Approved: 2-17-98
Date

MINUTES OF THE HOUSE COMMITTEE ON INSURANCE.

The meeting was called to order by Chairperson Dennis Wilson at 1:32 p.m. on February 3, 1998 in Room 527-S of the State Capitol.

All members were present except:

Committee staff present: Bill Wolff, Legislative Research Department
Robert Nugent, Revisor of Statutes
Beth James, Committee Secretary

Conferees appearing before the committee: Roy Worthington, Kansas Land Title Association

Others attending: See attached list

The meeting was called to order at 1:32 p.m. by Chairperson Dennis Wilson. The Chairperson reopened the hearing on **HB2692.**

HB2692: Title insurance, requiring certain disclosures and prohibiting certain actions.

Chairperson Wilson called Roy Worthington to the podium to speak as an opponent on this bill. (Attachment #1). Mr. Worthington's testimony is extensive. He basically gave three reasons why the Kansas Land Title Association opposes this bill. All three reasons support the current law. "Current law does not prevent anyone from entering the title business." "The current law is an extension of the federal Real Estate Settlement Procedures Act passed in 1974." And, "The current law, K.S.A. 40-2404b (14) (e) and (f), was passed in 1989 and its provisions are derived from the Model Title Code approved by the National Association of Insurance Commissioners."

Mr. Worthington believes that realtors don't really want to be in the title business and compete for business, that they only want to receive income from a controlled marketplace. He said that there are two real issues involved in this situation; Consumer Issues, and Competition Issues. He explained these two issues to the committee, as outlined in his testimony. In conclusion, Mr. Worthington feels that the title industry is healthy and competitive and the present laws protect the consumer.

Mr. Worthington stood for questions. He was asked if it was true that counties under 10,000 are not under the current law. He said yes and there are 62 counties. He was asked where his title company was located and he said Manhattan. He was asked how many title companies were in Manhattan and he said one. He said his company operates as if there was competition. They offer both a competitive price and service. He was asked what his company charges for a real estate closing fee and he said $175.00. His title company in Westmoreland, which does have competition, charges a little less. He was asked what the closing fees are in Topeka, but, he didn't know. Hayden St. John of Lawyers Title, here in Topeka, said they charge $150.00. Representative Tomlinson asked how many closed companies are there in the state of Kansas now? Mr. Worthington said he did not believe there were any. Mr. Worthington was asked what percentage would be acceptable to him in regard to competing for all of the title/abstract business in the state. Mr. Worthington said he couldn't answer that question. Mr. Worthington was asked, to his knowledge, how many title companies advertise their rates to the consumer. He said none. Representative Tomlinson said that isn't it true that the title companies advertise to the realtors and the people handling the transactions. Mr. Worthington said yes. Representative Burroughs asked Mr. Worthington if he would be supportive of the bill if it said 50% instead of 20% and a penalty phase of 3 times the premium title insurance issuance, as well as, a well defined disclosure inclusive of a time frame in which that disclosure needs to be made, and inside that disclosure a recent declaration of rates charged by local title companies within a certain time frame, whether it be monthly, bi-monthly, bi-yearly, or bi-annually? Mr. Worthington said he could would have to take that query back to his executive committee, but personally he did not have a problem with that.

There were no further questions for Mr. Worthington. There were no other opponents that had asked to speak. There is written testimony from Kansas Building Industry Association, Inc., as proponents. (Attachment #2). The hearing on this bill was closed.

The meeting was adjourned at 2:45 p.m. The next meeting is February 4.

HOUSE INSURANCE COMMITTEE GUEST LIST

DATE: 2-3-98

NAME	REPRESENTING
Bill Mosiman	Title Midwest Inc
Nancy Kernick	Farm Bureau
Joe Hansen	Farm Bureau
John Peterson	Ks Land Title Assn
Jill Grant	"
Chris & John	Lawyers Title
Hayden (St John)	Lawyers Title
Sally Kyler	Washburn SW student
Holly Klein	Washburn SW Student
Carl Primm	Farm Bureau
Fred Primm	✓
MARTY HAZEN	KANSAS INSURANCE DEPT.
ROBERT KELLER	KANSAS FARM BUREAU
Karen Franck	Ks. Assn of REALTORS
Diana Wharton	Washburn Univ
Karen Gerke	KS Assn of Realtors

PRESENTATION TO HOUSE INSURANCE COMMITTEE

RE: Testimony in Opposition to House Bill 2692 - Controlled Business in the Kansas Title Insurance Industry

DATE: February 3, 1998

FROM: Kansas Land Title Association
Roy H. Worthington, Legislative Chairman

THE KANSAS LAND TITLE ASSOCIATION OPPOSES HOUSE BILL 2692 FOR THE FOLLOWING REASONS:

1. The current law, K.S.A. 40-2404b (14) (e) and (f), was passed in 1989 and its provisions are derived from Model Title Code approved by the National Association of Insurance Commissioners. The current law is the result of a 1988 study group formed by the Kansas Department of Insurance to study a significant problem involving controlled business title insurance companies existing at the time which were detrimental to the healthy functioning of competition in the title insurance industry.

2. The current law is an extension of the federal Real Estate Settlement Procedures Act passed in 1974 to help eliminate abuses in the real estate settlement services industry - specifically prohibiting the payment or receipt of fees, kickbacks, rebates or any thing of value for the referral of business.

3. Current law - does not prevent anyone from entering title business - but if entered, must compete for "public business" - at least 80% of business must be business other than from producer of title business having a financial interest in the title company.

