INTRODUCTION: THE RATING COMPANY

The motivation for purchasing insurance of any type is to obtain protection against or to manage some type of risk. In the case of property and casualty insurance, the insured is attempting to protect against loss caused by natural and manmade catastrophe. In the case of title insurance, the insured attempts to protect against losses that may occur by virtue of the title to the real property being other than the parties think it is when the policy of title insurance is purchased.

In each of these cases the premiums paid to the insurance companies with the expectation that the companies will honor their obligations under the policies they have written, if the event triggering coverage under the policy occurs. An insurance purchaser's expectation is really only as good, however, as the financial strength and viability of the insurer at the time of the loss. Where the risk is likely to be known in a short time frame, as with most claims, on property and casualty policies, reliance on the insurers rate is a reasonable and prudent course of action. However, where the risk may not turn into a loss for decade, as in the case of a title insurance claim, the insurer's current rating may serve little more than a current procedural requirement or transferability to a mortgage loan.

The solvency of companies writing casualty insurance have been on the rise over the last several years and, unlike the protection provided to bank customers by the Federal Deposit Insurance Corporation, most insurance purchasers have far less protection in the event their insurer fails. As discussed subsequently, the State Guaranty Fund provides little protection for the commercial insured as these funds vary greatly in terms of their coverage than most. They do not extend to cover reinsurance and commercial lines of coverage.

The choices confronting purchasers of insurance products represents a blend of many factors, including coverage costs, service and financial stability of the insurer. No single insurance company offers the best of all factors, so the purchase of insurance necessarily involves tradeoffs to reach a blend which meets the purchasers need.

The current rating procedures for insurance companies are based either on a purely quantitative evaluation of the insurer's financial filing or a combination of quantitative analysis adjusted by the rating company's qualitative analysis of the insurer's management and capital structure in areas of risk insured.

The firms providing ratings of insurance companies came into existence to provide objective third-party analysis of the viability of insurance companies. A.M. Best Company ("Best") and Standard and Poors Corporation ("S&P") is a primary source for the ratings of property, casualty insurance companies and life health insurance companies. These materials will analyze the services

they provide in rating property casualty companies. Best describes its rating as its "independent opinion of financial strength and operating performance of an insurer relative to standards Best has established". S&P describes its rating of an insurance company as "an opinion of an insurance company's financial capacity to meet the obligations of its insurance policies in accordance with their terms".

The rating of title insurance companies is a more recent occurrence, occasioned by the imposition of rating standards for title companies by the Federal National Mortgage Association ("Fannie Mae") for residential mortgages it purchases. Demo Tech, Inc. ("Demo Tech") and Lace Financial Corporation ("Lace") the most title underwriters voluntary basis without charge to the insurance companies. S&P has rated only two title underwriters to date. These underwriters are Chicago Title and Trust Company Group ("Chicago") and Old Republic Title Insurance Group ("Old Republic"). S&P only rates title insurers on a voluntary basis with the annual charges of between $25,000 and $80,000 to the company being reviewed. These materials will also review the differences among these rating services for title insurance underwriters.

SECTION II BEST INSURANCE RATINGS – PROPERTY/CASUALTY

The oldest player in the insurance rating industry, A. M. Best Company, provides insurance ratings for property and casualty insurance company, life health insurance company, and a number of different products and services. When the ratings are referenced for property/casualty companies in these materials, reference is made to the 1994 edition of Best Key Rating Guide. The 1994 edition rates more than 2,400 property/casualty insurance companies. Ratings are carried out annually with quarterly updates. The ratings are also reviewed following any significant events, such as catastrophes, law suits, management or ownership changes. Annual review is based primarily on the detailed analysis and computer checking of the company's sworn annual statements filed with the National Association of Insurance Commissioners ("NAIC"). In most states, these filings are due by March 1st of each year. Best also supplements companies sworn annual financial statements with financial questionnaire directly to the rated company and other financial data, such as state insurance department examination reports and audit reports prepared by the companies certified public accountants.

A. Best Rating System

The Best rating system considers many factors in determining an insurance company's rating. Review includes both qualitative and quantitative evaluations of the company's financial condition and operating performance.

1. Quantitative Evaluation. Quantitative evaluation analyzes a company's reported financial performance for at least five years, utilizing over a hundred key financial tests and various types of supporting data. The quantitative analysis

focuses on the company's performance in the areas of (1) profitability; (2) leverage/capitalization; and (3) liquidity. The quantitative analysis and financial performance of the insurers is performed at two levels. First, the NAIC statement data filed by the insurer is submitted to the various tests and models developed by Best to develop the various ratios reported in the Best Insurance Guide. Secondly, individually rated companies in the NAIC statement data is adjusted as a result of policyholders surplus factors to give a more current evaluation of the company's surplus position. This coupled with additional analysis of the consolidated financial of the individual companies affiliated with the rated company is used in determining any adjustments to the quantitative portion of the company's rating.

