KBRA KROLL BOND RATING AGENCY

Coronavirus (COVID-19): Headwinds for U.S. Title Insurers

Insurance Research

Kroll Bond Rating Agency (KBRA) believes the coronavirus (COVID-19) pandemic will generate headwinds for U.S. title insurers during the remainder of 2020, but reiterates our stable outlook for the sector. And while title insurers' balance sheets are vulnerable due to elevated exposure to equities, the expected surge in mortgage refinancings should offset investment declines, leading to the sector's ninth consecutive year of net income (NI). However, we expect some of the smaller and independent title insurers with elevated equity holdings to experience more significant challenges.

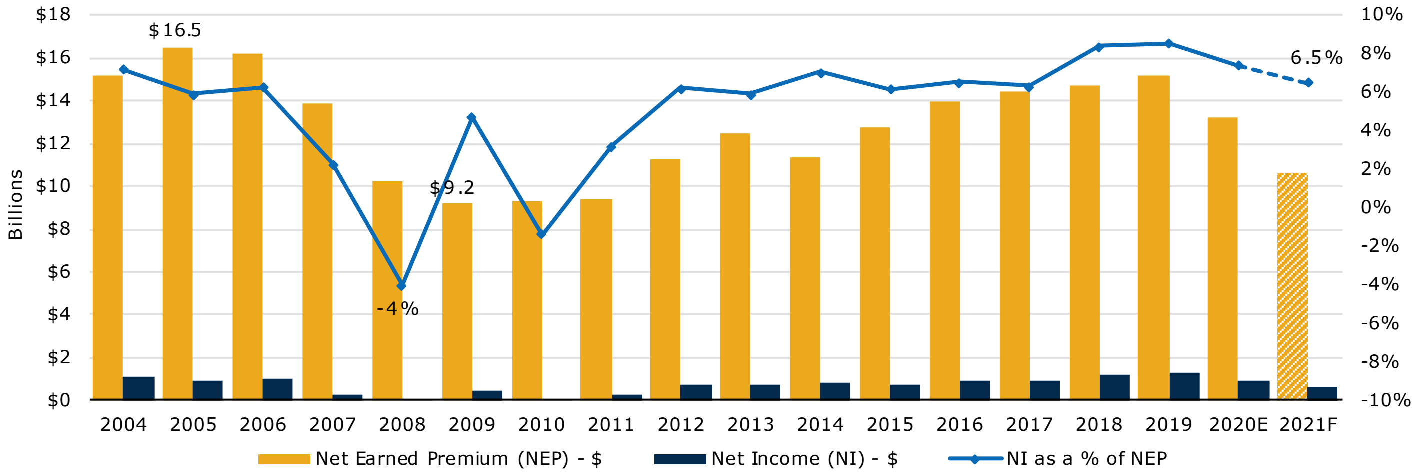
The industry's 2019 results were largely in line with KBRA's expectations, as detailed in our **U.S. Title Insurance 2020 Outlook**, with NI for the full year at $1.4 billion (slightly above our estimate of $1.3 billion) and policyholders' surplus (PHS or surplus) at an all-time high of $5 billion. For 2020, KBRA has reduced its premium and profitability expectations for the sector.

The Tide Is Turning for Increasing Premiums

The sector's strong operating performance and profitability in recent years—driven by a supportive environment for real estate and mortgage originations—reflected the long U.S. economic expansion which came to halt in February 2020. High mortgage originations, led by a surge in refinancing activity, helped title premiums to cross the $15 billion threshold for full-year (FY) 2019, levels not seen since 2003-06. As a result of COVID-19, KBRA has lowered its 2020 premium projection premium to around $13 billion from our previous estimate of $15 billion (see Figure 1). The lower year-over-year (YoY) estimates are challenging and evolving. The Mortgage Bankers Association (MBA) forecasts a sharp increase in mortgage originations, driven by mortgage refinancing this year, followed by a sharp decline in 2021. In its previous forecast in January, MBA estimated mortgage originations this year to reach $1.9 billion, consisting of $1.3 billion in new purchases and $0.6 billion in refinance originations. This compares with MBA's most recent estimates in early April, which sees a rise in originations to $2.4 billion, of which new purchases and refinance activity are evenly split at $1.2 billion each. For 2021, MBA's mortgage originations are forecast to decline to $1.9 billion.[1]