Why don't realtors want to form title companies under current law? - because they don't really want to be in the title business and compete for business - they want to receive income only from a controlled marketplace.

EXAMINE 2 ISSUES - CONSUMER AND COMPETITION.

Consumer Issues:

House Insurance
Attachment # 1-1
2-3-98

1. The need for the present restriction on controlled business is due to the following unique nature of title insurance, i.e.:

a. the consumer does not understand that title insurance can be shopped around for the best price and service, like property insurance, life insurance and the purchases of other consumer goods;

b. that the placement of title insurance services is usually made not by the consumer but by a "producer of title insurance", such as a real estate agent or lender, who is in a "fiduciary relationship" with the consumer and to whom the consumer looks for disinterested advice; Duties of a realtor under existing license law: "to promote the interests of the client with the utmost good faith, loyalty and fidelity." If realtor has a financial incentive to direct his client's title business to his broker's title company, is there a conflict of interest???

2. Significant that present law was not passed as a stand alone statute to keep realtors out of title business, but as part of Unfair Trade Practices Act.

The 1989 minutes of the Senate Financial Institutions and Insurance Committee reveal express statements by legislators - "problem with controlled business is that it is anti-competitive - the producers of title business try to steer customers to the title company they own and they have no incentive to look out for the consumer."

Dick Brock, Insurance Dept - testified in favor of bill (3/2/89) - indicated that Dept had been studying complaints about persons offering or receiving special inducements, rebates and other advantages in the sale or placement of title insurance that is not generally available to others similarly situated, causing increased cost to consumer

3. In 1991 the law was upheld by the Kansas Supreme Court - court indicated that "purpose of Unfair Trade Practices Act is to prevent unfair methods of competition and unfair or deceptive acts or practices in the business of insurance." The "purpose of the law is to stimulate competition by decreasing vertical integration between producers of title business and title insurers."

4. Attached as Exhibit "A" are excerpts from 10 studies conducted by federal and state agencies and scholars which illustrate the detriment to the consumer of a controlled business marketplace. Examples of 3 of those studies are set forth below:

a. Controlled business in the title insurance industry is not new. It has appeared in other states and in each case has been met with varying degrees of state regulation. **The United States Department of Justice in its 1977 report entitled The Pricing and Marketing of Insurance indicated the following: "To sum up the major evils of controlled title companies, where a real estate settlement producer is able to direct the purchaser of title insurance to a particular title company and at the same time that producer owns the title company, the purchaser is likely to end up (1) paying unreasonably high premiums, (2) accepting unusually poor service, or (3) accepting faulty title examinations and policies from the controlled title company."**

b. **The Michigan Insurance Commissioner, in June of 1977, summarized the impact of controlled business arrangements as follows:** "The findings and conclusions by various executive, legislative, and judicial branches of the Federal and State Governments and the results of the Insurance Bureaus investigations have caused me to recognize that **permitting real estate brokers to own or control a licensed title insurance agency for the purpose of channeling title insurance business is detrimental both to the consumer of title insurance and to actual and potential competition in the title insurance market.... The anti-competitive nature of such arrangement is obvious and widely acknowledged. Its effect on the title insurance industry and consumers can only be harmful."**

c. A 1981 study performed for the Department of Housing and Urban Development by Peat, Marwick, Mitchell & Company, stated the following: ".... a fundamental characteristic, generally referred to as reverse competition, serves to create a market in which traditional economic principles of a competitive market do not apply. **Since the consumer has no significant role in the selection process, there is little incentive to keep prices low or otherwise be concerned about the consumer...."**

Competition issues:

1. You have heard that the present law restricts competition and free enterprise.

- lots of competition now between independent title companies - 14 companies in Johnson Co. - 11 companies in Leavenworth Co. - 6 companies in Sedgwick Co.

1-3

- all are independent and compete against one another based on price and service - realtors can select the best company for the client.

2. PROPONENTS TESTIFIED THAT THEY WOULD NOT ACCEPT ANY PERCENTAGE REQUIREMENT ON AMOUNT OF PUBLIC BUSINESS THEY ARE REQUIRED TO HAVE - EVIDENCE THAT THEY DON'T WANT TO COMPETE FOR PUBLIC BUSINESS.

3. In effect the purpose of the present law is to encourage controlled business title companies to compete for "public business" and not to just service "captured consumers."

4. Independent title companies realize the enormous competitive problems posed when a real estate broker can, IF NOTHING MORE, suggest that a sales agent to refer business to that the broker's captive title company.

5. Competitive prices and service for the consumer can only be forged in a competitive marketplace - **controlled business title companies, regardless of how many, will not compete with one another unless they are forced to seek out business beyond referrals.**

6. **If controlled business title companies only service "captured consumers" and are not competing with other title companies for business, then the consumer will be subject to non-competitive prices.**

7. Independent title companies never get an opportunity to compete for the business, since the consumer will likely take the recommendation of the realtor and the realtor has a powerful incentive to recommend the affiliated title company when the realtor receives financial gain from such referral.

8. Since producers of title business can only receive a return on investment, they will need to affiliate themselves with existing title companies - form cartels in larger markets (i.e. several large brokers "buy into" an existing title company - title

company becomes a controlled business title company and is guaranteed the business of the investing brokers - title company wants to make as much money as before - brokers want a return on investment - prices go up - consumer pays increased prices.

Controlled business title companies are not competing with one another, since they are servicing a captured consumer - since the consumer is unfamiliar of his right to choose a title company, the consumer pays the prices set by the controlled business company and those prices are not forged in a competitive marketplace.

