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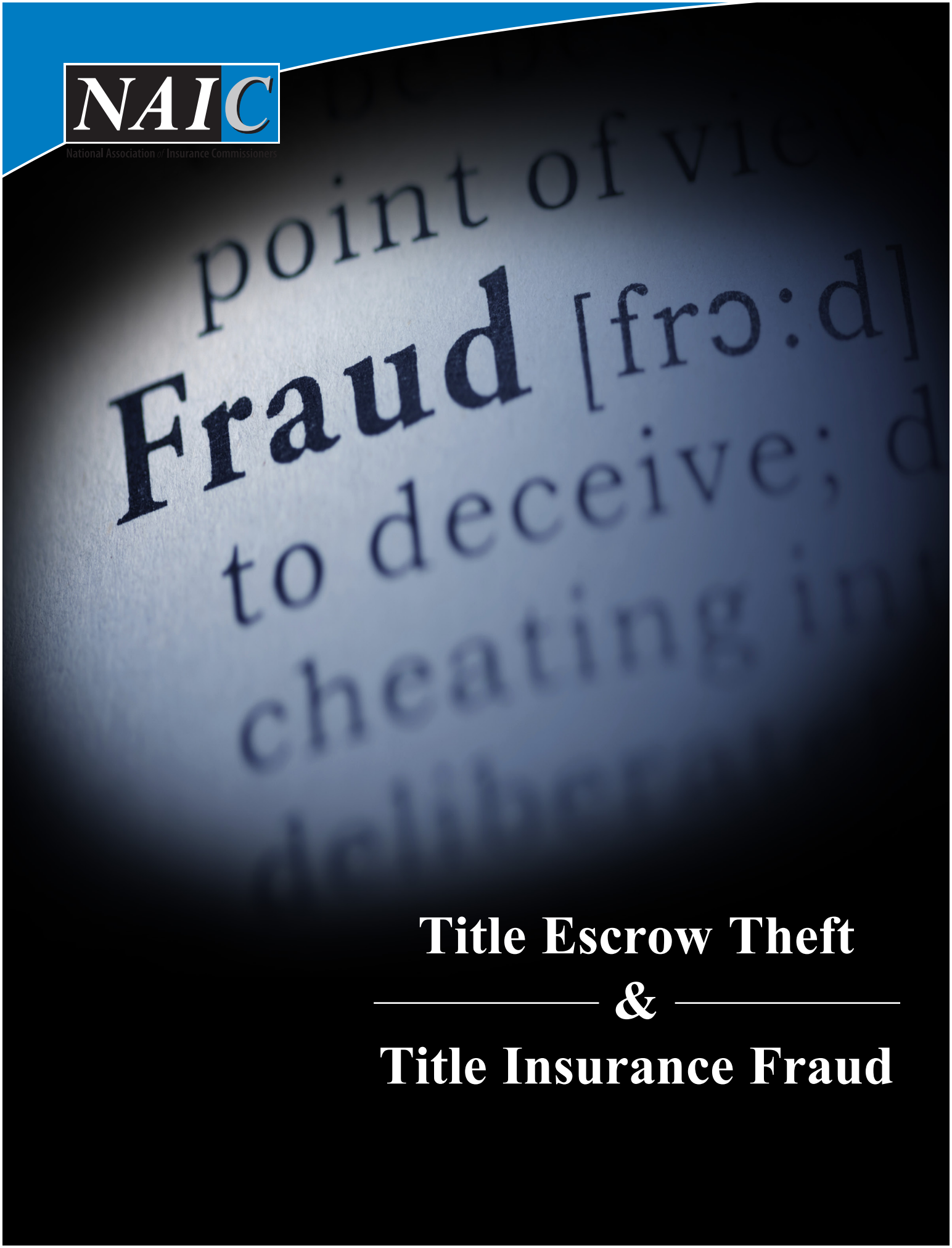

Title Escrow Theft & Title Insurance Fraud

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Adopted by Property and Casualty Insurance (C) Committee December 2013

NAIC
National Association of Insurance Commissioners

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I. Introduction

Purpose and intended users

This white paper is intended to raise awareness of and to be available as a tool for regulators to research methods for combating and preventing escrow theft, title insurance premium theft and other forms of fraud associated with title insurance and closing services. When reading this paper, it is important to recognize regional differences in the way title insurance and closing services are provided and regulated. There are few one-size-fits-all solutions for such a complex problem. Nor is there a single solution to the problem for any particular jurisdiction. Therefore, a variety of methods are identified. Where practical, this paper will attempt to discuss the merits as well as the shortcomings of each identified method. The availability of proprietary solutions such as software and systems approaches will also be discussed without identification of specific providers. The ultimate goal of this paper is to recognize ways to identify and prevent theft surrounding title insurance and closing service transactions. In doing so, regulators and the title insurance industry will ultimately provide enhanced consumer protection.

