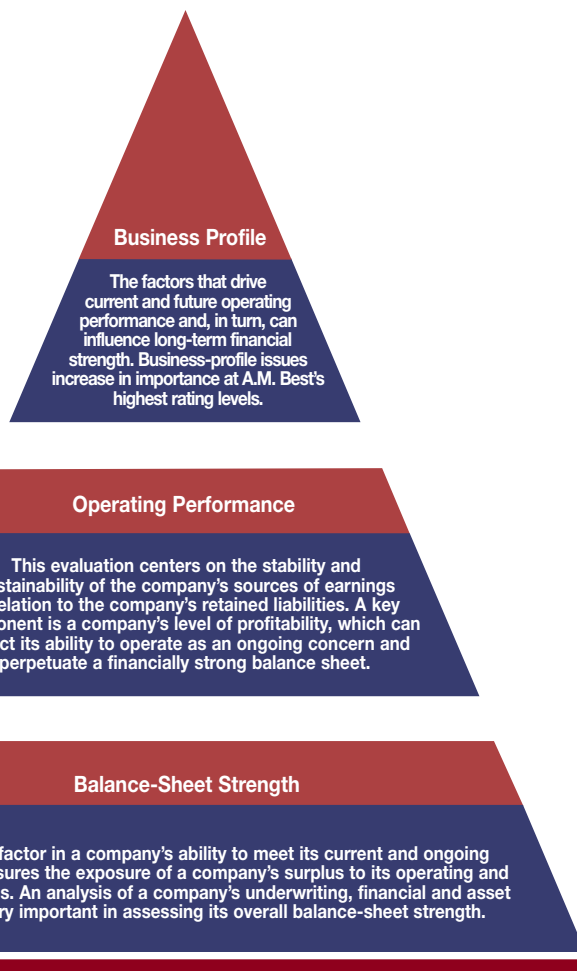
Title insurers carry a statutory liability known

as the statutory premium reserve (SPR), which is mandated by each state to be kept aside to provide ultimate loss protection to policyholders. This is in addition to the Known Claims Reserve (KCR). Rules for maintaining the level and length of time of these reserves vary by state. To compare companies domiciled in different states, the excess of the SPR over incurred but not reported (IBNR) reserves is treated as an adjustment to surplus when calculating a title company's overall capitalization and its leverage and return-on-surplus ratios. The excess of the change in SPR over change in IBNR is treated as an adjustment to earnings when calculating the loss ratio as well as return on revenue.

Another factor that makes comparing ratios difficult between title companies is the different methods each state uses in accounting for title premium and agent fees. Some states use the Risk Rate (RR) method, which allows agents to deduct search-and-exam fees up front. Other states use the All-Inclusive (AI) method, whereby the insurer includes the search-and-exam fees in the commission it pays to the agent. The typical commission that the insurer pays to agents in "RR" states therefore is significantly lower than that of the "AI" states. This implies that those companies that primarily do business in "RR" states are likely to have significantly lower expense ratios than companies operating in "AI" states, thereby making combined ratios (termed "composite" ratio in title insurance terminology) difficult to compare between companies that primarily do business in different jurisdictions. Therefore, the preferred method of comparing results among title companies is to use the return on surplus measure.

The title industry is more susceptible to changes in the real estate cycle than is the P/C industry. As real estate closings generate title orders, the title industry is far more dependent on changes in real estate market conditions, and therefore, premiums and profitability are far more sensitive to interest rate changes than in the P/C industry. The cyclical nature of title insurance, which is synchronized with the economic cycle rather than the underwriting cycle that characterizes the P/C industry, is a major factor in the evaluation of title insurance companies and their ability to withstand downturns in the economy and the real estate market. Since relative to P/C lines, a significant portion of the cost structure is fixed, sudden declines in revenue can have a disproportionate impact on profitability. Companies that have more flexible operating cost structures,

Key Rating Components



as evidenced by better management of the distribution mix (agency versus direct), are in a better position to respond to rapidly changing economic conditions.