TESTIMONY BY PROPONENT THAT SALES AGENTS ARE INDEPENDENT CONTRACTORS AND WOULD NOT BE PRESSURED TO USE THE BROKER'S TITLE COMPANY?? HOW NAIVE TO SUGGEST THAT PRESSURE CANNOT BE BROUGHT TO BEAR ON SALES AGENTS TO USE THE BROKER'S COMPANY!!!

9. At least 26 other states have controlled business insurance legislation of various forms. Some states, such as Ohio and Oregon prohibit lenders from acting as title agents when the lender is the lienholder due to conflict of interest issues. All at least recognize the potential problem of a controlled marketplace in various forms of insurance.

Some other states with controlled business statutes similar to Kansas are:

	Percentage Limitation on Controlled Business
*California	50%
Connecticut	20%
New Jersey	50%
Tennessee	40%
Utah	33%
Wyoming	25%
Arizona	50%

***For instance, California's law requires that any applicant for title insurance indicate the applicant's intent to <u>actively compete in the marketplace</u> for title insurance in each county in which the applicant seeks to or does conduct business. The failure to do so will constitute grounds for denial of the license. Further, the company must demonstrate that its business conduct will not involve reliance for than 50 percent of its closed title orders from controlled business sources.**

10. House Bill 2692 is an attempt to change the current law and in its place substitute certain disclosure requirements the proponents

of the bill believe will protect the consumer. **To believe that the disclosures proposed by House Bill 2692 will protect the consumer is naive indeed. Because consumers generally purchase title insurance only in connection with a real estate transaction and title related charges are a small portion of the costs involved, consumers do not typically have the knowledge, time, or incentive to become effective shoppers for title insurance. Rather, they tend to rely on the recommendations or referrals of those real estate professionals in the transaction. With all the forms required to be signed by a buyer of real estate, another disclosure form will be meaningless to a buyer.**

Disclosures are normally given at the settlement table - does not give consumer comparison of prices with independent companies - no monitoring by state agencies - no real penalties for failure to comply.

It is absurd to suppose that disclosure cures the problem of controlled business - in fact, disclosure is quite likely to add to the coercive nature of a real estate loan transaction. Informed that one's prospective mortgage lender has an interest in its recommended title firm will only increase the pressure to go along, not diminish it.

In conclusion, under present laws Kansas has a very healthy and competitive title insurance industry which protects the consumer. The proponents of this bill have introduced similar bills in 1991, 1995 and 1996 and all were unsuccessful. The Kansas Land Title Association requests that you defeat House Bill 2692.

Respectfully submitted by,

Roy Worthington

Roy H. Worthington
Legislative Chairman
Kansas Land Title Association

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EXHIBIT "A"

CONTROLLED BUSINESS IN THE TITLE INSURANCE INDUSTRY: CONSUMER, COMPETITIVE AND CONFLICT OF INTEREST PROBLEMS

EXCERPTS FROM STUDIES BY FEDERAL AND STATE AGENCIES AND SCHOLARLY COMMENTARIES

TABLE OF CONTENTS

INTRODUCTION

For a variety of reasons, the majority of consumers who purchase residential real estate do not have the time, knowledge, or ability to shop effectively for the title insurance services that are needed to consummate the purchase. Accordingly, such consumers invariably rely upon the advice or recommendations of other real estate professionals who are assisting them in the transaction -- their real estate broker, mortgage lender, or attorney -- in selecting a provider of title insurance services. When this real estate professional refers his client's or customer's business to a title insurance entity that he has a financial interest in, a situation known as "controlled business" exists. The growth of such controlled business arrangements in the title insurance industry has created serious anti-competitive and conflict-of-interest problems that adversely affect the interests of consumers -- problems that have been identified and explained by federal and state agencies, consumer groups and others who have studied the problem. The following are excerpts from the various reports, studies, and articles that have been written about the controlled business problem in the title insurance industry.

1. U.S. Department of Justice, The Pricing and Marketing of Insurance: A Report to the Task Group on Antitrust Immunities 254-74 (1977).

The market demand in the title insurance industry also differs from that of most other forms of insurance. Title insurance is ancilliary to the principal transaction, which is the purchase of an interest in land. . . .

The effects of this phenomenon are described as follows:

> Perhaps nowhere in the economy is there such a maldistribution of economic knowledge and power than in the financial and real estate markets. . . .

Due to lack of knowledge, lack of time, and lack of interest the purchaser of a title insurance policy frequently exerts little, if any, influence on the selection of sellers. . . .

In other words, competition in the title insurance business is directed at the producer of business rather than the consumer. A title company wishing to increase its share of the market would not necessarily try to reduce prices or improve coverage in order to attract retail purchasers of title insurance. Rather, the company would seek to influence those brokers, bankers, and attorneys who are in a position to direct title insurance business to it. The most direct manner of influencing this business is to grant the producer of the business a fee, commission, rebate, or kickback -- to the detriment of the title insurance purchaser. This is the phenomenon of reverse competition.

* * *

Congress attempted to deal with the problem of kickbacks and unearned fees in the real estate settlement services area by passing RESPA. Section 8 of the Act makes it illegal to give or receive anything of value for mere referral of business in connection with a federally-related real estate mortgage settlement service such as title insurance . . . . While this law is designed to close the front door to rebates and kickbacks in the title insurance business, a loophole has appeared which may ultimately cause a problem worse than outright kickbacks. This loophole is the title company affiliate of a real estate agency, which we will refer to herein as the "producer's affiliate" or "controlled title company."

