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Time-Tested Title Insurance Emerges as 'Best Practice' Risk Management Tool for Secured Lenders

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Anticipating change has become the foremost challenge to the professional risk manager, and perhaps no place in society has change, uncertainty and risk become more problematic than the financial services industry. Challenges to risk managers are presented by economic, credit cycle, asset quality, regulatory and institutional changes.

It's no easy task: anticipating the negative shift in credit cycles; receiving regulatory pressure to improve credit quality; protecting reliance collateral; managing the staggering legal costs associated with charge-offs, modifications, foreclosure strategies and legal opinions; managing loan loss reserves; maximizing the demands of investors, secondary market offerings, recourse, puts, takes; determining operational risk; managing risk-adjusted capital; managing operating margins and liquidity. It can be just another day in the office — no simple task, indeed.

According to regulatory authorities gathered recently in Chicago for the professional Risk Management Association's Annual Conference, risk managers were, in consideration of anticipated yet undetermined changes to the financial markets, urged to shift risk when possible, and to use all risk management tools at their disposal.

A Regulatory Perspective

Generally consistent in their remarks, representatives from the Office of the Controller of the Currency, the Federal Reserve System, The Federal Deposit Insurance Corporation and the Office of Thrift Supervision discussed similar general themes. Namely, that economic cycles cannot be effectively defined except to say, they are unpredictable.

Further, the consistent theme in their comments seemed to reflect that we are likely at the tipping point of the current credit cycle. Liquidity in the market has resulted in too much money chasing too few deals. The result is an apparent erosion in underwriting standards and the lender's related exposure to loss-given-default in the event of an economic downturn. Loan concentration is a concern, asset quality is critical and there was the suggestion that the future practice of examiners can be expected to focus on risk management techniques as evidence of the bank's capital and liquidity plans.

Blocking & Tackling

Risk managers want their lending institutions to have better credit quality, less risk, lower risk-based capital requirements, reduced loan loss reserves, enhanced liquidity, greater margins and the opportunity for improved value of loans sold into the secondary market. Risk managers want to avoid legal expenses associated with challenges to reliance collateral, and the costs associated with the loss of collateral due to documentation defects and clerical errors. They seek to shift risk.

Fundamental "blocking & tackling" has been used by lenders to shift risk in the past, in what has become an essential component of the real estate-secured lending business and mortgage-backed securitization market. Traditionally real estate lenders and investors have used title insurance to minimize documentation errors and to manage problems associated with challenges to lien priority. Lenders have benefited from the related improvement in credit quality, secondary market value and liquidity

Title insurance is the real estate industry's time-tested and preferred method of shifting risk. In recent years traditional real estate title insurance has emerged as a best practice risk management tool for secured lenders … with one significant update; it is now available to lenders in which "reliance collateral" is personal property as defined by Article 8 and Article 9 of the Uniform Commercial Code.

Anticipating Change

The title industry has essentially adapted the time-tested American Land Title Association (ALTA) real estate title insurance policy form to provide the benefits of title insurance to commercial lenders securing loans with non-real estate collateral. In a few short years the nation's leading title insurers have produced so-called "UCC Insurance Policies" in amounts covering an estimated $150 billion in secured lending.

proof

The industry has geared up to provide market-critical risk shifting for commercial lenders exposed to the dynamics of uncertainty, driven by anticipated yet undetermined factors such as changes in employment, manufacturing, retail spending, interest rates, energy costs, real estate values, global stability, unfunded pension liabilities, and both regulatory and institutional changes in perception. In short, the cycle of loosening of credit common during economic expansion and the tightening of credit anticipated during economic contraction will require a new level of risk management expertise.

Time Tested

The original concept of applying the benefits of real estate title insurance to the commercial finance market segment was simply this: If virtually every bank in the United States originating real estate-secured loans requires real estate title insurance, would those lenders originating non-real estate secured loans not enjoy the same benefits of title insurance?

As late as the mid-1950s real estate title insurance had not yet become universally accepted or utilized by lenders. Lawyers' legal opinions and abstracts were widely utilized in the nation's real estate markets. Standardized real property title policy forms of coverage, endorsed by the ALTA, were still a decade away.