Title insurance companies are also subject to agency defalcation risk. Defalcation occurs when agents illegally divert fiduciary escrow funds without authority. Defalcation losses are similar to catastrophe losses experienced by property/casualty insurers. Agent defalcation claims are the only shock-loss type of claim that has concentrated geographic reach, depending upon the region controlled by the defrauding agent.

unique to title insurers need to be incorporated in their evaluation for a more accurate analysis.

Leverage Tests and Capitalization

Measurement and analysis of a title insurer’s underwriting, asset and financial leverage are key components in determining its capital adequacy. The primary objective of an evaluation of balance-sheet strength is to determine the exposure of a company’s surplus to operating and financial risks. While a highly leveraged company can demonstrate strongly favorable rates of return on surplus, it also may be exposed to a greater degree of volatility in its earnings and may be hindered in its ability to withstand financial and market risk events. Companies that are more conservatively leveraged, however, may not show high rates of return on surplus, but they generally produce earnings that are less volatile and are generally better able to manage risks to surplus. Because title insurance is a loss-prevention line of business that results in low loss ratios and a resulting low level of required loss reserves, title insurers can and often do have

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Rating Methodology For Title Insurance Companies

Although A.M. Best’s approach to the evaluation of a title insurer’s financial strength and creditworthiness is similar to its approach toward other insurance entities, A.M. Best also recognizes within its evaluation certain unique aspects of title insurance that distinguish it from other forms of insurance. Implicit in this analysis is an assessment of an insurer’s enterprise risk management, which includes an evaluation of the degree of underwriting, market, financial and economic risks and management’s ability to monitor, manage and mitigate these risks. The evaluation of a title insurer also includes both quantitative and qualitative comparisons with industry peers as a measure of the rating’s appropriateness. The resulting rating is an opinion on a title insurer’s financial strength as determined by its current and ongoing ability to meet its obligations to policyholders and creditors.

Balance-Sheet Strength

As mentioned previously, balance-sheet strength forms the base of the ratings “pyramid,” as all securely rated companies must demonstrate adequate capitalization, which represents the foundation of a company’s financial strength and flexibility. There are several criteria for measuring balance-sheet strength, and while many of these criteria apply to all insurance entities, certain features

Translation of Financial Strength Rating to Credit Market Scale

	Financial Strength Rating	Credit Market Scale	
Secure	A++	aaa	Investment Grade
		aa+	
	A+	aa	
		aa-	
	A	a+	
		a	
	A-	a-	
	B++	bbb+	
		bbb	
	B+	bbb-	
Vulnerable	B	bb+	Non-Investment Grade
		bb	
	B-	bb-	
	C++	b+	
		b	
	C+	b-	
	C	ccc+	
		ccc	
	C-	ccc-	
		cc	
D	c		
E, F	d		

significantly higher premium leverage than their P/C counterparts. However, in measuring leverage ratios for title insurers, A.M. Best recognizes that because of statutory premium reserve requirements as mandated by title insurance regulators in most states, reported surplus generally is understated, which results in inflated leverage measures.

Ratios therefore are calculated both on a reported surplus basis and on surplus adjusted for excess statutory premium reserves when evaluating underwriting, asset and financial leverage. Leverage ratios on a reported basis tend to be significantly higher than those measured on an adjusted basis. Underwriting leverage includes premium writings to surplus, which is a measure of the exposure of a company's capital to risk of underpricing its book of business. Other measures of underwriting leverage include net liabilities to surplus, which measures exposure of unpaid obligations

to surplus, and premiums and reserves ceded and related reinsurance recoverables to surplus, which measure reinsurance dependence. Since title insurance companies do not normally rely on traditional reinsurance, the latter measure is usually negligible. To assess the appropriateness of a company's underwriting leverage, consideration is also given to its geographic spread of risk; quality and diversification of its asset base; type of title insurance business written (residential versus commercial); and distribution mix (agency versus direct). A.M. Best also evaluates asset leverage, which measures the exposure of a title insurer's surplus to investment, credit and interest rate risks. These leverage measures take into account the credit quality, market volatility and asset-class concentration of a title insurer's investment portfolio and its impact on balance-sheet strength. A.M. Best also reviews a company's financial