Profitability An insurance company's ability to manage its business operated and pay necessary losses is still making a profit. In addition to paying dividends, the profit may fund the surplus of the company which represents additional security for the policyholders. The company's surplus also provides a safety cushion protecting against catastrophes and other unexpected events and also against burdensome state regulations. In analyzing profitability, Best reviews earnings, underwriting capital, gains and losses, income from investments and the total picture of the company's operation, both before and after taxes. Premium volume is analyzed to determine important changes in the amounts of diversification of products offered, geographic spread and volatility of the kinds of coverage written by the company. These factors can either have an adverse or beneficial effect on the profitability of the company being analyzed. Changes in the economic climate, the regulatory landscape and the judicial and financial market environments in which the company operates can significantly impact its profit and surplus. In addition to more obvious and natural and manmade catastrophes resulting in higher losses. These factors are external to the company. Internal factors include growth levels, the taxes and expenses the company pays its unearned premium reserves and loss reserves, its reinsurance arrangements and the mix of its assets. The concentration of those assets and the value of its assets on its statements versus the market value of those assets.

Leverage/Capitalization considers the exposure of the company's surplus to various operating and financial practices the company employs. While a high-leverage company might generate high return on surplus, the company might also be exposed to high risk of instability resulting from the nature of investments that generate the high return. Conservative leverage levels enable an insured to better withstand various types of catastrophe, adverse changes in the results of underwriting, decrease in investment returns and changes in the economic or regulatory climate which are of an adverse nature to the company being rated. The cost of a conservative approach to leverage is generally a lower return on the company surplus.

Best considers both financial leverage and operating leverage. Financial leverage considers the use of debt, or debt-

like instruments, to leverage the capital of the company. Operating leverage arises from four sources:

- currently written insurance
- reinsurance
- reserves maintained for policies
- losses in the company's investments.

In determining operating leverage, the factors analyzed by Best as unique to the company include the following:

- spread of risk
- credit quality and appropriateness of reinsurance programs
- quality and diversification of assets
- adequacy of the policy or loss reserves.

In analyzing operating leverage factors, Best developed a capital adequacy ratio model and, since 1994, has been separately publishing that ratio as Best's Capital Adequacy Ratio ("BCAR"). That ratio is similar in many respects to the NAIC risk-based capital discussed subsequently. Fundamentally, the BCAR issue is calculated as the net required capital necessary to support various business risks in relation to a company's adjusted surplus. The amount of required capital is calculated as the required level of capital to support seven broad-risk categories, which include fixed income securities, equity securities, interest rate credit, loss reserve, net written premiums and business risk. For companies underwriting predominantly long-tail liability risk, the normal range for the BCAR ratio is 100% to 150%. Companies underwriting predominantly short-tailed property risks, the normal range for the BCAR ratio is 150% to 200%.

Liquidity is the company's ability to meet its anticipated short and long term obligations to policyholders and other creditors. The ability to satisfy financial obligations by holding cash and investments which are sound diversified and able to be converted to cash without major exposure to loss of value is a measure of liquidity. As is true in most other tests conducted by Best, the liquidity test involves reference to comprehensive data base, including information on both individual insurance companies in the entire industry.

2. Qualitative Evaluation. In addition to analyzing quantitative factors, Best procedures also include a more judgmental review. A qualitative evaluation of the following factors:

- spread of risk
- quality and appropriateness of reinsurance program
- quality and diversification of assets
- adequacy of policy or loss reserves
- adequacy of surplus
- capital structure
- management and experience and objectives

- market presence
- policyholder confidence.

Spread of Risk Spread of risk can be accomplished by a company issuing a large number of policies in diverse geographic locations extending across many product lines and handled through different types of distribution systems. The number of catastrophes in recent years have shown that even regional and national insurers are vulnerable to isolated catastrophe losses because of their lack of geographic spread of risk or concentration on a single line of insurance.

In evaluating spread of risk work in the company's rating, Best subjects the insurance company to a series of catastrophe modeling. For small single state companies, the modeling test subjects 10% of the companies property policy _________ to full limits losses. For larger companies, modeling includes whether an earthquake catastrophe modeling of the insurers book of business. The other spread of risk element which Best analyzes involves exposure of companies to regulatory residential market risk within certain states. These risks include state mandated rate rollback, guaranty fund, residual market assessment or severe restrictions on rate promulgations.

Quality and Appropriateness of Reinsurance Program The quality and appropriateness of reinsurance program is studied because of the essential role that reinsurance plays in protecting insurers by spreading risks. Reinsurance is especially important for small and medium sized insurers. This analysis determines whether the reinsurance program is appropriate in size and has a good credit quality. Quality and diversification of assets: The invested assets of _____________________ common stocks, bonds, real estate, and mortgage loans are evaluated to determine the potential impact on surplus if the sale of these assets occurred unexpectedly. Simply put, the higher the liquidity, diversification and quality of the assets, the less uncertainty there is to its value as a ready asset and back policy claims.