The white paper is also available for use by the title insurance and closing services industry when evaluating their own enterprise risk management and auditing guidelines for combating escrow and title insurance premium theft. These problems cause consumer losses and a great deal of expense for title underwriters in terms of claims, auditing, legal fees and mopping up resulting failed title agencies. In addition to direct monetary costs, the potential for reputational damage or insolvency is a major concern. Because of the unpredictability of the frequency and magnitude of these events, serious negative results to title underwriters' financial condition can result. The unnecessary and hopefully preventable expenses associated with mishandling of title insurance premium and closing funds are ultimately borne by customers in the form of higher title insurance premiums and closing costs.

For purposes of this paper, "title underwriter" means a title insurer; "title insurance agent" means any person who solicits the policies and may perform escrow or other closing services; and "escrow company and settlement service provider" means any person or entity that performs escrow or other closing services that is not a title underwriter. An escrow company may or may not also be a title insurance agent or attorney for a title underwriter.

II. Overview of Fraudulent Actions

a. Background and Definition of the Problem

Title insurance and closing services have historically been labor-intensive processes with few opportunities for centralization of services within a title underwriter. Although direct services have grown due to increased availability of digitized courthouse records, title underwriters rely on a large number of licensed and unlicensed individuals who are not directly employed by the title underwriter for title searches, issuance of commitments and policies, handling of premium and escrow funds, and providing closing and post-closing services. This decentralization, along with the large number of individuals and large number of financial transactions, increases the opportunities for those who decide to operate in a dishonest or untrustworthy manner. An oft-repeated urban legend recounts a newspaper reporter asking gangster Willie Sutton why he robbed banks, with the answer being, "Because that's where the money is." Although the legend is not authenticated, that purported response could be one reason why so many cases of escrow account and title insurance premium misappropriations have taken place. In other cases, a gambling addiction, a financially unsupportable lifestyle, medical expenses or other situations may cause an owner or employee to use trusted funds for their own purposes. This inappropriate use of funds that belong to others always catches up with the title agency, resulting in a defalcation. One thing is clear, however. The vast majority of title insurance agents and settlement service providers are honest and service-oriented individuals who are devoted to providing an excellent outcome for their customers. The few individuals who do misappropriate or mishandle customer and title underwriter funds generate a disproportionate number of problems and damage to the image of the title industry.

All parties involved have a responsibility to minimize the risk of escrow theft. Some problems can and ought to be detected and reported by vigilant co-workers who notice irregularities. Underwriters are responsible for contracting with agencies and appointing agents, and they primarily manage escrow theft risk through agency audits and by requiring agencies to utilize sound business processes. The industry is primarily responsible for escrow theft prevention. Additionally, some jurisdictions require underwriter or third-party certified public accountant (CPA) audits. Regulators can help reduce the number of misappropriations by periodic or random audits of title and escrow agencies to the extent such audits are practicable and authorized in each jurisdiction. Licensing and regulatory requirements for closers and escrow agents vary by jurisdiction, and not all agents are governed by insurance regulators.

b. Types of Escrow Theft

Methods by which closing funds and title insurance premiums can be misappropriated are numerous. Some of the potential methods include:

- Misappropriation of closing funds for use other than as provided for in the closing instructions.
- Failure to pay off existing mortgage loans in full, diverting closing funds for personal use while attempting to make periodic payments on the existing loans.
- Misappropriation of title insurance premium with failure to report and issue title insurance policies.
- Failure to perform all services specified in the closing instructions or U.S. Department of Housing and Urban Development (HUD) form.
- Fraudulent activity by unlicensed or unauthorized entities.
- Engaging in check-kiting or other banking-related fraudulent schemes with title agency accounts.
- Acceptance of funds that are not “good funds” for the purpose of closing transactions.
- Intentional or fraudulent misrepresentation of title defects or failure to disclose title defects with the intention of burdening the title underwriter with subsequent losses.
- Participation or complacency in mortgage or real estate fraud schemes such as flipping and flopping (reverse staging), phony appraisals or rushed escrow closings.
- Cyber-fraud aimed at identity theft or misdirection of escrow funds to the accounts of unrelated parties, typically via fraudulently obtained online banking credentials of the title company.

c. Harm to Consumers

Escrow and title insurance thefts harm consumers in a number of ways. The most obvious example of loss to consumers is instances where customer funds are outright stolen without recourse from responsible parties such as title underwriters. In some instances, closing services and title are transacted by separate entities, thereby reducing the likelihood that any specific title underwriter will be responsible to step in and reimburse for loss of escrow funds. Escrow funds subject to loss include pre-closing funds such as down payments and post-closing funds intended for recordation of documents, payment of title insurance premiums and disbursements necessary to clear the title. Theft of title premium frequently means no title policy is issued and the consumer does not get what he or she paid for, namely evidence of coverage. Since many customers do not know exactly what to expect after closing, they may not be alarmed at not receiving a title policy. When lenders complain about not receiving a policy, the offending title agency frequently responds to those complaining the loudest in prioritizing which policies get issued. Failure by the title agency to pay off certain escrowed funds, may not surface for years or until the property is resold.