[1] https://www.mba.org/news-research-and-resources/research-and-economics/forecasts-and-commentary/mortgage-finance-forecast-archives

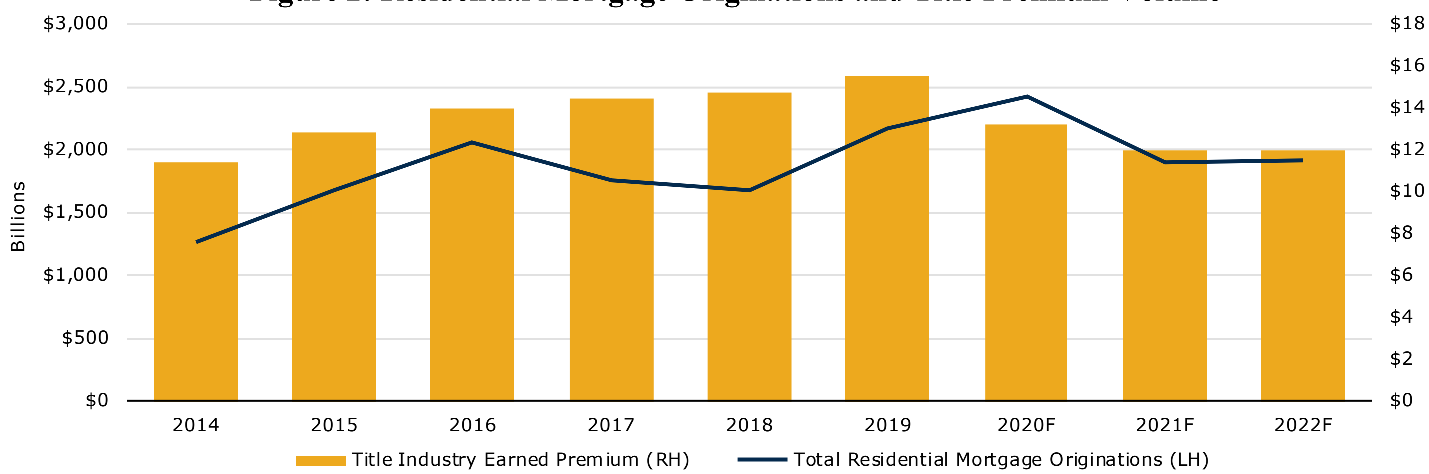
Figure 1: Premium Revenue and Net Income



Sources: American Land Title Association (ALTA), National Association of Insurance Commissioners (NAIC), KBRA Analysis

The projected jump in refinancing is driven by the interest rate environment as well as by homeowners looking to lower monthly expenses given the economic environment. Title insurance premium revenues are directly connected to the volume of mortgage originations (see Figure 2). Although total originations are forecast to be flat, KBRA anticipates a sharp premium decline to reflect the higher proportion of refinanced title insurance premiums which are typically 15%-50% lower than for new home purchases. A decline in large commercial premiums will also be significant, as KBRA has noted the **commercial real estate market is being meaningfully affected**.

Figure 2: Residential Mortgage Originations and Title Premium Volume



Sources: MBA, KBRA Analysis

Title companies that have significant refinancing premiums will benefit the most if the expected surge materializes. However, there are indications that some industry participants may be less willing to offer refinancing transactions. "Wells Fargo and Co. substantially curtailed its programs for making large loans," according to a Wall Street Journal article on April 4. "America's largest mortgage lender will only refinance jumbo mortgages for customers who hold at least $250,000 in liquid assets with the bank".[2] If this trend continues, KBRA anticipates a downward revision for the MBA's May forecast, which would have a similar impact on KBRA's industry premium projection.

[2] https://www.wsj.com/articles/wells-fargo-curtails-jumbo-loans-amid-market-turmoil-11586037701

Operational Challenges: A Mixed Bag

KBRA has previously highlighted technology initiatives as a key component of the title insurance sector's evolving landscape. KBRA believes the trend is accelerating to address inefficiencies throughout the buying and selling process of real estate to meet the demands of its changing customers. However, real estate closings and title insurance remain high-touch transactions which generally occur in-person. In more than half of U.S. states, a notary is required to be physically present at the closing of the transaction. Current social distancing requirements present a unique set of challenges to the title insurance industry. KBRA believes the leading independent title companies have made more progress adapting to these transformations than some of the larger industry players and smaller independents. However, the title insurance industry lags many other insurance sectors with respect to adaptability and many title insurers will face headwinds as they attempt to navigate their business through the pandemic.