Adequacy of Policy/Loss Reserve In determining the adequacy of a policy/loss reserve, the __________ takes the companies NAIC file loss reserve data and subjects it to modeling based upon both historical industry reserve data for that particular line of insurance and the historical data reserved history of the individual company. Using this method Best estimates the ultimate loss reserve deemed to be reasonable for that company.

Adequacy of Surplus The adequacy of surplus is the evaluation made by the company's surplus relative to its underwriting investment and reinsurance exposure. This analysis goes beyond the NAIC data and quantitative test. The _________ becomes clear by virtue of the fact that unexpected exposure from underwriting decisions policy reserves reinsurance for company's investments, could impact surplus in a very serious fashion and have a major impact on the company's health.

Capital Structure Capital structure is the sums of the company's capital structure in the degree to which it is

unencumbered. The existence of financial instruments (letters of credit, surplus, notes, diventures, etc.) at either the company or holding company level which required that service will reduce the quality of the company's capital structure and place a drag on future earnings, cash flow and accumulation of additional surplus. The existence of these instruments at the holding company level impacts the company because the payments are generally handled by dividends or expenses allocated to affiliate companies.

Management Experience and Objectives ______________ represents a subjective consideration. Best notes, however, that since "the insurance business is based on underlying foundation of trust and physical responsibility, prudent management plays a more vital role than in most other industries".

Market Presence Market presence is an analysis of an insurer's strategy for responding to the competitive marketplace challenges and regulatory pressure. It is necessary in assessing a company's long-term viability. Hence, ___________ and sustainable competitive advantages include lower cost structure, easy access to capital, underwriting experience and ___________ product line, control over distribution and multiple distribution channels, spurious service and a captive market of insurers.

B. 1994 Rating Categories: What They Mean

The Best issues are two basic rating distribution systems. For those companies of adequate size and five-year plus operating histories which complete the full Best rating inquiries are issued opinion of financial strength ranging from A++ to (superior) to F (in liquidation). The financial performance rating (FPR) is assigned to those companies who complete and file the NAIC annual statement but do not meet Best minimum financial size requirements or do not have five consecutive years of representative operating experience. The FPR is assigned to companies that submit copies of at least three consecutive years of representative operating experience of NAIC statements and complete supplemental questionnaires. The financial performance rating ranges from PR=9 (strong) to FPR=2 (below average). The highlights of these primary ratings are as follows:

A++ and A+ (Superior) Assigned to companies who demonstrate superior overall performance when compared to standards established by Best. They are defined as companies which "have a very strong ability to meet their obligations to policyholders over a long period of time".

A and A- (Excellent) Assigned to companies which have demonstrated excellent overall performance when compared to standards established by Best and, "have a strong ability to meet their obligations to policyholders over a long period of time".

B++ and B+ (Very Good) Assigned to companies which have demonstrated very good overall performance when compared to the standards established by Best and, "have a very good ability to meet their

obligations to policyholders over a long period of time".

Vulnerable Ratings:

B and B- (Adequate) Assigned to companies who have demonstrated adequate overall performance when compared to the standards established by Best and, "generally have an adequate ability to meet their obligations to the policyholders but their financial strength may be vulnerable to unfavorable changes in underwriting or economic conditions".

C++ and C+ (Fair) Assigned to companies who have demonstrated a fair overall performance compared to the standards established by Best and, "generally have a current ability to meet their obligations to policyholders but their financial strength is vulnerable to unfavorable changes in underwriting or economic conditions".

C and C- (Marginal) Assigned to companies who have demonstrated marginal overall performance when compared to the standards established by Best and, "have a current ability to meet their obligations to policyholders but their financial strength is very vulnerable to unfavorable changes in underwriting or economic conditions".

D (Very Vulnerable) Indicates a demonstration of poor overall performance but have current ability to meet their obligations to policyholders. However, a D rating also indicates extreme vulnerability to unfavorable changes in underwriting or economic conditions.

E (Understate Supervision)

F (In Liquidation)

Each of these letter ratings can be accompanied by the rating modifier which provides additional information regarding matters such as group ratings, reinsurance ratings and qualified ratings that might address concerns about regulatory climate in the state where the company operates.

Highlights of the FPR ratings are as follows:

Secured PR = 9, 8 (strong)
FPR = 7, 6 (above average)
FPR = 5 (average)

VulnerableFPR = 4 (average)
FPR = 3, 2 (below average)

In addition to the companies which are rated either by letter or FPR number, Best also provides "not assigned" categories which explain why a company so designated was not rated. Reasons why company rating is not assigned may vary from insufficient size of the company to insufficient number of years of operation.