d. Harm to Title Underwriters

Escrow, settlement fund and title insurance premium theft also harms title underwriters. Reputational damage, loss of revenue, resulting claims, regulatory responses and costs associated with remediation are all adverse effects of this problem. Additionally, title underwriters increasingly must expend a great deal of resources to detect, prevent and combat problems associated with these types of losses, including conducting audits, investing in software and monitoring

transactions. Title underwriters can exercise more "hands-on" control, policies and procedures for reduction of these problems with direct operations. Independent agent arrangements make surveillance and management more complicated. Most large title underwriters operate with a combination of both direct operations and independent contracted title insurance agents. In most jurisdictions, closing services are also commonly performed by attorneys. This may complicate a title underwriter's ability to obtain records to detect and prevent escrow and settlement problems.

e. Related Concerns

Practices of concern that may not rise to the level of fraud, but are non-compliant in many jurisdictions, contrary to title underwriter requirements, contrary to contractual obligations, or potentially indicative of fraudulent acts include:

- Mingling of escrow funds with personal or operational funds.
- Inappropriate investment of escrow funds in unsound or non-guaranteed accounts.
- Delays in issuing title policies and premium remittance.
- Failure to fulfill closing obligations (deed filings).
- Mishandling resulting from confusing or poorly written closing instructions.
- Inadequate prevention of fraud against title underwriters and cybercrime that is initiated by unrelated parties aimed at identity theft, obtaining fraudulent remittances or misdirection of funds.

III. Potential Tools and Methods to Address Escrow Theft

This section lists several ways to detect and prevent escrow theft and title insurance premium misappropriation. Although the methods and tools are categorized by which type of entity is potentially best suited to implement, there may be broader application. With this in mind, the reader should review tools for all listed consideration categories.

a. Considerations for Regulators

1. Existing Title Insurance Model Laws and Regulations

Insurance laws relating to title insurance and escrow handling tend to vary among the states. The National Association of Insurance Commissioners (NAIC) has developed two model acts that states may find useful when evaluating their own laws and regulations for effectiveness.

NAIC Model Law #230, the *Title Insurance Agent Model Act* and Model Law #628, the *Title Insurers Model Act* each contain provisions that assist in preventing escrow and title insurance premium theft and mishandling. Model #230 and Model #628 were not widely implemented by states, although many states have laws which contain components of the two models.

Among other requirements, the *Title Insurance Agent Model Act* includes provisions that address:

- Title agent licensing requirements.
- Fidelity coverage or acceptable alternatives other than closing protection letters.
- Examination of title agents by the insurance department.
- Required provisions for underwriting contracts with the title underwriters.
- Termination provisions.
- Timely remittance of title premiums to the title underwriter by the title agent.
- Fiduciary accounts for premium funds owed to the title underwriter.
- Title Underwriter access to records and accounts.
- Separation of records for different title underwriters.

- Timely submission of escrow and title claims to the title underwriter.
- Maintenance of an inventory of policy forms or numbers.
- Statements of financial condition of the title agent.
- Fiduciary trust accounts in a qualified financial institution for escrow and settlement funds.
- Disbursement of funds only pursuant to applicable written directions from buyers, lenders or sellers.
- Good funds requirements.
- Independent audits of escrow, settlement, closing and security deposit accounts.
- Record retention requirements.

Similarly, among other requirements, the *Title Insurers Model Act* includes provisions that address:

- Closing or settlement protection.
- Direct operations.
- Requirements to have title agents' financial condition statements on file.
- Annual on-site reviews of title agents.
- Notification of appointments and termination of title agents.
- Policy form or policy number inventories.
- Proof of licensing.
- Requirements of maintaining escrow and security deposits when the title underwriter operates as a closing agent.
- Record retention requirements.

Although not comprehensive, the above outlined provisions of these two NAIC models can provide added protection against mishandling of escrow, settlement funds and title insurance premiums. Many of the provisions mentioned here are discussed in more detail within this paper. For jurisdictions that have not adopted NAIC models #230 and #628, but wish to incorporate specific provisions intended to address proper handling of escrows and title insurance premiums, the models can be a source for legislative language. A list of jurisdictions that have adopted each of the models' language or related provisions is located in the NAIC's *Compendium of State Laws on Insurance Topics.*

In 2012, Demotech, Inc. compiled a study observing the relationship between title insurance loss and loss adjustment expense ratios and the relative strength of state regulations. Using the NAIC *Title Insurance Agent Model Act* as the baseline, Demotech analyzed the relative strength of each state's regulations for the licensing and oversight of title agents. Readers may learn more about the study and its conclusions by accessing the report at
www.demotech.com/pdfs/papers/20120604_defalcation_study.pdf.