Regulators and politicians have taken swift and favorable actions that will benefit title insurers. On March 20, for example, a bipartisan coalition of senators proposed legislation "which would permit immediate nationwide use of remote online notary (RON) with minimum standards and provide certainty for the interstate recognition of RON. With the need for social distancing to help prevent the spread of the virus, we want to provide options to consumers to close their transaction remotely nationwide," said Diane Tomb, ALTA's chief executive officer.[3]

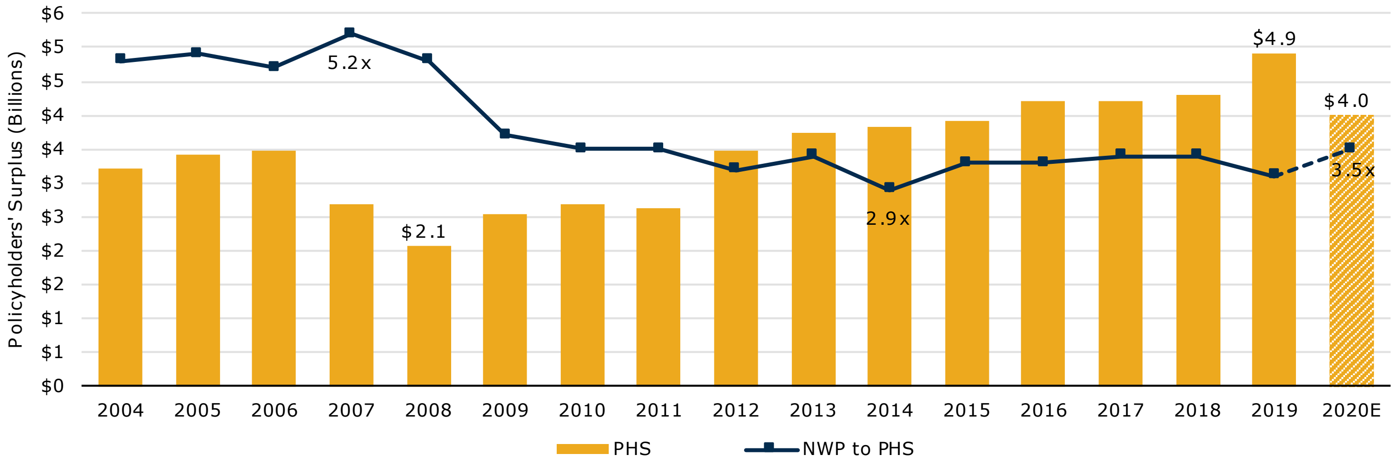
James M. Czapiga, ESQ., President and CEO of Connecticut Attorneys Title Insurance company (CATIC) told KBRA, "executive orders enabling RON aside, most—if not all—title agents are figuring out how to get closings done in a safe and practical manner. Some are setting up tents and tables in their parking lots to do closings and we have even had some do signings on the hood of a car. They are improvising, adapting, and overcoming a difficult situation." Further, many state regulators and governors have deemed insurance as an essential service, permitting many offices to remain open on a state-by-state basis. Lastly, refinancing closings face fewer operational challenges. CATIC further noted that "refis have less personal interaction and far fewer people involved, so they are much easier to close in this environment."

Recent Years Provided Stability … For Most

Surplus for the sector hit a record high of $5 billion at year-end (YE) 2019, representing YoY growth of 16.3% (see Figure 3). Absent stockholder dividends which totaled around $3 billion over the past three years, PHS would have ended 2019 even higher. The segment's aggregate ratio of net written premium to surplus hit 3.1x, its lowest level since 2014. KBRA expects surplus to remain at or above $4 billion for 2020, with a premium to surplus ratio well below levels preceding the financial crisis.