Additional Best Services In addition to the Best rating services, ______________ as a financial size category which indicates the size of an insurer is based upon reported policyholders surplus, conditional or technical reserve fund. The financial size category is represented by a roman numeral ranging from Class I (the smallest) to Class XV (the largest). Financial size category is an important reference in appraising the financial capability of the insurer. The ______________ surplus determines the size of risk which an insurance may prudently underwrite or assume on a net basis after reinsurance. Best also identifies the state in which companies licensed to do business. This information is very important to the insured by virtue of being able to call upon the state's regulatory authorities in the event of a problem, since the protection of the state guaranty funds generally apply only to companies licensed to do business within that state.

SECTION III - STANDARD & POORS PROPERTY/CASUALTY INSURER SOLVENCY REVIEW

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IN RE: FINANCIAL PERFORMANCE RATING

The FPR has also been endorsed by the secondary market lenders, Fannie Mae and Freddie Mac as an acceptable financial strength rating for homeowners insurance policies.

Non-Assigned Category NA-2 (less than minimum size) and NA-3 (insufficient operating experience) are both eligible for the FPR rating.

Rating Modifier Approximately sixty (60) percent of the Best rated companies also were assigned modifiers. Modifiers are as follows: G (Group); P (Pooled); R (Reinsured); Q (Qualified); and U (Under Review).

SECTION V - NATIONAL ASSOCIATION OF INSURANCE

COMMISSIONERS PROPERTY/CASUALTY RISK BASED CAPITAL RATIO

In 1994, the National Association of Insurance Commissioners (NAIC) began requiring property and casualty insurers to file a risk-based capital report. Although not intended to be a basis for rating of insurers, it is much like the previously discussed Best Capital Adequacy Rating (BCAR) in that it is a coverage capitalization ratio used for comparison between companies, similar businesses and insurance lines. The report develops a ratio by dividing the company's actual capital by an assigned risk-based capital number derived by submitting the actual capital to a risk-based capital model developed by the NAIC. This statistic is intended to assess the capital adequacy of the insurer and to provide an early warning tool to regulatory officials to prevent the capitalized companies from becoming insolvent.

Simply put, risk-based number denominators, the ratio, is derived by taking each category of capital assets (bonds, affiliated common stock, real estate, mortgage loans, etc.) premium and reserve items, multiplying it by an assigned risk-factor decimal. This risk-factor decimal assigned to capital assets range from .0 for U.S. Government Bonds to .5 for common stock for an affiliated alien insurer. The four major categories of risk analyzed by the model are: Asset Risk (the risk of assets, default of principal or interest or fluctuation in the market); Credit Risk (the risk of default on amounts due from reinsurers, policyholders or other creditors); Underwriting Risk (the risk of underestimating liabilities for business already written or inadequately pricing business to be written in the coming year; and Off-Balance Sheet Risk (the risk associated with items such as excessive premium growth, contingent liabilities and other items not reflected on the balance sheet). The use of the ratio by the regulators is tied to its adoption of a model enforcement law and promoted by the NAIC, which would require an insurer whose capital ratio fell below 150%, to provide regulators with more information about its business. The regulators take over a company whose capital level falls below 100%, action would be mandatory if the level fell below 70%. So far only seven of the fifty states have adopted the model law.

The ratio is purely a quantitative measurement and does not provide for any qualitative factors, such as management quality and competitive strategy. Much criticism has been directed at the quantitative nature of the ratio as the risk ratio does not adjust from year to year to reflect the changing riskiness of a company's assets, such as government bonds and commercial real estate, and that a year-end risk based capital is only a lagging indicator of solvency.

SECTION V - TITLE INSURANCE RATINGS

A. Introduction

The 1990's have seen the institution of independent third-

party ratings for title insurance companies. The development of title insurance rating companies was primarily a result of the anticipation of Fannie Mae posing new requirements with the title insurance policy covering one to four family properties being assigned to them. In November of 1994, Fannie Mae issued its announcement 93-13 dealing with "Acceptable Title Insurance Coverage". With that announcement, Fannie Mae amended its policies and procedures relating to title insurance covered by one, instituting a requirement that title insurers have an acceptable rating from an approved rating agency. Fannie Mae deemed the use of rating agencies performed by independent appraisal for the title insurers financial condition and ability to support its obligation would insure Fannie Mae's mortgage investments were protected by title companies ____________ acceptable claims paying ability. The practice would not supersede the need for title insurers to satisfy other eligibility requirements in Part 4 Section 105 of the Fannie Mae Selling Guide, rather replace the then current practice of publishing the name of each title insurer could issue mortgages that were delivered to Fannie Mae. Secondly, Fannie Mae determined that any American Land Title Association title insurance policy, which included the creditor's rights exclusion language that ALTA adopted in 1990, would not constitute an acceptable title insurance coverage. In 1990, ALTA loan title policy contained a creditor's rights exclusion statement that included "Any claim which arises out of the transaction creating the interest of the mortgagee insured under this policy, by reason of operation of federal, bankruptcy, state insolvency or similar creditor's rights laws". This exclusion language stated the possibility that the title insurer would have no liability because of a bankruptcy trustee's assertion of rights of a hypothetical or actual lien creditor would have arisen "out of a transaction creating the mortgage by reason of operation of federal bankruptcy laws". Because of concerns expressed by Fannie Mae and others, ALTA revised the creditor's rights exclusion when it issued its 1992 title policy form. Thirdly, we may have eliminated the need for lenders to call Fannie Mae's regional offices to determine the acceptability of specific title insurance company short form title policy or master title policies and related residential loan certificates provided that the lender (a) determine that the title insurer satisfied the rating requirement; (b) used the standard ALTA forms for these policies that are validly issued in jurisdictions in which the insurer does business; and (c) provides appropriate warranties to Fannie Mae. In case of item (c), their deliverance by the lender of the policy constitutes an agreement that it will promptly provide a replacement of the short form policy or residential loan certificate, if the full ALTA policy is later requested. There are currently five companies that can issue Fannie Mae acceptable title insurance company rating. They are Demotech, Inc., Duff and Phelps Credit Rating Company, Lace Financial Corporation, Moody's Investor Service or Standard & Poors, Inc. The level required by Fannie Mae as an "acceptable