2. Insurance Fraud Prevention Laws

Insurance fraud prevention bureaus help address insurance fraud because the specialized nature of insurance often makes investigation difficult for law enforcement that may not be well-versed in the nuances of insurance. Units dedicated to insurance fraud also help ensure that cases of suspected insurance fraud get an appropriate level of scrutiny. States may wish to carefully review their existing insurance fraud prevention laws to determine the extent that such laws are applicable to title insurance premium theft and escrow theft.

3. Regulatory Agencies' Establishment of Advisory Committees

Establishing advisory committees composed of industry members, regulators and consumers can assist states in understanding the scope of escrow theft and title insurance premium theft by researching ways to combat such problems. Solutions may be found by changing the way existing laws are administered, or identifying legislative solutions.

4. Encouraging Reporting of Known and Suspected Cases

Regulators should encourage consumers, title underwriters and title insurance agents to report known and suspected cases of title insurance premium theft and escrow theft. Laws that provide immunity for the good-faith reporting of suspected fraud and violations can promote reporting. States should consider periodic reminders where applicable.

5. Consumer Education

Consumer educational brochures and department of insurance websites can also provide consumers with information about title insurance practices that may help them understand what to expect. Such educational information may be especially useful for identifying instances where important documents are not being filed as specified in the closing instructions or where owners' policies are not being issued. Helping consumers understand which entity is ultimately responsible for safeguarding their funds is important, especially where closings may be performed by differently regulated entities.

6. Addressing Escrow Theft at the Licensing Stage

A tool or method for preventing escrow theft can commence with initial licensing regulation. Licensing standards established by a combination of regulatory rules and statutory provisions can alert a regulator to potential escrow theft requiring intense scrutiny of the licensee's involvement with an escrow account.

Enhanced initial audits or due-diligence investigations of title insurance agents or agencies by regulators at the time a title insurance agent is licensed may enable regulators to identify prospective title insurance agents with past legal or regulatory issues, or with backgrounds not indicative of trustworthiness.

The amount of money which potentially moves through a real estate escrow account is considerable. This can make escrow theft tempting to those who find themselves in a situation where they perceive an ability to misappropriate escrow funds without being discovered. Thought and further consideration should be given to setting initial licensing standards that strengthen consumer protections, thus being less attractive to those with illegal intentions. However, these initial licensing standards should not be so unrealistic as to discourage growth and expansion in the industry when positive economic conditions are present. Initial licensing standards vary among states, from requiring settlement service providers to be licensed with departments of financial institutions or departments of insurance to not requiring any such license for performing escrow services.

States historically have different procedures for monitoring title insurance agents' and settlement service providers' handling of escrow funds. Some subject escrow accounts to an audit by an independent CPA and submit the results to a regulatory agency. There are states that require title underwriters to perform audits of their agents' escrow accounts or employ examiners and auditors to conduct reviews. Consideration must be given to the cost burden associated with compliance for states and title insurance agents and settlement service providers. As an example, an independent CPA audit of an escrow account may be cost-prohibitive for the title insurance agent and settlement service provider. State regulatory agencies must consider the staffing requirements in reviewing the submitted audit reports and determining compliance.

An inexpensive and less time-consuming alternative is to require licensees to maintain escrowed funds held in trust in specially identified accounts with approved banking institutions and/or banking institutions that offer Positive Pay. Under a Positive Pay system, a title insurance agent transmits a list of the checks issued each day to the bank. The bank matches the list with the checks that are presented applicable to the account for payment. Only checks appearing on the submitted list will be paid. If the check is not on one of the lists, the bank will advise the title insurance agent and, unless the title insurance agent gives authorization, the check will not be paid. Another standard may be to require title agents to notify regulatory departments of non-sufficient funds notification and the initial opening or subsequent closings of escrow accounts.

In some states, attorneys are required to maintain their Attorney Trust Accounts with institutions approved by state attorney licensing boards. Additional requirements in place for these types of accounts require the institution to report to the state's disciplinary commission when an Attorney Trust Account discloses a negative balance. Further, the title agency could be required to register its banking account information with the licensing authority for periodic review.

An alternative approach is to institute a license designation or separate license altogether for individuals who handle escrow funds versus those who simply sell title insurance. If these functions are separated by licensing destinations, the educational requirements and supervision for individuals who conduct escrow transactions could focus on account balancing techniques and theft prevention. Pre-licensing and continuing education requirements for license renewals would therefore shift to escrow accounting procedures and red flags that could indicate a co-worker, title agency owner or employee is misappropriating escrow funds.