[3] https://www.alta.org/publications/press-release.cfm?American-Land-Title-Association-Applauds-Sens-Cramer-R-ND-and-Warner-D-VA-for-Introducing-Bipartisan-SECURE-Notarization-Act

Figure 3: Policyholders' Surplus and Net Premium Leverage

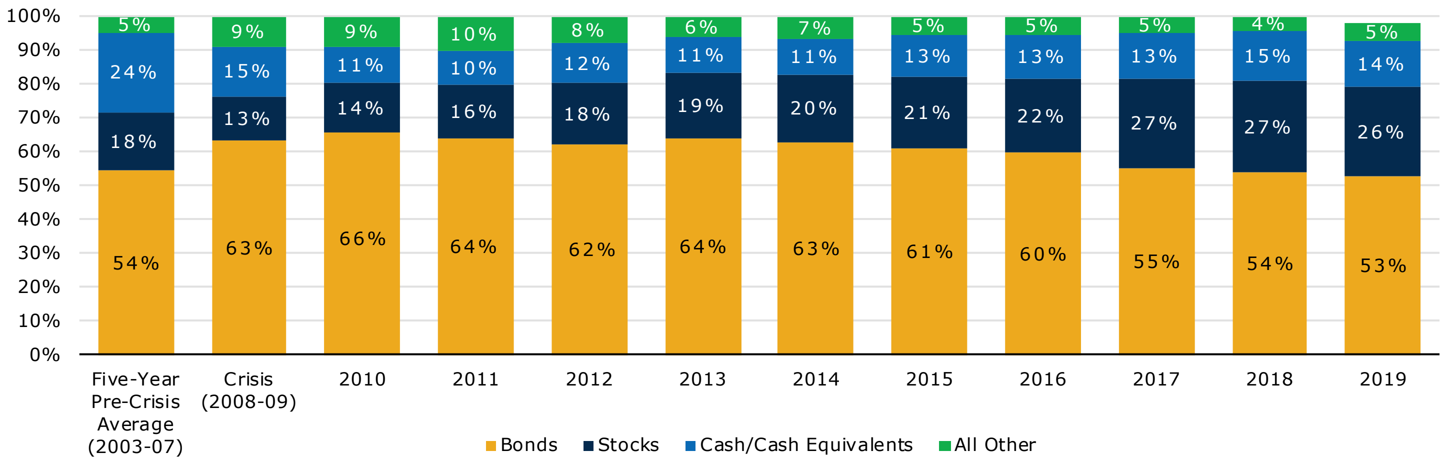


Sources: ALTA, NAIC, KBRA Analysis

Asset Composition Will Dampen Balance Sheets

The growth of surplus over the last 10 years has driven underwriting leverage considerably lower versus the pre-crisis period and we note that the sector currently enjoys a substantial and historically high capital cushion. However, these positive considerations in sector-wide financial strength is tempered by changes in overall asset composition, which continues to have increased exposure to equity investments and associated valuation volatility.

Figure 4: Invested Asset Composition



Sources: ALTA, NAIC, KBRA Analysis

As shown in Figure 4, as equity market valuations steadily increased during the past few years, title insurers' exposure to equities surpassed historical averages, rising to 26% of total invested assets at YE 2019. KBRA believes that due to the severe decline in the equity markets and other investment losses, it is likely that invested assets are down by as much as 10% or $1 billion.

Dampened but Stable Outlook Despite Headwinds

KBRA acknowledges the negative impacts of the COVID-19 economic and financial market downturn in the U.S. title insurance sector. KBRA believes the overall financial strength of the U.S. title insurance sector in 2020 remains stable, although some of the independent title insurers with elevated equity holdings and lack of scale will be tested. Multistate writers with market share leadership positions should fare better than companies with limited geographies and operations. With record levels of surplus entering 2020, KBRA believes the sector remains reasonably positioned to weather macroeconomic headwinds this year. Our near-term expectations are that operating results will be dampened but remain strong enough to maintain financial strength consistent with current rating levels.

KBRA continues to monitor the direct and indirect impacts of the coronavirus disease (COVID-19) on the insurance sector. Please refer to our recent publication, **KBRA Monitors COVID-19 Credit Impact by Sector**, for more details.

As events surrounding the crisis unfold, our thoughts are with the individuals and families who have been affected by the virus.

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