rating" is: Financial stability rating of "S" (strong) or better or a statutory accounting rating of "C" (average) or better from Demotech, Inc.; a "BBB" or better rating from Duff and Phelps Credit Rating Company; a "C" or better from Lace Financial Corporation; a "Baa" or better rating from Moody's Investor Service or a "BBB" or better rating from Standard & Poors, Inc.

The S & P ratings are voluntary and require payment of substantial fees by the title insurance company. To date, only Chicago and Old Republic are currently rated by Standard & Poors. Demotech, Inc. and Lace Financial perform ratings based upon information submitted by the title insurance companies themselves, including Form 9 data, SEC filing data for publicly traded companies and additional information supplied by the companies being rated. Title companies being rated pay no fees to Lace or Demotech.

B. Demotech, Inc.

Demotech, Inc. is a Columbus, Ohio corporation which began rating title insurance companies in 1992. Demotech provides a subscription service of its title insurance ratings. It sees the rise of title insurance ratings as a response to the financial turmoil of the 1980's and the increasing paid claims and incurred losses and loss adjustment expenses shown by title insurers on their Form 9 filings. Demotech sees itself as "a leading indicator of financial solvency" of title insurance companies.

1. <u>Financial Stability Ratings.</u> Demotech states that, in its opinion, insurers earning Financial Stability Ratings of S or above "present negligible exposure to financial instability, and insurers rated A' or A" "present virtually no exposure to financial instability". Demotech's ratings are described as follows:

A" (A Double Prime) Unsurpassed: Unsurpassed financial stability related to the payment of loss and loss adjustment expenses; these title insurers have substantial policyholders' surplus (net worth).

A' (A Prime) Unsurpassed: Unsurpassed financial stability related to the payment of loss and loss adjustment expenses. The difference between a title insurer earning a Financial Stability Rating of A" or A' is generally related to the dollar amount of policyholders' surplus available as a safety margin.

A Exceptional: Exceptional financial stability related to the payment of loss and loss adjustment expenses.

S Strong: Possesses well above average financial stability related to the payment of loss and loss

adjustment expenses.

M Average: Possesses at least Average financial stability related to the payment of loss and loss adjustment expenses.

L Licensed: Licensed by state insurance departments and currently possesses sufficient financial ability to pay loss and loss adjustment expenses; ability to withstand a deterioration in general economic conditions or a deterioration in the underwriting cycle is Below Average.

D Default: Considered likely to Default in the payment of loss and loss adjustment expenses.

Dd Danger of Default: Present an immediate Danger of Default related to the payment of loss and loss adjustment expenses. Immediate action should be taken to protect the interests of policyholders, claimants and other interested parties.

I-Y Insufficient years: Insurers are Ineligible for a Demotech Financial Stability Rating due to Insufficient Years of representative operation.

I-D Insufficient Data: Pubic information requested by Demotech is incomplete or inconsistent. Demotech has deferred its opinion of a Financial Stability Rating.

W Withheld: Insurer has requested that its rating be withheld.

2. Statutory Accounting Rating. Statutory Accounting Ratings are provided for insurers that have decided not to respond to Demotech's annual data request or have an insufficient operating history to earn a Financial Stability Rating. Statutory Accounting Ratings are provided based only on the limited data available in the company's Form 9 filings.

C+ Above Average: Insurer appears to possess above average financial stability related to the payment of loss and loss adjustment expenses.

C Average: Insurer appears to possess average financial stability related to the payment of loss and loss adjustment expenses.

C- Below Average: Insurer appears to possess below average financial stability related to the payment

of loss and loss adjustment expenses.

Distribution of Demotech's 1993 Financial Stability Ratings. Demotech's distribution of ratings are shown on Exhibit C attached to these materials.