* * *

When the producer has an affiliate that issues the policy, naturally the producer will direct all of its title insurance business to its affiliate. Title insurers, who generally need a large volume of business to cover the costs of creating and maintaining their title plants, will bargain with the producer's affiliate in order to get a guaranteed source of title underwriting business; that is, the producer's affiliate will contract with whatever title insurer offers the best deal to have all of its policies underwritten by that one insurer.

Title companies controlled by producers have been steadily increasing in number since the passage of RESPA. They possess several anticompetitive features. One is that they encourage, on a new level, the type of activity sought to be eliminated by RESPA. As the producer's affiliate becomes established, competitive pressures will push title insurance rates higher. The only way a title insurer can guarantee itself adequate business is to outbid its competition in negotiating the percentage of the premium for the title policy that it is willing to accept as an underwriting fee or to outbid them in providing the work product and services normally assumed by the producer's affiliated title company (i.e., providing a search package requiring the title company to do little other than deliver the policy and collect the fee). Naturally, as the title insurer's profits decline due to reduced underwriting fees or because of increased costs due to commitments to assume more of the duties normally provided by a title company, the cost of title insurance will inevitably rise.

* * *

[T]he presence of the controlled title company creates other anticompetitive problems. Real estate brokers and others will have no desire to direct business to the best title company; rather they will direct business to their own companies. Instead of receiving a kickback for this service, they will receive corporate dividends . . . . Reverse competition would be strengthened since the affiliate's decision as to whom it chooses to underwrite its policies would be based on how much it would receive as compensation, not how much the policy will cost the purchaser; and the producer, who profits as the controlled title company profits, will continue to direct business to its own affiliate.

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This controlled placing of settlement services has a definite tendency to increase the price paid by the consumer. In recent hearings conducted by the California State Department of Insurance into the licensing of controlled title companies in that state, the Department uncovered evidence that where a real estate company applying for a license to operate an affiliate had formed a controlled escrow business and channeled all of its real estate business through that escrow company, consumer's costs for full escrow services from that company were significantly greater (in excess of 150% more) than the consumer's cost for the same or substantially similar escrow services from title insurers providing escrow services in the same locality, and the Insurance Department concluded that the same result could be expected if controlled title companies became licensed. The Insurance Department also concluded that by combining a parent real estate company's financial data with the financial data of a controlled title company, many of the statistics necessary to properly regulate title insurance rates would be lost.

* * *

To sum up the major evils of controlled title companies, where a real estate settlement producer is able to direct the purchaser of a title insurance policy to a particular title company and at the same time that producer owns the title company, the purchaser is likely to end up (1) paying unreasonably high premiums, (2) accepting unusually poor service, or (3) accepting faulty title examinations and policies from the controlled title company.

2. Professors Alfred F. Hofflander and David Shulman, The Distribution of Title Insurance: The Unregulated Intermediary, 44 Journal of Risk and Insurance 435 (1977).

[F]or California at least, the percentage of title insurance placed by controlled UTCs ["underwritten title companies," or title insurance agencies] is large and growing. In 1970 the market share of controlled UTCs for 20 California counties averaged 10.5 percent. By the first nine months of 1975 it had increased to 19.8 percent. A continuation in the growth of their market share may present potential problems to consumers.

* * *

The inequality of economic power in the real estate settlement industry is readily apparent when one looks at a specific transaction. Individual homebuyers engaged in a generally non-repetitive transaction, are faced with real estate settlement producers -- real estate brokers, attorneys, mortgage companies, builders or lenders -- whose knowledge, experience and business relationships give them an inherent power with respect to the transaction. Through the settlement process the producers control or have the potential to control the placement of orders for (or to tie) a whole array of ancillary services, such as . . . title insurance.

* * *

Once the primary transaction has been agreed upon, producers generally are in an inherently anticompetitive position because of their near monopoly power, defined here as the ability to place the foregoing ancillary business emanating from that transaction, independent of price (within a relevant range). It can be argued that because consumers usually are unfamiliar with the settlement process, producers should act in a fiduciary capacity with respect to the placement of orders for ancillary services. However, producers have many powerful incentives to abuse their position of trust. It is too easy to receive kickbacks from the suppliers of the ancillary services in return for directing business to them. Consumers, lacking time and knowledge about the process, generally go along with or even seek out the suggestions of producers. Even for knowledgeable consumers there is little incentive to shop separately for ancillary services because the total price of these services represents a small percentage, both of the total purchase price and of the cash down payment, and thus the price of any one service is much smaller in relation to the entire transaction.

* * *

A "controlled" UTC is one owned directly or indirectly by "producers" in the real estate settlement process, that is, real estate salespersons and brokers (collectively, "real estate brokers"), mortgage lenders, escrow agents, and so on. . . .

Through the ownership of UTC's, the controllers of business could continue to receive payments for controlled (tied) sales in spite of legal prohibitions. The payments

could be made as corporate dividends rather than illegal kickbacks with no difference in their purpose and in the parties receiving them. As such activity would circumvent the purposes of the law, elimination of kickbacks has led real estate settlement producers to seek to form or purchase UTCs as an alternative means of capitalizing on their economic power. . . .

As the existence of controlled and directed business can foreclose the market from other competitors, it acts as a barrier to entry. In industries such as title insurance, characterized by high economies of scale, the barrier can be substantial, rendering what appears to be a large market small and uneconomical from the insurer's perspective. The consumer then is deprived of the benefits of competition. . . .