Many believe it is the secondary market, with the advent of Fannie Mae and Freddie Mac and their crucial roles in the American economy, that led to not only the importance of title insurance for individual loan originations, but the investment community's need for enhanced, high quality, real estate related "securities."

Enhancing Credit Quality

This quality enhancement was provided by the nation's title industry, based on the industry's ability to deliver, insure and defend "clear title." Although UCC insurance, available from the nation's leading real estate title insurance companies, is a relative newcomer to the financial markets, lenders and investors are poised to gain many of the same benefits currently and prominently enjoyed in the real estate markets.

Similar in many respects to traditional real estate title insurance, UCC insurance was developed specifically to insure the lender's security interest in non-real estate collateral.

UCC Insurance… A Risk Management Tool

UCC insurance is a title insurance product, which insures the lender's security interest in loans secured by non-real estate assets for validity, enforceability, attachment, perfection and priority. UCC insurance covers fraud, forgery, insures the gap and provides cost-of-defense coverage in the event of a challenge to the lender's security interest. Policies include UCC search and filing services, are life-of-loan and are assignable.

Articles 8 and 9 of the Uniform Commercial Code, refer to "personal property," which includes inventory, furniture, fixtures, equipment, accounts receivables, deposit accounts, general intangibles, and securities and pledges (often crucial to the mezzanine lending markets). Now lenders can outsource UCC search, document preparation and filing functions, while wrapping the entire transaction in an insurance policy offered by a handful of Fortune 500 insurance companies, effectively shifting risk for the proper attachment, perfection and priority of their security interests.

The policy replaces the costly traditional legal opinion rendered by borrower's counsel as a lender requirement, and provides cost-of-defense in the event of a challenge to lien attachment, perfection or priority. And, only UCC insurance overcomes limited "UCC search vendor" indemnification in connection to search office errors and omissions, indexing inconsistencies and financing statement inaccuracies.

Fire Insurance Before the House Burns Down

Market research has shown that most commercial loan documentation defects that lead to a lender's security interest being set aside are rather clerical in nature: incorrect name of borrower, searching of the wrong jurisdiction, wrong state of filing, the lack of filing the appropriate documents, an error in the collateral description, etc. The research indicated that it might be the lowest paid individual at either the bank or the law firm that was responsible for perhaps the greatest risk to the lender: the loss of reliance collateral.

The research also noted, that like the perception of the value of insurance products, UCC insurance may be viewed by many as similar to the fire insurance we all purchase for our personal homes — You don't really need the fire insurance until the house catches on fire. In other words, there was unlikely to be a challenge to the lender's security interest, unless there was a default. However, unlike the fire at your home (that may not result in a total loss of contents), when a perfection or priority defect occurs — even though a technical or monetary default may not yet have surfaced — it is often catastrophic to the lender in that it consumes all collateral.

So even loans known by the lender to be defective in documentation have, in some institutions, not been an issue until such time as they were in (monetary) default. By then, it is often too late — for our homes — as well as for the lender's collateral position. The $35 indemnity furnished by the bank's UCC search vendor, or the right to sue outside counsel, do not represent attractive alternatives to proper perfection and priority to the lender's risk management team.

Shifting & Managing Risk

In recent years the stable economy has "masked" commercial loan defects, not linking them particularly to defaults and loan recovery. Documentation defects that will directly impact value and recoverability of collateral have been kept somewhat below the surface by the simple fact that many of the affected loans are not in monetary default. This, notwithstanding the potential for the borrower being headed toward an insolvency proceeding, which is likely to result in a challenge to the lender's security interest.

Perceived equity cushions and ample alternative sources of capital may have artificially hidden problems associated with loan concentration, market saturation, actual cash flow and management difficulties in core lending segments.

What those of us who attended the Risk Management Association Annual Conference learned is that not even the top economic and regulatory minds in the nation are willing to gamble on unlimited growth, economic expansion, available credit or luck for underwriting commercial loans — or in managing the risk inherent during a time of economic change and instability.

With change comes uncertainty. With uncertainty comes risk. A risk manager should use all available tools in shifting risk. UCC insurance is a time-tested concept, now available to secured lenders and commercial risk managers. **abfj**

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