C. Lace Financial Corp.

Lace is a Frederick, maryland corporation. Lace provides claims-paying ability ratings for title insurance companies "primarily for the guidance of lenders originating mortgages for the secondary mortgage market and for title insurance policies issued in conjunction with such residential transactions". Lace notes that its ratings are not intended to be indicative of the capacity of any title insurance company to write large commercial title insurance policies.

Lace has rated only title insurance companies that actually issue residential loan title insurance policies. Companies engaged only in reinsurance transactions, whether facultative or pursuant to treaty arrangements, have not been rated. Lace notes that many title companies have financial support arrangements with other title insurers, both affiliated and unaffiliated. These arrangements may impact a company's ability to pay claims. In its ratings Lace sets forth the basis of the rating, given the information supplied to it. There is a caution in the Lace materials that those needing more information about any such financial arrangements should contact the company being rated. Lace does not charge title insurance companies that it rates and these ratings are done on an involuntary basis. Lace notes that it currently rates companies that control 98% of the title insurance industry's assets. Lace states that it reserves the right to crop a company from its ratings service or withhold the rating where it is concerned about the integrity of the data supplied to Lace or where Lace feels that it does not have a property dialogue with management concerning the company's financial condition.

1. Ratings Methodology The acronym "LACE" stands for liquidity, asset quality, capital and earnings. These are the four measures that Lace highlights as part of its methodology for rating title insurance companies' claims-paying ability. The analysis represented by these measures is described below.

   Liquidity ratios consider the company's ability to generate enough cash to meet its liabilities for incurred but unreported claims from premium income, investment income and the sale of liquid assets. As Lace notes, the expected liability for such claims is not reported at present under the current statutory accounting practices. This fact makes an analysis of liquidity even more important and the gauge of liquidity is an important factor in determining a

company's ability to meet such obligations as they arise in the future.

Asset Quality measurements consider the uncertainty of future claims. Lace considers the company's loss trends (comprised of already paid losses, incurred losses and loss adjustment expenses) relative to the company's equity plus statutory premium reserves. In order to determine the demand on the company's assets, Lace also considers loss trends against premiums earned by the company. This analysis may show that a given company has low past claims expenses in relation to the balance of the industry in its geographic region, where a geographic analysis is appropriate. Such a company has demonstrated that it is doing a better job than the balance of the industry in managing its underwriting risks. This would be important information to consider in choosing a title insurance company.

Capital and the company's premium reserves provide a safety cushion for the title company to absorb unreported claims. As Lace notes, the higher these levels are for a given company, the better that company's health. Another factor in determining the company's strength is the level of earnings that the company retains as capital. In its analysis Lace considers both long-term and short-term debt as it relates to capital and also fixed charge coverage ratios. All of these factors can impact the capital level of the company.

Earnings for title insurance companies vary significantly over time, given the cyclical nature of the real estate industry which is served by the title insurance industry. In this area, Lace notes that the company's use of agents versus its own employees in generating business can have a significant impact on earnings. When the business cycle is in a downturn, companies whose revenues are concentrated more fully on their own facilities are likely to have higher expenses than those that rely more on agents. During economic expansions the opposite, of course, is true. During economic downturns claims are likely to rise. Lace follows regional statistics for the housing industry and each company's market concentration in analyzing issues related to earnings.

2. Claims-Paying Ability Ratings. Lace provides claims-paying ability ratings from "A+" to "C". these semi-annual ratings are explained by Lace as follows:

"A+" The company has a strong overall financial

"A" condition that will allow it to meet future "B" claims. As a rule, these companies have good operating earnings, are well capitalized and have adequate reserves.

"C+" The company may have some financial ratios that are below average but are considered "investment grade".

"C" May be financially weak in one or more areas of liquidity, asset quality, capital and reserves, and earnings.

"D" Companies are likely to have a lower "E" probability of meeting their future claims (as shown by poor key LACE financial ratios). Careful consideration should be made when dealing with these companies.

Lace notes that most title insurance companies will have ratings in the "B" category. Since the range in this category of financial soundness and ability to meet future claims is reasonably large, Lace cautions that a purchaser of title insurance should compare the individual ratios when making choices among these companies. Lace also notes that some companies may receive higher ratings than warranted by their financial condition, by reason of their affiliation with the strong parent. Another reason why a company might receive a higher rating would be its reinsurance agreements with other title insurance companies.

Depending upon the information supplied to Lace by the various title insurance companies, Lace's reports may also supply the following types of information:

. corporate structure and management philosophy;

. geographic ares of company operations;

. nature of title policies issued by the company (e.g. co-insurance, joint and several policies, etc.);

. companies' self-imposed policy limits, internal or external reinsurance treaties, or other formal financial support arrangements; and

. significant recent changes in corporate structure likely to be of interest to Lace subscribers.

Attached to these materials as Exhibit D are materials supplied by Lace showing its ratings distribution among title companies, as of December 14, 1993 and the Peer Group Averages as determined by Lace as of December, 1992.