More immediate than the foregoing prospect is the impact of controlled UTCs on the price and quality of title insurance. If the settlement process worked in the public interest, various title insurers and their local representatives (branch offices and UTCs) would compete for the consumer's business. Such competition might be reflected in price and quality differences and pointed out in advertising. Given effective regulation limiting rebates, no illegal benefits would flow to those entities involved in the settlement process. The various parties would not be a barrier to consumer shopping among competitive products. While this type of ideal world does not and perhaps even cannot exist, actions and institutions which move toward the goal of more competition are in the consumers' interests. Actions such as controlled sales and institutions such as controlled UTCs, which move away from the goal, are counter to the interests of the consumer. The elimination of rebates and kickback schemes moved toward greater competition at the consumer level. The replacement of these schemes with controlled UTCs is a step in the reverse direction.

* * *

The economic relationship among the controlled UTCs, the buyer and the title insurer could result in a phenomenon known as "reverse competition" -- competition that operates to raise prices instead of lowering them. The controlled UTC chooses the insurer which will be its underwriter. A major factor in this decision is the amount that the controlled UTC receives as compensation for the handling of insurance transactions for this insurer. As the controlled UTC does not pay

for the coverage, its price to the consumer is of little concern, except that it should not be so high that the producer-owner's failure to act in a fiduciary manner is evident.

A higher premium charge would yield a larger amount of compensation to the controlled UTC, after costs and claims are paid. Thus, the controlled UTC has an incentive to force up the price. The principal bargaining factor that title insurers can use to compete with each other in negotiating with a controlled UTC is the amount of the title premium they will allow the controlled UTC to retain. Because an insurer must meet or surpass the competition if it is to have a successful operation, competition among title insurers will drive up the price that each title insurer is willing to pay the controlled UTC for its business. As the insurer is not competing directly for the consumer's business, it will either operate at a greatly reduced profit margin, without passing the benefit of the reduction on to the consumer, or will raise prices to the consumer in order to offset the shift in profits from the title insurer to the UTC and its controlling owners.

* * *

Probably one of the most lasting consequences of the controlled UTC phenomenon could be a decline in the quality of title insurance underwritten, with concomitant further increases in cost. The real estate settlement producer's key to profits is "a closing." It is natural to expect pressure from real estate brokers and other owner-producers to seek a clean title report so as to not upset a deal. This pressure already exists. However, with a controlled UTC there is a potential for conflict of interest. Because the UTC searches the title and issues the policy for its underwriting title insurer, the title insurer is at the mercy of the UTC. A controlled UTC could issue a statement of clear title and write a title policy even though neither is justified so that its owners can generate a real estate commission, financing fee, or builder's profit.

Even if the potential for conflict of interest were not fully realized, the divided loyalties of the management of the controlled UTC has the potential to cause a gradual deterioration in the quality of work

and eventually in the quality of the product. This conflict of interest might lead to the double-barrelled effect of increasing title insurance costs to all consumers while lowering the reliability of the service. If this degradation of the quality of land ownership occurred, the solvencies of title insurers could be endangered. It also could place policyowners in risk of losing their homes, an occurrence they undoubtedly thought payment for the title search and the insurance policy would prevent.

3. California Department of Insurance, Findings of Fact, Conclusions of Law and Order, In re Application of Guardian Title Co. (1976).

[Note: In 1975 Coldwell Banker & Company, a large real estate broker, applied to the California Department of Insurance to obtain an organizational permit and license for its wholly owned subsidiary, Guardian Title Company, which would act as a title insurance agent for real estate transactions handled by the parent broker. The Insurance Commissioner denied the application, and the decision was affirmed in the California Court of Appeals, Coldwell Banker & Co. v. Department of Insurance, 102 Cal. App. 3d 381 (1980). The following are excerpts from the Insurance Department's findings.]

> 8. With rare exception, buyers and sellers of residential property either express no preference or look to the real estate broker or salesman (real estate producer) for advice in choosing an escrow holder, a title insurer or other supplier of services ancillary to the transfer of real property. Accordingly, the real estate producer not only has the potential to control, but generally does control, the placement of orders for such ancillary services . . . .

9. The competitive effort of title entities (title insurers and underwritten title companies) is directed primarily at the realtor, the agent of the consumer of title services, rather than at the buyer and seller of real estate, the true consumer of these services.

10. The real estate producer can and often does have financial and other incentives to channel or direct ancillary services to providers of such services with the result that the request for ancillary services made by the real estate producer on behalf of his or her client is often made for reasons that are not in the best interest of the client, the consumer in the transaction. The Commissioner's Bulletins No. 74-2 and 74-2A, wherein 33 unlawful rebate activities are described, address this problem and enforcement of the provisions of these Bulletins, eliminating or reducing many of the unlawful incentives, has stimulated interest in the ownership of underwritten title companies by real estate brokers.

* * *

21. The potential for real estate producers, who now channel, direct or influence the placement of most title insurance, to further control that business by placing it in their subsidiary title companies can damage the market even if a large share of the business is not actually so controlled because potential new entrants, seeing the possibility of tie-ins, may not enter the market for fear of being at a competitive disadvantage that could not be overcome, even by offering lower prices, better coverage, or higher quality service.

22. . . . [A]nalogizing to the history of credit life and disability insurance in California wherein a similar phenomenon of "reverse competition" exists, if GUARDIAN [the controlled agent] and other underwritten title company applicants owned or controlled by realtors are licensed as underwritten title companies, competitive pressures will dictate an increased charge for title insurance because the only way for title insurers to compete in such a business environment is to outbid each other in negotiating the percentage of the fee for the policy of title insurance that they are willing to

accept as an underwriting fee or to outbid each other in providing the work product and services normally assumed by the underwritten title company (i.e., providing a search package requiring the underwritten title company to do little or nothing other than deliver the policy and collect the fee).