Comprehensive Analysis

Below are details of key quantitative and qualitative factors that A.M. Best's analysts use in the evaluation of a title insurance company. Most factors are universally important to all insurance companies, including title insurers. In the case of several quantitative rating factors, including loss and combined ratios, underwriting and asset leverage ratios, and return on revenue and policyholder surplus, A.M. Best evaluates these ratios on both a reported surplus and an earnings basis, as well as on surplus and earnings adjusted for excess statutory premium reserves, which are unique to the title insurance industry. Examples of key qualitative rating factors include spread of risk, competitive market position and management experience. The relevant weight given to any one factor varies by rating level and the specifics of the company. Many of the quantitative rating factors detailed below will appear in the tables included in the full rating analysis report that supports Best's Rating Opinion.

Key Capitalization Tests:

Net Premiums Written to Policyholder Surplus. This ratio measures the company's exposure to pricing errors in its current book of business.

Net Liabilities to Policyholder Surplus. This ratio measures a company's exposures to errors of estimation in its loss reserves and all other liabilities. The higher the loss-reserve leverage, the more critically a company's solvency depends upon having and maintaining adequate reserves.

Net Leverage. This ratio measures the combination of a company's net exposure to pricing errors in its current book of business and to errors of estimation in its net liabilities after any reinsurance, in relation to surplus.

Gross Leverage. This ratio measures a company's gross exposure to pricing errors in its current book of business and to errors in estimating its liabilities, and exposure to any reinsurers, in relation to surplus.

Key Loss-Reserve Tests:

Loss and Loss-Adjustment Expense Reserves to Policyholder Surplus. This ratio measures the trend and magnitude of loss reserves to surplus. The higher the multiple of loss reserves to surplus, the more critical reserve adequacy becomes to an insurer's solvency.

Development to Policyholder Surplus. This ratio reflects the degree to which year-end surplus was either overstated or understated in each of the past several years.

Key Liquidity Tests:

Quick Liquidity. This ratio measures the proportion of net liabilities covered by cash and investments that can be converted quickly to cash.

Current Liquidity. This ratio measures the proportion of liabilities covered by unencumbered cash and unaffiliated investments.

Overall Liquidity. This ratio indicates a company's ability to cover net liabilities with total assets.

Operating Cash Flow. This test measures a company's ability to meet current obligations through the internal generation of funds from insurance operations.

Non-Investment Grade Bonds (Class 3 – 6 Bonds) to Policyholder Surplus. This test measures exposure to non-investment grade bonds as a percentage of surplus.

leverage, which measures to what extent debt or debtlike instruments may place a burden on a title insurer's earnings and consequently impact its cash flow. Common measures of financial leverage include debt-to-capital and debt-to-equity ratios, as well as coverage ratios, which measure the extent to which a company's earnings and cash flow cover interest payments and other fixed obligations. However, in determining whether a company's financial leverage is excessive, consideration also is given to management's history in managing debt. In cases where a title insurer has a parent, the analysis is conducted at the holding-company level. Holding companies and their associated capital structures can have a significant impact on a subsidiary company's financial strength. While holding-company structures can provide greater financial flexibility and access to capital to a title insurance subsidiary,

any debt or debtlike obligations at the holding-company level also can reduce financial flexibility and place greater strain on future growth in earnings and surplus of the operating subsidiary. A holding company may have obligations comprising debt, preferred stock or hybrid securities in its capital structure. Therefore, A.M. Best places great emphasis on evaluating the quality of capital of both the operating company and its parent, reviewing both the debt and equity components of individual securities in determining overall financial leverage.

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Methodologies

A.M. Best's Ratings & the Treatment of Debt
— October 2004

Key Profitability Tests:

Loss Ratio. This ratio measures the company's underlying profitability, or loss experience, on its total book of business.

Expense Ratio. This ratio measures the company's operational efficiency in underwriting its book of business.