D. Standard & Poors

S&P considers the title insurance business to be "one of the more risky segments of the insurance industry" and notes that title insurer returns, over the long term have been "lower, yet more erratic" than the returns of companies in other sectors of the insurance industry.

S&P notes that title insurance differs from most other lines of insurance by having typically low claims (generally under 10% or in the teens) but higher expenses (typically ranging from 80% to 90%). Since the expenses are often fixed, including maintenance of a title plant, reductions in revenue may not result in a corresponding reduction in expenses. Similarly, this high cost structure leaves little room to absorb increased losses, whether through large title losses or occasional instances of fraud.

S&P observes that current economic conditions have cut for and against title insurance companies. The lowest mortgage rates in several decades have generated a residential refinance boom which has benefitted title companies. At the same time, however, the state of the economy combined with an oversupply of commercial space in most markets has contained to depress the sale of commercial title insurance policies. Another factor impacting title insurance companies is the level of state regulation. Because the size of the title insurance industry is small compared to the insurance industry as a whole, regulation of the title insurance industry has been "largely uncoordinated and superficial".

S&P notes the wide variety from state to state for statutory premium reserve formulas for title insurance. As a result of this variety, S&P considers statutory solvency measures a useless tool in connection with title insurers. In its analysis, S&P uses GAAP information when analyzing title insurance companies. S&P also notes that the requirement in most states that title insurance be written by companies that provide only title insurance products limits the ability of the title insurers to diversify their revenues streams and reallocate resources as need arises and business cycles demand.

In the midst of the problem areas in the title insurance, S&P does see two bright spots. It considers the first of these to be industry consolidation. The Graifman Article notes that in 1980 thirteen companies wrote approximately 90% of the title insurance business across the country. In 1992 the same level of business was written by eight companies. S&P sees this as a positive development, with the goal that consolidated companies could achieve economies of scale and reduce their costs. Additionally,

the opportunity to leverage their expertise would permit larger companies a competitive advantage over their smaller competitors.

A different interpretation of the nature of the fixed costs of title insurance companies was provided by Joseph Petrilli of Demotech at the 1993 ALTA Convention when he stated his opinion that the nature of title insurance being involved in the examination local titles and focusing on local real estate makes economies of scale less available in this industry that in other sectors of the insurance industry.

The second positive development noted by S&P is a trend towards better oversight. Graifman notes that the industry has been working in conjunction with NAIC to standardize and improve reporting requirements. He also focuses on the increased involvement of Fannie Mae and the Federal Home Loan Mortgage Corporation ("Freddie Mac") in the areas of policy language and policy coverage.

In analyzing title insurance companies S&P employs the same analysis of four key elements related to management and corporate strategy that it employs for its review of property/casualty insurance companies. S&P notes that since the largest losses in the title insurance industry involve fraud, oversight of agents is of particular interest. As part of its review, S&P analyzes agent selection, auditing of agents and general oversight methods employed by the title insurance company being reviewed.

In analyzing the business characteristics of the title insurance company, S&P considers geographic dispersion an important consideration. S&P notes that a high concentration of a title insurance company's business in one state puts the company at risk in regard to changes in that state's regulatory environment. In addition, concentration in one geographic region will link the health of the title insurance company to the economic cycles of that region, with economic downturns having the potential to seriously lower title insurance companies' revenues. In addition, during times of economic downturn loesses are likely to be greater, ranging from mechanics liens to reduced incentives to work through problems when property values are falling rather than rising.

S&P also reviews the level of commercial title insurance that a company writes, noting that the higher premiums for commercial insurance make this a relatively attractive segment of the industry, despite the greater complexity and potential for losses. Finally, S&P reviews the growth that the company exhibits as an important element due to the industry's high fixed-cost structure. With growth S&P expects that a title company's expense ratios should decline and operating performance should improve. S&P also notes that this has been the case historically.

S&P's operational review of a company involves both past and expected future performance in relation to the cycle of the industry as a whole. Good results by an insurer are viewed even more favorably if they occurred during a low part of the cycle. Principal performance measures include pre-tax return on revenue, return on average assets, return on equity and return on capital.

S&P also reviews loss, expense and combined ratios. In terms of investments, S&P expects title insurance companies to have a generally liquid portfolios so that the company would have minimal difficulty liquidating its investments to meet claims requirements. S&P notes that investment income as a percentage of premiums is lower for title insurance companies than for most other companies in the insurance industry. With a net investment income ratio of 5% for the title insurance industry, a combined ratio of over 105% will result in a loss to a company which tracks the average. The property/casualty industry, by comparison, has a net investment income ratio of 14.9%, meaning that a company following these averages could sustain a combined ratio of up to 114.9% and still earn a profit.

