How US-Style Title Insurance is Transforming Risk Management in European Real Estate Markets

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I. BACKGROUND

In this paper, we will review the reasons why Title Insurance has become a universal instrument for real estate transactions in the US, and examine the increasingly important role that it is playing in Europe.

Once only available in the US, Title Insurance is now a well-established financial instrument for mitigating risks in property acquisition, financing and securitization in Canada, Latin America, the Caribbean, Asia and Australia.

In Europe, especially Central and Eastern Europe (CEE), the demand for Title Insurance has increased along with the growth and sophistication of cross-border real estate transactions. According to a survey by Jones Lang LaSalle, the flow of cross border investments in Europe reached €46 billion in 2004. It grew 27% in the first half of 2005 to reach €24 billion and there is no reason it should slow down in 2006.

II. WHAT IS TITLE INSURANCE?

Title Insurance guarantees that buyers and lenders benefit from a clean ownership title. For a one-time premium, it provides coverage against financial loss arising from title defects and other irregularities relating to real estate, such as compliance with zoning, codes and permits. Title Insurance also frees investors and their lenders from having to understand complex legal opinions in various languages, formats, contexts and degrees of reliability. Two aspects should be highlighted:

- Financial Protection Against Both Known and Unknown Title Defects. The original purpose of Title Insurance was to insure against "unknown" defects, with "known" defects shown as exceptions in the policy. That coverage has evolved, and now title companies often provide insurance for "known" or existing defects or title problems.

- Protection Beyond a Legal Opinion. Lawyers provide an *opinion*. Title Insurance provides a *guarantee*. A legal opinion, especially in a large transaction, is fundamentally a disclosure document, in which counsel carefully defines the state of title and related issues, identifying – but not eliminating – risks. Title Insurance goes *beyond* a legal opinion to underwrite risks due to faulty records, ambiguities, negligence, fraud, or even simple mistakes.

III. A BRIEF HISTORY OF TITLE INSURANCE IN THE UNITED STATES.

Title Insurance was created in the last part of the 19th Century. Until then, buyers could acquire insurance for errors and omissions only from their lawyers.

At that time – as in Europe today – each state in the US operated with different laws for conveyance and property rights. Each had a multitude of counties with different sets of regulations for zoning, permit or deed recording. Certain states operated under a system of deed recording similar to France, others under registration of rights similar to the UK. Title Insurance competed with land registration systems, such as Torrens, which 22 states adopted between 1900 and 1922. After the First World War, the Title Insurance industry began to create a national market and became the preferred mechanism.

It is important to keep in mind that until 1974, US banks could not have offices or branches outside their own state and, some, outside their county. (In Chicago, banks were limited to one branch). Banks that wished to operate nationwide could not rely on their own network to perform due diligence or have local expertise. They required two elements:

1. Assurance that there were no potential legal problems for the assets that backed their financing, and

2. A common standard throughout the maze of laws and regulations that still exists in the US. Insurers were successful in convincing lenders that Title Insurance was critical for financing residential mortgages. As a national market grew, Title Insurance policies helped standardize loan documentation and create a secondary mortgage market.

The intervention of the Federal government in the housing market during the Depression, and the ensuing evolution of loans into long-term amortizing mortgages, broadened the need for Title Insurance. The trend accelerated with the housing boom that followed World War II and the creation of Federal mortgage refinancing agencies such as FNMA and GNMA. By 1969, the industry passed the $1 billion mark in total premiums and in 2005, it represented over $17 billion in annual revenues.

When the securitization market started in the US 20 years ago, Title Insurance was already universally accepted. Every asset behind every mortgage, and every mortgage, whether residential or commercial, already benefited from Title Insurance.

IV. THE EUROPEAN MARKET FOR TITLE INSURANCE

Until recently, Title Insurance was unknown in Europe except for the UK, where a more limited type of insurance, Legal Indemnity, has existed for over a hundred years. Several American Title Insurance companies, and one European, recently entered the European market and provide coverage similar to ALTA (American Land Title Association) policies in the US. These not only cover *known* defects or restrictive use of a property but also issues that are *unknown* at the time of closing.

Unlike Title Insurance, which covers defects *unknown* at the time of closing, legal indemnity addresses *specific* title flaws or restrictive covenants. Land Registry (the Queen's Registry) only appeared in the UK in the second half of the 20th Century, much later than in the rest of Europe. Consequently, the Registry is of no use for properties that have not changed hands since it was established. The abundant tracks of land not yet entered in the Registry have created a growing demand for policies that will cover defective title or restrictive covenants.

Defective titles can include a gap in the chain of recorded ownership, missing documents or invalid signatures. *Restrictive covenants* can affect the use of a property but may no longer be enforceable, such as deeds dating back to the 1850s that limit dwellings on a property to "upstanding Christian families."