Combined Ratio (also known as Composite Ratio). This ratio measures the company's overall underwriting profitability, including escrow and other title fees and services. A combined ratio of less than 100 indicates the company has reported an underwriting profit.

Operating Ratio. The operating ratio measures a company's pretax operational profitability from underwriting and investment activities. An operating ratio of less than 100 indicates the company has reported an operating profit.

Pretax Return on Revenue. This ratio measures a company's operating profitability on its core business before capital gains/losses and income taxes.

Yield on Invested Assets. This ratio measures the average return on a company's invested assets before capital gains/losses and income taxes.

Change in Policyholder Surplus. This ratio measures the annual change in a company's policyholder surplus derived from operating earnings, investment gains, net contributed capital and other miscellaneous sources.

Total Return on Policyholder Surplus. This ratio measures a company's efficiency in utilizing its surplus on a total-return basis. "Total return" is calculated as the after-tax profitability from all underwriting and investment activity, including realized and unrealized capital gains.

Key Business Profile Issues:

Spread of Risk. Analysis of a company's book of business in terms of diversification by geography, product segment and distribution channel.

Revenue Composition. An analysis of net premium volume is important to determine changes in the amount, product segment, geographic spread, distribution type and volatility of business written by a company, which can have either a beneficial or an adverse effect on its prospective profitability. Underwriting income, investment income, capital gains, asset values and consequently surplus can be affected significantly by external changes in economic, regulatory, legal and financial market environments.

Management. The experience and depth of management are important determinants for companies in achieving operational success.

Competitive Market Position. An analysis of a title insurer's operating strategy and competitive advantages is essential to assess a company's ability to respond to market challenges, economic volatility and regulatory changes in relation to its book of business.

Market Risk. Market risk reflects potential volatility in real estate markets, changes in the mortgage and financial services industry, and interest-rate movements, all of which may impact a title insurance company's prospective revenues and earnings.

Event Risk. Event risk can encompass a variety of sudden or unexpected circumstances that may arise and potentially impact an insurer's financial strength and its Best's Rating.

Adequacy of Loss Reserves

Although title insurers have relatively low levels of case loss reserves called Known Claim Reserves (KCR), they also carry statutory premium reserves (SPR) as liabilities on their balance sheet. The comparison of SPR and KCR reserves to estimated IBNR and KCR determines whether a title insurer is reserved adequately. If SPR and KCR is less than the combined IBNR and KCR, then a supplemental reserve must be posted to make up the difference. However, if the SPR and KCR is greater than the IBNR and KCR, then the resulting “excess reserves” are included as a component of surplus in A.M. Best’s evaluation of a title insurer’s overall capitalization.

Quality and Diversification Of Assets

The quality and diversification of a title insurer’s invested assets is an important indicator of its balance-sheet strength and overall financial stability. The quality of assets is evaluated to assess the risk of default and premature liquidation. Greater diversification also contributes to greater stability of investment income and lessens the impact of a default on the balance sheet. A.M. Best reviews a title insurer’s investment portfolio for any concentration of asset classes, geographic and industry spread of risk, and the presence of any large single investment that exceeds 10% of a company’s total capital. Title insurers that hold illiquid, concentrated and/or speculative assets may experience high volatility in investment earnings from sudden changes in economic and market conditions, which could pose greater risks to policyholder surplus.

Liquidity

A title insurer’s liquidity impacts its ability to meet its short- and long-term obligations to policyholders and other creditors through the holding of liquid, high-quality investments and through solid operating cash flow. A high degree of liquidity enables a title insurer to meet unanticipated needs for cash without the untimely sale of investments and fixed assets that could result in significant realized losses due to adverse market conditions. A.M. Best evaluates several liquidity measures, including quick liquidity, which measures a company’s ability to meet short-term liquidity needs with cash or assets readily convertible to cash, and current liquidity, which measures a company’s ability to meet its long-term liquidity needs with cash and unaffiliated invested assets.

A.M. Best also reviews a company’s operating and net cash flows as an indicator of its ability to meet liquidity needs, provided that they are positive, stable and large relative to cash requirements.