Some states require title agencies to be licensed but do not require licensing of those employees who handle escrows nor the submission of a list of employees to the licensing authority. In order to determine which individuals were performing escrow handling functions, it would be prudent to require title agencies to report a list of their employees with their duties and responsibilities. The licensing authority would maintain this list and, in the event potential problems arise, the individuals responsible would be identified. Many states require title insurance agents/agencies to provide a fidelity bond and/or errors and omissions insurance. It is important to remember that most errors and omissions insurance policies do not cover theft. In addition, an initial background search of license applicants could reveal potential problems before these individuals or firms have access to escrow funds.

Detailed reporting requirements may add additional cost and expense for regulators and consumers. Similarly, when an industry is required to report information to a licensing authority, the licensing authority will need to audit the information for compliance and accuracy. Therefore, this management style dictates higher costs to the regulator in terms of personnel and time required to conduct the audits, as well as commencing and completing administrative actions for non-compliance.

Some states license only the title insurance agents in a title agency—the settlement service providers are not required to be licensed or have any CE. Requiring some sort of examination, licensure and CE could be a valuable tool, but to do so would probably require statutory changes in most states.

Some states require a separation of escrow settlement funds from title insurance premiums. The accounts are to be "separate fiduciary trust accounts" wherein the funds are segregated in a manner that permits them to be identified by individual consumer.

7. Minimum Capitalization and Other Requirements for Title Agents

Some jurisdictions may require title insurance agents to meet capital requirements. Such regulatory requirements—or enhanced financial capital requirements for title agents expressed in underwriter-title agent contracts—could reduce the incentive for title agents responsible for escrow to commit escrow theft.

Some jurisdictions that do not have the authority to require title insurance agents to maintain certain capital or other requirements may be able to do so indirectly through the contract between the title agent and the title insurer.

Enhanced bonding/surety requirements are required by some states. Title insurance agents may be required to have an escrow, settlement or closing accounts bond or irrevocable letter of credit in varying amounts. These amounts may need to be adjusted periodically.

8. Enhanced Regulatory Oversight

In most jurisdictions, title insurance business makes up a relatively small proportion of the total business of insurance in the state. When problems such as a defalcation emerge, however, the time and resources for dealing with the aftermath can be staggering. It is important that regulators remain diligent in their duties to oversee this line of business. Important measures that can be taken include:

- Making best efforts to promote sound and strong title insurance laws and regulations within the jurisdiction.
- Having sufficient staff persons who are trained and knowledgeable about the intricacies of title insurance and settlement services.
- Maintaining an open channel of communication with title underwriters, title insurance agents and applicable associations.
- Maintaining a reasonable and visible schedule for conducting examinations or other types of oversight activities of both title underwriters and title agents.
- Identifying and addressing potential gaps in regulation of entities that may perform closing services.
- Having a clear plan of action on how to respond to cases of defalcation. In addition to assisting with remediation for customers, regulators should be prepared to coordinate or make referrals to applicable law enforcement for subsequent action, if warranted.

i) State Oversight via Market Conduct Regulation

Regulators should give consideration to periodic market conduct reviews of title underwriters and title insurance agents. By incorporating periodic reviews, states might instill further barriers to escrow theft and title insurance premium theft. The NAIC has developed a tool to assist market conduct examiners in performing reviews of title agencies. Chapter 18 of the NAIC *Market Regulation Handbook* is titled, "Conducting the Title Insurance Company and Title Insurance Agent Examination." Provisions in Chapter 18 include review standards for escrow, settlement, closing and security deposit funds. Training market conduct staff regarding basic title insurance and escrow practices is an important factor in promoting sound market conduct oversight. Training should also be provided to consumer affairs staff responsible for responding to consumer complaints and inquiries. Effective investigation of consumer complaints can help identify potential instances of improper escrow or title insurance premium handling. Potential sources of training include national, state or local title insurance associations, peers within the regulatory community who have experience with title insurance and escrow, and the NAIC.

ii) Coordination of Regulatory Efforts

State regulators responsible for oversight of title insurance and escrow entities should strongly consider participation in coordinated efforts on a regulator-only basis. Periodic communication with proper confidentiality agreements in place allows regulators to share investigative information regarding known or suspicious activities that may cross state borders. Such communications can also improve regulators' knowledge and awareness of various types of schemes and trends relating to escrow theft as well as mortgage fraud.

9. Communication between Regulators, Title Agents and Title Underwriters

Prompt and complete communication between title insurance agents, title underwriters and their respective regulators whenever problems with escrow or premium funds are discovered is essential to a healthy title insurance marketplace. The open flow of communication permits regulators to take appropriate action in relation to public inquiries and regarding malfeasant individuals. In some cases, examination, investigation or other regulatory action may be in order. Regulators should advise title insurance agents and title underwriters of whether communications may be received confidentially and refer parties as appropriate to any other regulators who are responsible for oversight of entities performing escrow activities. It is appropriate for regulators to share information received confidentially from title insurance agents or title underwriters relating to escrow or premium theft with other regulators.