These covenants may be so old that it is impossible to determine who has a right to have them enforced, such as church deeds forbidding alcohol to be served on the land. With Title Insurance or Legal Indemnity, a developer can go ahead with a residential project or a shopping center and obtain financing without going through the court system in order to have those problems resolved before starting construction.

Traditionally, the various European land titling systems, through registration or deed recording, appear to have generated fewer errors and claims than in the US. There is, however, no hard data available in most countries to know the exact extent of title litigation taking place every year. This lack of demand to cover domestic direct acquisitions, whether commercial or residential, presents different opportunities for Title Insurance in Europe:

1. Notaries or lawyers are only responsible for errors and omissions. Once they have disclosed a potential issue, Title Insurance can assume the risk, freeing the buyer from assuming the risk himself.

2. Most European countries have created a favorable regulatory framework for real estate companies, whether unlisted or in the form of REITs. There is an increasing number of indirect transactions – through acquisition of shares of real estate companies or units of Limited Partnerships – that are not recorded in land registry or by a notary. With title insurance, buyers of shares or units can obtain coverage assuring that they benefit from a clean title as of the day of the transaction.

A Two-Fold Benefit: Protection and Standardization

Acquisition or lending has traditionally been considered safer in one's own country than abroad. There are several benefits to Title Insurance in cross-border transactions:

- The *traditional* role of insurance, since participants often feel uncomfortable with risks taken abroad that they would readily assume in their own country.

- A form of *standardization*. Title insurance provides lenders and buyers with a standard text in English that applies (with only limited variations) in every single country of the European Union and in most CEE countries. For investors or lenders active in cross-border transactions, it can eliminate the need to refer to lengthy legal documentation translated from a variety of languages.

- In large residential portfolios, Title Insurance can greatly simplify the legal due diligence for developers, buyers and lenders. In countries like Spain, where a very high proportion of secondary home buyers are foreigners, providing title insurance can give developers a strong competitive advantage. It can also pave the way for future securitization of the portfolio.

Furthermore, sellers may be not be in a position – or may be reluctant – to provide legal representations and warranties.

- Public companies have to disclose contingent liabilities and carry explanations in the footnotes of their annual reports.

- Private companies may not want to continue having exposure on a property that they no longer own.

- SPVs (Special Purpose Vehicles) that are commonly used may not be dissolved immediately after a transaction and may have to keep a portion of the sales proceeds to back up those "Reps & Warranties."

V. TITLE INSURANCE: A CRITICAL ROLE TO PLAY IN EUROPEAN CMBS/RMBS SECURITIZATION

By the time securitization appeared in the US in the late 1980's, title insurance had already become the norm for commercial and residential loans. In Europe, however, the securitization market developed before the appearance of Title Insurance.

Title Insurance Makes Securitization More Efficient

Securitization in the United States had a dual purpose, one was to absorb the volume of loans that the RTC (Resolution Trust Corporation) put on the market, following the debacle of the Savings and Loans institutions, the second was to make access to home ownership possible for a much larger percentage of the population by creating a secondary mortgage market that can function on a much larger scale.

Title Insurance enhances the efficiency and liquidity of CMBS/RMBS markets by:

1. Helping mortgage-backed securities achieve satisfactory credit ratings

2. Providing a *private* solution to harmonizing legal due diligence across different laws, regulations and languages, especially critical in multi-country transactions

3. Allowing fund managers to respond to investor demands for safety and common standards for legal due diligence and thus helping fulfill their fiduciary requirements.