Operating Performance

Operating performance represents the second rung of the ratings “pyramid.” As companies move up the ratings scale, this measure of financial strength takes on greater importance. To reinforce and enhance its balance-sheet strength, a title insurer should demonstrate consistent, profitable statutory operating earnings over time. A.M. Best reviews the components of a company’s statutory earnings over the past five-year period to assess the sources of growth in earnings and how profitability measures are trending. In the case of title insurance, where companies face high fixed costs and highly volatile revenues, profitability is correlated with the ability of a company to manage its variable expenses over the course of the business cycle. Generally, title insurers that have flexible cost structures and can anticipate and adapt to sudden changes in real estate markets and rapid interest-rate movements tend to demonstrate greater consistency in generating profitable operating earnings.

Profitability

A.M. Best reviews several areas of profitability, including underwriting, investments, capital gains and losses, and total operating earnings, on both a pretax and an after-tax basis. Similar to the adjustment made to reported surplus for any excess statutory premium reserves and KCR over IBNR and KCR, reported earnings also are adjusted for any potential “earnings credit” by calculating the difference between the change in SPR and the change in net IBNR. This credit then is applied to premium and operating earnings when calculating the combined ratio (called composite ratio in the title industry) and rates of return on operating revenue and surplus on an adjusted basis. A.M. Best also recognizes that there may be differences in composite ratios and return on revenue between title insurance companies, depending on their geographic mix of business. This is because some states, called “Risk Rate” states, exclude certain premiums and their associated expenses such as title agent fees and services as part of underwriting expenses. Other states, known as “All-Inclusive” states, require all fees and services to be accounted for when calculating underwriting income or loss. Since these fees often can be a large portion of a title com-

pany's underwriting expenses and premium base, they potentially can make comparisons of composite ratios and return on revenue difficult between companies that primarily operate in states with starkly different regulatory regimes. For this reason, A.M. Best places a greater emphasis on return-on-surplus measures when comparing operating performance across the industry.

Business Profile

Business profile represents the top rung of the "ratings pyramid" and is an important qualitative component of the overall rating evaluation. Along with solid capitalization and consistent, profitable operating performance, highly rated companies must demonstrate a strong business profile that reflects the title insurer's competitive market position, the degree of risk inherent in the company's book of business, and the quality and stability of its management, which can have a significant impact on its ability to manage enterprisewide risks as well as sustain and enhance its market position.

Geographic and Product Segment Spread of Risk

Title insurance is a monoline business that derives its income from the residential and commercial real estate industry. It is also subject to highly volatile revenue and earnings, as the demand for its product depends greatly on changes in the economic environment, real estate market cycles and sudden interest-rate movements. As such, it is critical for title insurance companies to achieve greater spread of risk geographically to mitigate their product and industry concentration. Generally, larger companies with a nationwide book of business have a natural spread of risk. However, smaller companies that have a long-standing presence in certain markets and efficient distribution channels may be able to compensate for their more concentrated book of business. Although title insurance is written nationwide, approximately 50% of total premiums are written in four states: California, New York, Texas and Florida. These states, along with other densely populated states, usually have highly fragmented real estate markets that afford title insurers operating in these markets some degree of geographic diversification. While most title insurance companies are predominantly writers of residential title policies, the commercial title market represents an important source of revenue

because of the high value of premiums associated with these policies. The commercial segment also requires title insurers to have greater underwriting sophistication in writing these large policies. Title insurers that have an established presence in the commercial market segment characterized by a long history of commercial underwriting may be at a greater advantage than companies that are new to this market segment. A.M. Best takes into consideration a title insurer's geographic and product-segment spread of risk, as well as a company's operating history and market presence, to assess the quality of the company's overall spread of risk.