10. Time Requirements for Policy Issuance and Policy and Premium Remittance

Establishing time requirements for title insurance policy issuance and policy and premium remittance can be a helpful red flag to reduce the impact of title insurance premium theft. It can provide regulators with a basis for enforcing title insurance laws and title underwriters with a basis for enforcing contractual agreements. One difficulty in establishing time requirements for title insurance policy issuance is that, frequently, the title agent cannot issue a policy until all outstanding defects have been cured. In those states where title insurance laws do not address timeliness of policy issuance, title underwriters should consider addressing the matter in their contracts with title agents. Title underwriters can set a timeframe for policy issuance and policy and premium remittance, and if there is a delay, the agent can easily be required to provide a detailed update to the insurer at defined intervals.

11. Good Funds Requirements

Settlement funds heretofore referred to as "good funds" specify what type of funds may be accepted by the settlement entity for the completion of a real estate transaction. Good funds are frequently defined legislatively or administratively by the states. The concept of good funds is not recognized by the banking industry or the Federal Reserve Bank. In this regard, only available funds and collected funds are recognized by the banks. Under the Expedited Funds Availability Act enacted by Congress in 1987, banks will make checks available for disbursement within 48 hours of deposit, and in many instances overnight. These "available" funds are not collected funds. Collected funds are described as "irrevocably credited" to the agent's account and cannot be withdrawn. Currently only cash and Federal Reserve wires are considered to be collected funds upon deposit. The concept of good funds emanated decades ago, before the extensive use of wires and other technologies was introduced. Today it is exceptionally easy for those wishing to commit fraud to prepare counterfeit cashier's checks that are nearly indistinguishable from valid cashier's checks. These counterfeit checks are then accepted at settlement as good funds, made available to the settlement entity, and then dispersed. Several days later these counterfeit checks are returned as fraudulent and the funds are deducted from the agent's escrow account. Several states—Illinois, Indiana, North Dakota and Utah—have recognized this flaw in the concept of good funds and have enacted legislation that limits how much can be accepted as good funds for settlement. The concept of legislatively defined good funds must be reconsidered in light of the current conditions in the marketplace. It is highly recommended that acceptable funds at settlement be limited to collected funds and that only a small portion of settlement funds may be what has previously been described as good funds. It has been noted that some wire transfers can be reversed.

12. Statutory or Regulator Required Independent Audits

On an annual basis, independent audit laws and regulations may require title insurance agents or settlement service providers that handle escrow, settlement, closing or security deposit accounts to submit a filing to their regulator which would require an independent review of its accounts. Independent audits of title insurance agents and settlement service providers' depository accounts can be a useful tool for regulators to determine if title agents are performing best practices within their agency. In addition, regulators can use the data to look for early warning signs of potential problems within the accounts. Statutory guidelines for the completion of the audits ensure the audits are completed in a timely and concise manner. The filing would also require supplementary information to be submitted to the regulator. The following sections will provide additional information regarding the requirements/guidelines of the independent annual audit in addition to any regulator follow-up that may be needed in response to the audit.

i) Exemption Defined

In certain instances, a title insurance agent may be exempt from filing an independent audit—if they do not handle escrow funds, if they only handle a small number of transactions per month and/or if they had an audit by one of their title underwriters. In lieu of the independent audit, the title agency may be required to complete and submit an exemption form, in addition to any supplementary forms to the regulator.

ii) Required Filing Forms for Supplementary Information

Every title insurance agent and title agency may be required to complete necessary forms as a part of their annual filing. The form contains data fields for information that would be useful to the regulator. Possible information that can be collected by the regulator is listed below.

Title Insurance Agent/Agency Contact Information

Name
National Producer Number
Residential Contact Information
Preferred Mailing, Email and Phone

Supplementary Insurance Information

Errors and Omissions Insurance
Surety Bond Coverage
Fidelity Bond Coverage

Depository Account Information

Listing of all depository accounts used by title agent/agency

- Name of account
- Account Type (Directed Funds, IOTA, Non-IOTA, Premium Trust, Operating, Other)
- Account Number
- Depository Institution and Address
- Date Opened and Closed

Determination of Filing Status

Questions to Determine Status

- Do you handle funds that are required to be deposited into an Interest on Trust Account (IOTA) in your name?
- If yes, have you had an audit by one of your title underwriters?
- Provide name of title underwriter that completed audit and a copy of the audit report.
- Did you average five or fewer transactions per month during the review period?

Exempt Status

- Handle funds that are deposited into an IOTA which is not in the title agency's name.
- Handle funds that are deposited into an IOTA which is in the title agency's name, AND a title underwriter's completed audit report on the title agency's IOTA, AND the title agency's average five or fewer transactions per month.