As the margin of profit for title insurers diminishes because of a reduced fee for underwriting or because of increased costs due to a commitment to assume more of the duties normally provided by an underwritten title company, the cost of title insurance will inevitably rise. . . .

Further, there will be no incentive for maintaining the present rates for title insurance or reducing those rates. Rather, once conventional price competition between title insurers is effectively eliminated, the incentive will be for title insurers to increase the rates for title insurance to increase the margin of profit to the real estate producer owning or controlling the underwritten title company, both parties to the underwriting contract being assured that the source of business to the underwritten title company is secure. . . .

* * *

25. Those few underwritten title companies owned or controlled by real estate producers have generally enjoyed success in terms of market penetration and profitability that is unmatched by other underwritten title companies and title insurance companies operating in the same geographic area. No reason for the extraordinary success of such underwritten title companies has been shown other than their ownership or control by real estate producers.

4. State of Utah, Office of Legislative Research, Title Insurance in Utah: Issues and Perspectives - Report to the 43rd Legislature 18, 34 (1978).

The competitive structure of the [title insurance] industry is also seriously jeopardized by the practice of controlled business. . . . Under this practice, the producers of title business, the lenders, real estate brokers, building contractors, etc., own an interest in

or have financial ties to a title insurance agent. With this tie, there are added incentives to direct business to this captive agent in order to insure profitability of the agent's business and gain added financial benefits not available otherwise. Under controlled businesses, the quality of the search, timeliness of the service and even the cost of certain aspects of title services, such as escrows, closings or settlements may be jeopardized to the detriment of the consumer.

5. Roger L. McNitt, Title Insuance Rates and Controlled Business, A Report to E. V. 'Sonny' Omholt, State Auditor and Commissioner of Insurance for the State of Montana (1979).

A third business influencer controlled title agent is First American Title & Escrow of Billings ("FATEBILL"). . . . The Bylaws of FATEBILL limit shareholders to Montana licensed real estate brokers. . . . [T]he record shows the phenomenal growth of FATEBILL from a mere 11% of the Yellowstone County market in 1974 to 51.6% of the market for the nine months ending September 30, 1978. Competitors at the hearing complained that the substantial increase in market share was attributable to broker control. Although given ample opportunity at the hearing to rebut that fact, FATEBILL presented no testimony or subsequent statement for the record setting forth reasons for its phenomenal growth (such as better service) other than broker control. In a letter dated July 18, 1979, a copy of which is attached to this Report, Zane K. Sullivan, President and General Counsel of the American Land Title Companies, ("American") contends that his company was advised that even though it might be able to render faster or better service, brokers would not direct business to it because they had a financial commitment to FATEBILL. Other brokers, according to Sullivan, advised his representatives that they should not even bother to solicit business because brokers received a dividend payment from FATEBILL on an annual basis in an amount reflective of the amount of business directed to FATEBILL. Sullivan further points out that his company has been attempting to establish a new agency in Billings. Yellowstone County contains

approximately 125,000 people and at the time American attempted to establish an operation there, there were three existing title companies. Sullivan felt that this was sufficient population to justify a new agency, but that the "chilling effect" of FATEBILL has left him questioning that initial view. . . .[H]ad he known at the outset "the percentage of the local real estate agents who were financially tied to the First American office and the strength of that financial commitment", he would not have attempted to enter the Billings market.

* * *

The question of licensing persons who control the flow of title insurance as title agents is a major national issue and one which cannot, and should not, be ignored.

6. Michigan Department of Commerce, Insurance Bureau, Broker Owned Title Insurance Agencies: Compliance with Chapters 12 and 20 of the Insurance Code of 1956 - Procedural and Interpretive Guidelines, Bulletin: 77-2; and Real Estate Broker Ownership of Title Insurance Agencies: Consumer Protection Imperatives - A Report to the Michigan Commissioner of Insurance (1977).

The findings and conclusions by various executive, legislative and judicial branches of federal and state governments and the results of the Insurance Bureau's investigation have caused me to recognize that permitting real estate brokers to own or control a licensed title insurance agency for the purpose of channeling title insurance business is detrimental both to the consumer of title insurance and to actual and potential competition in the title insurance market. . . .

* * *

Reverse Competition

The real estate broker with no financial connection with title insurers or agents could be expected to seek the best title policy for his or her client based on coverage, service, and cost. However, this expectation may be thwarted where the broker profits by

channeling his or her clients to an agency owned or controlled by the broker. With the ordinary restraint of competition missing, the broker controlled title agent is free to choose an insurer based on how much it will receive as compensation, not on the best price it can offer the purchaser. The broker, whose dividends depend on the controlled agent's profits, will continue to direct its business to the controlled agent.

* * *

It may be argued that coercion, in the context of commercial transactions, is generally deemed to occur when a purchaser is denied a free choice of products or services. The purchaser of title insurance, it may be contended, is denied free choice by his broker when, without knowledge or understanding of the options, he relies on the broker to fulfill his title insurance requirements and the broker directs the business to the title insurance agent owned by the broker.

* * *

There has been a proliferation of title insurance agencies in the last few years. In 1969, there were only 46 agencies. Between 1970 and 1973, 35 more came into existence. Since 1974, 50 more agencies have been created. . . . Of 131 active agencies, 45 have some ownership by real estate agents. There is a trend in this direction. The more recently an agency has been formed, the more likely it is that it will have a high proportion of real estate brokers as equity holders. . . . A typical full service title insurance agency writes title insurance commitments and policies, does title searches and abstracts of title, maintains a title plant, and performs escrow services or closings. Nine agencies appear to be something less than full service agencies, in that they obtain title searches and abstracts of title from outside the agency. Eight agencies purchase title data from insurers and one agency purchases data from another title agency. The eight agencies that purchase title records from the insurers are owned by a majority of real estate brokers.