In analyzing the tolerance of a title insurance company for financial risk, S&P considers current, past and expected future debt levels and also anticipated debt coverage ratios to determine the level of stress put on earnings and cash flow of the company. Debt-to-capital ratios are reviewed, as are debt-to-tangible capital ratios. S&P notes that it does not deduct the title insurance company's title plant from the company's capital when carrying out its debt ratio analysis,

> ... since the title plant is a permanent part of a company's ability to write business, and, therefore, is not a depreciable asset. Furthermore, S&P believes the value of a well-maintained title plant is probably higher than its reported value.

S&P analyzes operating leverage by reviewing revenues-to-equity. S&P notes that there is a high degree of variability in operating leverage among the large industry players. Generally, the characteristic of title insurance regarding low losses has resulted in higher operating leverage than some other sectors of the insurance industry.

The Graifman Article also reviews reserve adequacy, quality of capital, liquidity and financial flexibility. The final issue which Graifman discusses as being reviewed by S&P is the parental support issue. A title insurance company's rating may be favorably impacted by the presence of a large, well established, highly-rated parent. On the other hand, a relationship with a lower-rated or non-rated parent may have a negative impact upon the title insurance company's rating. The Graifman Article speaks about "parental support implied".

The author finds it interesting to speak about implied support, the subject which was also touched upon in the S&P ratings of Old Republic and Chicago Title, copies of which are attached to these materials as Exhibit E. The areas which Graifman notes S&P considers in connection with parental support are the following:

- the subsidiary's fit within the parent's overall strategies;

- the ability of the subsidiary to operate without continued parental support;
- the level of contribution the subsidiary makes to the parent's business;
- the parent's history of support offered to its subsidiaries;
- operational integration levels between the parent and subsidiaries; and
- the closeness with which the subsidiary is associated with the parent in terms of corporation identity (e.g., commonality of name).

E. Duff and Phelps Credit Rating Company

F. Moody's Investor Services

SECTION VI – PROPERTY/CASUALTY GUARANTY FUND

As mentioned in the introduction, the consumer deposits monies in the bank and is assured that the Federal Deposit Insurance Corporation will protect the funds up to $100,000.00. No system backed by state taxing authority exists to carry through on the obligations of insurance companies to become insolvent. In response to opposed Federal legislation to establish a national guaranty agency, the National Association of Insurance Commissioners (NAIC) ___________ a model Property Casualty Guaranty Association Act set up a system of state guaranty funds to pay the claims of policyholders of failed insurance companies. Today, every state (except New York, District of Columbia, Puerto Rico and the Virgin Islands) has a model act type statute.

The guaranty funds are involuntary, non-profit associations consisting of and financed all the licensed companies writing the lines of insurance covered by the Fund. The purpose of the funds are to pay the insurance claims of insolvent carriers up to specific limits and to guaranty funds to refund at least a portion of the unearned premiums of insolvent insurers.

The NAIC Model Act is based upon a "post assessment" method of financing. This means that the guaranty programs are not true funds at all, because no actual ongoing pool of money exists at

the time of the insolvency of an insurer. Upon the insolvency of an insurer, participating insurers are then assessed to create the necessary pool of funds. The maximum allowable assessment on an insurer is usually 1% or 2% of the insurers in-state insurance revenue (see accompanying chart). The amount of the assessments are made only on the insurers that write the same type of insurance as the insolvent company. New York is the single state which has adopted a pre-assessment approach to create an existing ongoing pool of funds to deal with insurer insolvency.

In all states, insurers who purchase or obtain assessments to the guaranty funds are allowed to recoup their contributions by either paying a reduced premium tax, raising their premium rates or by receiving proceeds of a special insurance policy surcharge. The net effect is that the guaranty funds are eventually financed by the taxpayers or policyholders and not the insurance companies themselves.

Wide variations in coverage exists from state to state, as does the particular line of insurance which may be covered by the guaranty funds. In addition, policyholders of the same company who live in different states are likely to receive quite different levels of protection because of the variance of the particular state fund. Although state guaranty funds vary in types of insurance or claims are generally excluded from coverage, such as coverage of groups that are self-insured, punitive damages and claims from companies that are not licensed to do business in the particular state.

Substantial difference in the amount of guaranty fund protection exists amongst the states. The NAIC recommended cap of $300,000 is met or exceeded by 33 different state funds and 18 state funds fall below the recommended NAIC limits. The sophisticated commercial policyholder should be particularly cautious with regards to reliance on state guaranty funds. ________________ sixteen states employ a net worth criteria to determine eligibility for their guaranty funds, i.e. Georgia excludes claims from those insured with a net worth of more than $3,000,000.00 and Michigan excludes claims of any individual or entity with a net worth greater than .1 of 1% of the aggregate premiums written by member insurers. Missouri will not pay claims to corporate policyholders with a net worth above $25,000,000.00.

A recent increase in insolvencies involving large multi-state carriers put in question the guaranty fund systems continuing ability to handle insolvencies. From 1968 through 1980, the post-assessment guaranty funds assess their insurers $65,000,000.00 for 63 failures. From 1981 through 1983, these funds assessed more than $3.5 billion dollars for 348 failures.