Non-Exempt Status

- Must submit an Independent Annual Review.
- Must be completed by a Certified Public Accountant (CPA).
- Must include a copy of the CPA Report of the Agreed Upon Procedures as outlined in the laws, rules and/or regulations.

iii) Title Insurance Agent/Agency Explanations

All findings in the CPA Report should be fully explained.
All other issues in the filing should be fully explained.

13. Federal Real Estate Settlement Requirements

According to the Consumer Financial Protection Bureau website, federal laws applicable to title-related escrow transaction services include the following:

- The Real Estate Settlement Procedures Act (RESPA) and its implementing regulation, Regulation X, impose requirements for servicing transfers, written consumer inquiries, and escrow account maintenance.
- The Truth in Lending Act (TILA) and its implementing regulation, Regulation Z, generally impose requirements on lenders for home mortgage ownership transfers. They also impose requirements on servicers regarding crediting or payments, imposition of late fee and delinquency charges, and provision of payoff statements with respect to closed-end consumer credit transactions secured by a principal dwelling. For open-end mortgages, Regulation Z provisions related to payment crediting and error resolution apply to the extent that the servicer is a creditor.
- The Electronic Funds Transfer Act (EFTA) and its implementing regulation, Regulation E, impose requirements if servicers within the scope of coverage obtain electronic payments from borrowers.
- The Fair Debt Collection Practices Act (FDCPA) governs collection activities conducted by third-party collection agencies, as well as servicer collection activities if the servicer acquired the loan when it was already in default.
- The Homeowners Protection Act (HPA) limits private mortgage insurance that can be assessed on customer accounts.
- The Fair Credit Reporting Act (FCRA) requires servicers that furnish information to consumer reporting agencies to ensure the accuracy of data placed in the consumer reporting system. The FCRA also limits certain information-sharing between company affiliates.
- The Gramm-Leach-Bliley Act (GLBLA) requires servicers within the scope of coverage to provide privacy notices and limit information-sharing in particular ways.
- The Equal Credit Opportunity Act (ECOA) and its implementing regulation, Regulation B, apply to those servicers that are creditors, such as those who participate in a credit decision about whether to approve a mortgage loan modification. The statute makes it unlawful to discriminate against any borrower with respect to any aspect of a credit transaction:
    - On the basis of race, color, religion, national origin, gender, or marital status(provided the applicant has the capacity to contract).
    - Because all or part of the applicant's income derives from any public assistance program.
    - Because the applicant has in good faith exercised any right under the Consumer Credit Protection Act.

Since laws are subject to change, agreements should either be amended or written to reflect law changes that may arise. For this reason, in lieu of referencing a particular statute, a statement in the agreement such as "except as otherwise required by law" or something similar may be preferred.

In a 2012 report, the Financial Crimes Enforcement Network of the U.S. Department of the Treasury (FinCEN) indicated that thousands of instances of suspicious activity reports filed by banks and money services businesses involve title and escrow service providers and that often the reports involve mortgage fraud. FinCEN has engaged with law enforcement and regulators to better understand the criminal risks and possible opportunities to mitigate them.

b. Considerations for Title Underwriters

1. Strict Requirements and Adherence to Underwriting Contracts

Title underwriters and title insurance agents should review applicable state laws for requirements of underwriter contracts or agreements with agents. One of the purposes of these contracts or agreements is to define audit rights and information-reporting rights when performance under the contract or agreement is in question. The contracts or agreements can also

specify the types of trust accounts that can be maintained, the types of institutions where they need to be maintained and fraud detection tools.

Title underwriters and title agencies should consider adopting strict requirements for handling of premium and escrow funds by their title insurance agents and employees in accordance with federal laws applicable to title-related escrow transaction services (see below under "Federal Real Estate Settlement Requirements" for additional information). In so doing, account review processes and oversight and internal control guidelines adopted by industry associations such as the American Land Title Association (ALTA) may be incorporated into the contracts between title underwriters and title insurance agents that define the business practices employed by these entities. By establishing strict requirements and requiring adherence thereto through underwriting or title insurance agent appointment contracts, premium and escrow losses should be more easily detected and losses minimized. Detailed contract provisions may facilitate loss prevention. Loss prevention is a sound business objective, and also protects the consumer from financial harm.

While insurance premium and other related charges may be divided between the title underwriter and the title insurance agent, escrow funds belong to the depositing party. When title insurance agents and/or underwriters receive, deposit and process premium and escrow funds, the law imposes a duty of care on the title insurance agent and/or title underwriter that is handling these funds. Specifying the particular manner by which these funds should be processed in the underwriting contract or agreement, or the title insurance agent's appointment agreement between the title underwriter and the title insurance agent, defines the obligations that will protect the contracting parties and the consumers. Therefore, contracts or agreements between the title insurance agent and the title underwriter should specify those procedures reasonably calculated to prevent misappropriation, disappearance or wrongful use of premium and escrow funds. Also, these contracted-for provisions for handling premium and funds deposited into escrow or sub-escrow accounts must reflect compliance with applicable state and federal law.