7. H. Roussel and M. Rosenberg, Lawyer-Controlled Title Insurance Companies: Legal Ethics and The Need for Insurance Department Regulation, 48 Fordham L. Rev. 25 (1979).

In a real estate transaction, the lender often requires the purchaser-borrower to obtain title insurance as a condition of receiving a mortgage. When the transaction involves a residence, the purchaser generally relies upon real estate professionals, such as the lender, the lawyer, or the realtor, for the selection of a title insurance company. The result is a process called "reverse competition" by which title insurance companies compete for the recommendation of these real estate professionals rather than appealing directly to the ultimate consumer. Reverse competition has frequently taken the form of rebates, commissions, or other payments from a title insurance company to lawyers, realtors, or other business referrers. Such payments are generally not justified by the work performed by the referrer.

Regulations issued by the Pennsylvania Insurance Commissioner prohibit, as rebates, payments made or inducements for business given to someone other than a bona fide insurance agent. To circumvent this prohibition, a number of real estate brokers in the suburban counties of Philadelphia established wholly-owned title insurance agencies to which they referred their real estate purchasers, and to which the title insurance companies made payments. The realtors thereby received payments indirectly from the title companies as dividends from the title agencies, which payments arguably would have been rebates had they been made directly to the realtors. The practical effect was no loss of revenue to the referring realtor, who could no longer accept direct rebates.

[In response to this problem the Pennsylvania Insurance Commissioner initiated a proposed rulemaking to prohibit controlled business, Pa. Bull. 2021 (July 16, 1977).] As described in the proposal: "[A]gencies owned by real estate agents or brokers or attorneys also create problems of self-dealing and conflicts of interest. The prospect of profit from an agency creates an incentive for title insurance to be selected based on the interests of the real estate agent or broker or attorney owner rather than the person seeking insurance protection."

8. Public Citizen Litigation Group, Request for Regulatory Action, Letter dated October 29, 1980, submitted to the Department of Housing and Urban Development.

[We would like to request action on a related problem] . . . the financial injury to purchasers which can occur when real estate professionals, such as attorneys, real estate brokers and bank officers, own or own an interest in a related real estate service such as title insurance. The problem arises because the average real estate buyer has little expertise in the problems connected with the purchase of a house. Further, the cost of title insurance represents only a small fraction of the costs associated with the real estate transaction. Thus the buyer tends to rely on his attorney, real estate broker and banker to guide him to a competent title company which charges reasonable prices.

However, where the real estate professional has an interest in a title insurance company there is a conflict of interest between the responsibility of the lender, broker or attorney to the client -- buyer -- and his own financial interest in the controlled title company. The buyer will be deprived of unbiased advice if the real estate professional steers him to a controlled company.

The effect of this practice is plainly anticompetitive. There is no incentive for the controlled title company to improve policy coverage or service and there is every incentive to increase prices, because its business is steered by its owners and is free from competition of the independent title companies. . . . Thus, the primary function of these captive title companies is to act as a conduit for the referral of fees to the attorney, broker or lender. This is the kind of abuse that the Real Estate Settlement Procedures Act (RESPA) was enacted to prevent, and we urge HUD, through enforcement of RESPA and the request for supplemental legislation, to promptly eliminate the steering of title insurance business to captive companies.

9. RESPA Staff, Department of Housing and Urban Development, Informal Opinion Letters, 1980.

As you may know, RESPA is based upon a Congressional determination that settlement costs were unnecessarily high. A contributing factor to these costs was the practice of paying kickbacks or fees for the referral of settlement business. In banning kickbacks and unearned fees, Congress sought to eliminate pecuniary interests from referrals for settlement services. Since the enactment of RESPA, we believe that the direct payment of cash for referrals has ceased. However, some settlement service providers have sought to circumvent the prohibition against compensated referrals by employing a form of corporate organization called controlled business.

In a classic controlled business scenario, one or more providers of settlement services band together to form a corporation. This corporation is authorized to provide a settlement service to the public. Each participant in the corporation obtains an ownership interest and refers all or some percentage of its clients to the owned entity. Profits generated by the corporation are then distributed or attributed to the owners/referrors. As stated in the interpretive rule [published in the Federal Register, 45 Fed. Reg. 49360, July 24, 1980], this course of conduct may constitute a violation of Section 8. The only apparent distinction between the direct cash payment and the controlled business profit distribution appears to be the corporate intermediary. We are not convinced that this distinction is material for the purposes of Section 8. [R. J. Patterson, Acting Director, Real Estate Practices Division; reproduced in Barron, Federal Regulation of Real Estate: The Real Estate Settlement Procedures Act, (1981 Cum. Supp. No. 1) at p. 5-217.]

* * *

In recent years, some providers have sought to avoid the application of Section 8 by establishing corporate intermediaries in which they retain an ownership interest and to which they refer business. The rule states that the imposition of a corporate middleman does not automatically remove another otherwise prohibited transaction from the coverage of Section 8.

The rule does not create a new violation, nor does it expand the statute's prohibitions. It represents

the Department's view of an application of Section 8 to an increasingly prevalent settlement practice. . . .