CMBS/RMBS – A Financial Product Growing in Importance in Europe

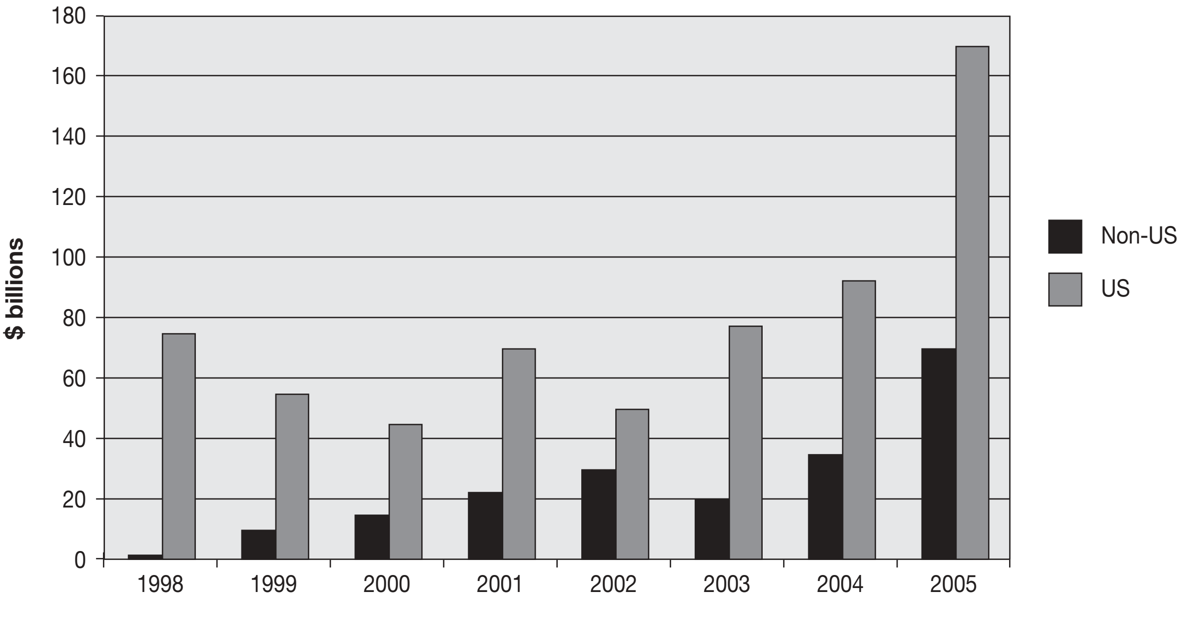
Volumes in Europe lag 10 years behind those in the US. Although European CMBS grew 89% last year (Deutsche Bank, 2005 Review & Outlook for 2006), Europe may *not* witness the sharp increase that the mortgage securitization market experienced in the US after 1995.Source : Commercial Mortgage Alert

There are specific traits of the European securitization market that have, so far, limited its ability to follow the US pattern of growth:

1. The European securitization process has been driven more by issuers than investors. While the ESF (European Securitization Forum) and CMSA (Commercial Mortgage Securitization Association) have set up procedures/standards, and are active in lobbying the European governments and institutions to create favorable legal frameworks for the securitization market, there are still no European standards for loan documentation or legal due diligence. Issuers have attempted to follow certain formats, but there are significant differences remain in the information disclosed to the public for each issue.

2. The focus of European issuers has been to obtain the most favorable financing rather than unload various risks off their balance sheet.

Figure 1: CMBS Volume Trends: US vs Non-US



Source: Commercial Mortgage Alert

AAA tranches in the US represent less than 40%, and AA another 20%, of all MBS issues. By contrast, in Europe, over 90% are AAA and AA, with some issues rated 95% or even 100% AAA.

1. The MBS market continues to be dominated by the UK, which still represented 60% of new issues in 2005. The percentage of Pan-European securitization was only 4% last year, but is expected to grow significantly.

   For Pan-European issues, it is much easier to provide rating agencies and investors with a standard title policy that covers all countries, rather than with translations of legal documentation from different jurisdictions, languages and formats.

2. There will also be new market entrants from countries where the "perceived" legal risks are much greater and the need for title insurance more compelling:

   "Industry analysts predict that Russian mortgage lenders could have $45 billon of MBS outstanding" (Asset-Backed Alert 3/17/06), and Turkish bank, Isbank, is considering $1.4 billion MBS program (Security News, 3/13/06).

3. Single-borrower/single-property issues where title conditions are easier to grasp, represent 28% of transactions to date, but this percentage is expected to diminish.

In the wake of Basel II implementation, Title Insurance can play a key role in broadening the risk profile of European MBS issues.

VI. SUMMARY AND CONCLUSIONS

The formation of a global real estate market in Europe over the last 20 years has created a context similar, in many ways, to the situation in the US at the end of the 19th Century: investors and lenders operating through different jurisdictions, with different laws or rules, as well as very different methods to record and guarantee title.

Title Insurance has evolved into a universal standard in the US real estate market with over $17 billion in annual premiums in 2005. While no one expects the European need for Title Insurance to generate similar volumes, demand for Title Insurance has increased in Europe due to the rising volume of cross-border transactions, the increase in indirect real estate transactions, and the development of a securitization market as a tool for home ownership to a much larger percentage of the European population.

As for securitization, real estate professionals, bankers and rating agencies are becoming increasingly aware of the role Title Insurance can play in simplifying and expediting issuance, covering known and unknown legal risks, thereby enhancing the safety and liquidity of CMBS/RMBS markets.

While there are efforts to harmonize mortgage markets within the European Union, it may take years to move forward. Title Insurance provides a private solution that allows investors, as well financial institutions, to benefit from a vast unified market. In addition, there is a growing demand from American and European investors, rating agencies, and auditors for additional disclosures as well as stronger guarantees.