Competitive Market Position

As stated above, a title insurer's historical presence in markets where it operates may give it a competitive advantage over its peers. However, given that the title insurance industry is subject to high levels of fixed costs and volatile earnings, the ability of a company to respond quickly to such challenges ultimately will determine the sustainability of its competitive advantage. The ability to manage costs and use distribution channels efficiently is critical for a title insurer in maintaining a competitive advantage over its peers. Because title agents retain a significant portion of title insurance premiums, companies prefer to have a predominantly agency distribution mix during real estate down cycles; this cost structure automatically reduces expenses as revenue falls. Conversely, when real estate markets are on an upswing, resulting in stronger demand for title insurance, companies that write mostly direct business with relatively fixed labor costs may benefit more from an environment of rapid growth in revenue. Thus, companies with a flexible cost structure that can adapt quickly to changes in the real estate cycle can afford a greater degree of control over variable costs through the use of multiple distribution channels. Similarly, effective utilization and leveraging of technology, superior service, underwriting expertise, financial flexibility and access to capital will allow companies to be in a better position to both weather down cycles and take advantage of market upturns, and therefore to sustain and enhance their competitive market position.

Regulatory, Market and Event Risk

Title insurance companies, as all other insurance lines of business, are subject to state regulation. Title insurance premium and agent com-

mission rates are mandated by the state and are subject to revision, given changes in the regulatory environment. While these systemic risks are common to all market participants, title insurers also face a high degree of market risk due to the demand for their product, which is derived from the real estate and financial markets. Any adverse developments in these markets, such as changes or reforms in the financial services industry; changes in tax laws that negatively impact the mortgage and real estate industries; a sudden downturn in property prices; or a reduction in demand owing to either recessionary business and economic cycles or a sharp increase in mortgage interest rates, are likely to have a greater negative impact on title insurers whose business profile does not afford them a favorable spread of risk and a competitive market position.

Management Quality

The experience and depth of management represents a critical component in the evaluation of a company's overall business profile. Since the insurance business is based on a model of fiduciary responsibility, prudent guidance of management generally plays a more vital role than in other industries. Because of the high degree of competitive pressure in the title insurance marketplace, the ability of management to develop and execute a coherent, sustainable and

competitive operating strategy is vital to a company's long-term financial success. A.M. Best's assessment of management's active monitoring and mitigation of enterprisewide risks and a clear understanding of management's operating goals is inherent in the qualitative evaluation of a company's prospective operating performance and its ability to sustain and enhance balance-sheet strength. A.M. Best places great emphasis on ongoing communication and periodic meetings between its analytical team and company management. These interactions provide A.M. Best with crucial insight into the organization's operating mission and whether and how management policies are designed to implement that mission on an ongoing basis.

Conclusion

The title insurance industry plays an important role in ensuring the smooth functioning of real estate markets and the housing industry, which is a critical component of the overall U.S. economy. An accurate evaluation of the financial strength and credit rating of companies in this industry is therefore vital not only to the policyholders, creditors, regulators and investors of title insurance companies who are direct users of A.M. Best's ratings, but to the wider community of real estate and financial services professionals as well.

GUIDE TO BEST'S CREDIT RATINGS

A Best's Credit Rating is an independent opinion based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile and, where appropriate, the specific nature and details of a rated debt security. Best's Credit Ratings are not a warranty of a company's ability to meet its ongoing financial obligations.

Financial Strength Ratings

A **Best's Financial Strength Rating (FSR)** is an opinion as to an insurer's financial strength and ability to meet its ongoing obligations to policyholders.

	Rating	Descriptor
Secure	A++, A+	Superior
	A, A-	Excellent
	B++, B+	Good
Vulnerable	B, B-	Fair
	C++, C+	Marginal
	C, C-	Weak
	D	Poor
	E	Under Regulatory Supervision
	F	In Liquidation
	S	Suspended

A **Best's Long-Term Issuer Credit Rating (ICR)** is an opinion as to the ability of the issuer to meet its ongoing senior financial obligations. A.M. Best also assigns Issuer Credit Ratings to insurance companies using its Long-Term Credit Rating Scale. The definitions applied to insurance companies that are assigned a long-term Issuer Credit Rating are as follows: (aaa) - Exceptional; (aa) - Superior; (a) - Excellent; (bbb) - Good; (bb) - Fair; (b) - Marginal; (ccc and cc) - Weak; (c) - Poor; (rs) - Regulatory Supervision/Liquidation. The (nr) designation may be assigned to insurers that were previously rated.