We must disagree with Mr. . . .'s assertion that the rule will tend to eliminate competition which is beneficial to the consumer. In enacting Section 8, Congress sought to remove the pecuniary interests of providers from their referral decisions. This prohibition was based upon a realization that in some industries competition was for the person in a position to refer business rather than the consumer. Congress found that this practice contributed to unnecessarily high costs. It is anticipated that competition among providers will be enhanced if the consumer has an expanded field of providers from which to choose. [G. Baroni, Assistant Secretary; reproduced in Barron, op. cit., at pp. 5-215, 216]

10. Dr. Deborah Ford and Burgess Allison, The Impact of Title Insurance and Controlled Business on the S&L Industry, Federal Home Loan Bank Board Journal 2 (June 1981).

The study [performed for the Department of Housing and Urban Development by Peat, Marwick, Mitchell & Co.] revealed what professionals in the real estate industry have long known: that most homebuyers do not understand title insurance nor do they shop for it. They depend almost exclusively on referrals from real estate professionals in the local area. . . . The result of such a dependence on referrals is that title companies compete aggressively for those in a position to refer business, rather than for the consumers who will actually pay the bill.

This fundamental characteristic, generally referred to as reverse competition, serves to create a market in which traditional economic principles of a competitive market do not apply. Since the consumer has no significant role in the selection process, there is little incentive to keep prices low or otherwise be concerned about the consumer. . . .

* * *

Reverse competition in the title insurance industry has taken one of several different forms in provid-

ing benefits to referrers. Direct kickbacks are the most obvious form of benefit, and prior to RESPA they appear to have been a standard operating practice in many areas of the country. Following the enactment of RESPA, however, the open payment of such kickbacks appears to have diminished.

* * *

Controlled business is another manifestation of reverse competition in which referrers seek to benefit from their own referrals. In a controlled business situation, a broker or lender owns an underwritten title company, and refers all (or most) of its customers to its own title company. The controlled title company has an assured source of business and has only marginal liabilities for losses since it is acting as the agent for the insuring underwriter. It clearly has a competitive advantage entirely unrelated to the service it provides for the consumer.

The advantage in a controlled business, review fee, or other tied relationship is important because of its effect on the service eventually provided to the consumer. This assurance of customers virtually eliminates any competitive incentives to provide quality service. Further, the relationship offers an opportunity to raise prices substantially without losing customers. . . .

In fact, it appears quite likely that such a relationship helps to maintain high prices and provides the capability of raising prices without losing customers. Given the financial incentives involved, there is every reason to believe that a controlled business would take full advantage of its relationship.

* * *

The problem of institutions benefitting from their own referrals -- a problem Congress or HUD must eventually address directly -- is that a controlled business relationship tends to create a situation in which one provider has an assured source of business, regardless of its prices or the quality of its services. In such a situation, it may be unrealistic to believe that consumers will get fair value for their money.

KANSAS BUILDING INDUSTRY ASSOCIATION, INC.

OFFICERS

President
JOHN SAMPLES
P.O. Box 259
Osage City, Ks 66523
785-528-4163
Fax 785-528-4795

Vice President
MICHAEL STIBAL
8112 E. Greenbriar
Wichita, Ks 67226
316-686-3984

Treasurer
JOHN YOUNG
1125 Garden Way
Manhattan, Ks 66502
785-539-4687
Fax 785-539-6419

Secretary
DAVID REYNOLDS
1017 Wildwood Dr.
Lawrence, Ks 66046
785-832-1414
Fax 785-832-0711

H.B.A. ASSOCIATIONS
Dodge City
Hutchinson
Lawrence
Manhattan
Montgomery County
Salina
Topeka
Wichita

PAST PRESIDENTS
Lee Haworth 1965 & 1970
Warren Schmidt 1966
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Dick Mika 1971-72
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Jerry D. Andrews 1977
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Vernon L. Weis 1992
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R. Neil Carlson 1996
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TESTIMONY BEFORE THE HOUSE INSURANCE COMMITTEE

by
Janet J. Stubbs

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

The Kansas Building Industry Association is a trade association comprised of approximately 1300 members statewide of the residential and light commercial construction industry. At their January 29, 1998, meeting, the Board of Directors adopted a position in support of HB 2692.

When this issue was before the Legislature a few years ago, we found that we have members on both sides of this particular issue and therefore would alienate both sides to take a position. The members with each philosophy on this issue are valued in our Association and as part of the real estate sales world. However, the substance of the issue as presented to the Board, and upon which the decision was made, came down to one which the members of the construction industry related . The comparison of the situation would be if there was a prohibition against a building contractor's interest (part ownership) of a subcontracting company such as an excavating company, sheetrock company, etc. In other words, if the contractor could not use a subcontracting company of which he was part owner on more than 20% of his projects even though his company provided equal or better service at a price of an equal or lesser amount.

Although the Board did not support a situation which would encourage price fixing or remove the free enterprise aspect of the marketplace, we believe those safeguards can be put in place without removing entrepreneurial endeavors of the individuals or benefits to customers of competition.

The membership of the KBIA firmly believe in the free enterprise system and do not believe protections should be built into the law to limit competition for any company. Service is the name of the game today and everyone should have to compete on that basis. The construction industry operates in that manner and we believe other businesses should also. The KBIA could never support a monopolistic philosophy that we view the current law to be.

Karen France of the Kansas Association of Realtors presented testimony which provided background information for you. The KBIA joins KAR in their support of HB 2692 and thank you for your consideration of our remarks.

House Insurance
Attachment #2
2-3-98

JANET J. STUBBS, Executive Director
2300 S.W. 29th St., Suite 121 • Topeka, Ks, 66611 • (785) 267-2936 • FAX (785) 267-2959