A.M. Best may also assign Short-Term Issuer Credit Ratings to certain insurance companies using its Short-Term Credit Rating scale.

Rating Modifiers		Affiliation Codes	
"u"	Under Review	"g"	Group
"pd"	Public Data	"p"	Pooled
"s"	Syndicate	"r"	Reinsured

Not Rated Categories (NR)

NR-1	Insufficient Data
NR-2	Insufficient Size and/or Operating Experience
NR-3	Rating Procedure Inapplicable
NR-4	Company Request
NR-5	Not Formally Followed

Long-Term Issuer Credit, Bank Deposit and Debt Ratings

A.M. Best uses its long-term credit rating scale when assigning:

- **Debt Ratings** (an opinion as to the issuer's ability to meet its financial obligations to security holders when due);
- **Issuer Credit Ratings** (an opinion as to the ability of the issuer to meet its ongoing senior financial obligations) and
- **Bank Deposit Ratings** (an opinion as to a bank's ability to meet its ongoing obligations to depositors).

	Rating	Descriptor
Investment Grade	aaa	Exceptional
	aa	Very Strong
	a	Strong
	bbb	Adequate
Non-Investment Grade	bb	Speculative
	b	Very Speculative
	ccc, cc, c	Extremely Speculative
	d	In Default

Ratings from "aa" to "ccc" may be enhanced with a "+" (plus) or "-" (minus) to indicate whether credit quality is near the top or bottom of a category, and a "u" modifier for Under Review.

Ratings prefixed with an ("i") denote indicative ratings. Issuer Credit Ratings may also be assigned a "pd" modifier, which indicates that a company does not subscribe to A. M. Best's interactive rating process. A.M. Best may also assign the "rs" designation, which indicates that a company is under regulatory supervision or liquidation.

Short-Term Issuer Credit and Debt Ratings

A.M. Best uses its short-term credit rating scale when assigning:

- **Debt Ratings** (an opinion as to the issuer's ability to meet its obligations having maturities generally less than one year) and
- **Issuer Credit Ratings** (an opinion as to the ability of the issuer to meet its senior financial commitments on obligations maturing in generally less than one year).

	Rating	Descriptor
Investment Grade	AMB-1+	Strongest
	AMB-1	Outstanding
	AMB-2	Satisfactory
	AMB-3	Adequate
Non-Investment Grade	AMB-4	Speculative
	d	In Default

A company's Short-Term Credit Rating also may be assigned an Under Review modifier ("u") that generally is event-driven (positive, negative or developing) and indicates that the company's Best's Rating opinion is under review and may be subject to near-term change. Ratings prefixed with an ("i") denote indicative ratings.

Not Rated (nr)

The nr designation may be assigned to issuers or issues that were previously rated.

Rating Outlook

Best's Credit Ratings (A++ to D, aaa to c) are assigned a Rating Outlook that indicates the potential direction of a company's/issue's rating for an intermediate period, generally defined as the next 12 to 36 months. A.M. Best does not assign Public Data Ratings to Bank Deposit or Debt Ratings. Financial Strength and Issuer Credit Public Data Ratings are not assigned an Outlook. Rating Outlooks are as follows:

Positive	Indicates a company's financial/market trends are favorable, relative to its current rating level, and if continued, the company has a good possibility of having its rating upgraded.
Negative	Indicates a company is experiencing unfavorable financial/market trends, relative to its current rating level, and if continued, the company has a good possibility of having its rating downgraded.
Stable	Indicates a company is experiencing stable financial/market trends and that there is a low likelihood that its rating will change in the near term.



A.M. Best Co., established in 1899, is the world's oldest and most authoritative source of insurance company ratings. Best's Ratings are the definitive symbol signifying the financial strength and operating performance of insurance companies worldwide. For more information, visit A.M. Best's Web site at www.ambest.com, or contact one of our offices:

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