Title insurance premium may be initially received by the title insurance agent. If contractually obligated to collect premium, the duty to maintain premium funds received by a title insurance agent should be a high fiduciary duty—such as a trustee—requiring the strictest of care, as premium funds are held by the title insurance agent on behalf of either the title underwriter or the consumer. In most states, title insurance agents who handle premium should maintain separate title premium trust accounts for this purpose. Even if not required by statute, title insurance agents should maintain separate title premium trust accounts. Once earned, premium and other related charges may be divided and disbursed between the title underwriter and the title insurance agent. The agreement should specify the manner in which premium funds are received, deposited, divided and disbursed, and that premium balances should be kept current. Title underwriters should require strict compliance with these premium contract provisions, except as they may conflict with applicable law.

2. Title Underwriter Audits

As an alternative or in addition to independent audits, many jurisdictions require title underwriters to audit the title insurance agents from whom they accept business. Even where audits are not required by law, they are generally part of the contractual agreement between the title underwriter and title insurance agent. It is important to include meaningful review processes and procedures that not only evaluate title insurance agents' effectiveness in conducting record searches and underwriting, but also to prevent premium theft and escrow theft where applicable. In addition to title underwriter audits, regulators may conduct audits or market conduct examinations. Following is a list of some audit procedures that can be used by title underwriters and regulators to detect fraud or potential escrow theft.

- Determine whether there is a backlog of unissued policies or if policy issuance is delayed because of cash flow problems. Reconciling policy issuance and the accompanying reporting to the title underwriter with order logs is one method of evaluating policy issuance. This reconciliation cannot be relied upon exclusively. It is possible that all orders are not recorded. Interviewing title agency employees and frequent customers such as local lenders may assist in this evaluation. It is also important to evaluate order cancelations to make certain that cancelation status reports are accurate. Tying bank account deposits to specific commitment orders will also assist in

indicating whether all orders are being properly accounted for. It is also important to make certain both lender and owner policies have been issued, if applicable. All delays in policy issuance should be documented with sufficient and justifiable reasons, such as waiting for clearance of releases, etc. It is important to physically inspect the areas within a title agency where unissued policy files are maintained.

- Require premium trust accounts.

- Evaluate the title agency's handling of escrow accounts to make certain that funds are handled in a fiduciary capacity, dispersed in accordance with closing instructions and HUD forms, where applicable, and in a timely manner. Tracing transactions from the closing file and cash receipt journal to cash disbursement journals and bank statements—as well as backwards from the bank statements to the applicable closing files—to verify legitimacy of payments is suggested. Deposits in transit should be reviewed. Escrow ledgers should be balanced by the title agency at least monthly.

- Follow state requirements where applicable. Some states, such as Texas, have specific audit requirements and forms that must be used.

- Interview management and employees to assist in identifying risks and weak controls. For example, it is important to verify that the title agency has appropriate controls in place for notary stamps and identification of parties in the closing. Controls, training and monitoring should be in place to address compliance with regulatory requirements.

- Review the title agency's overall financial condition to help determine whether the title agency has sufficient capacity to meet its ongoing obligations. Delinquent bills, payroll taxes or other unmet obligations should be of concern. Financial weakness may create incentive for mishandling or misapplication of funds.

- Make diligent efforts to ensure that the title agency has provided access to all appropriate records and accounts. The auditor should make every effort to ensure that all bank accounts have been identified.

- Employ adequate sampling techniques for escrow and file review.

- Evaluate the title agency's personnel practices for hiring closing staff. Determine if procedures are used to minimize the chances of hiring untrustworthy individuals.

- Evaluate the title agency's fraud prevention controls, such as separation of accounting duties. For example, permitting the same individual to make deposits, write checks, reconcile bank statements and provide financial reports may greatly increase the opportunities for embezzlement.

- Identify and follow up on any signs or indicators of potential problematic or fraudulent activity. Such indicators may include such factors as encountering roadblocks to receiving full access to accounts and records, evasiveness or poor cooperation during the audit, signs of expenditures or living standards that go beyond what would be expected for a title agency of the given size and revenue, sloppy accounting or co-mingling of records with other business interests, and rumors of expensive vices or gambling problems.

- Consider giving more frequent audits for title agencies which the title underwriter deems to be at higher risk due to such factors as past history, lack of experience, size or other indicators.

c. Considerations for Title Agency and Closing Service Owners

1. Addressing Escrow Theft during Active Business Operations

As explained in the previous section, addressing escrow theft at the licensing stage is an important tool to weed out potential problem title agents before they even enter the title insurance market. However, although a title insurance agent/agency may show no warning signs at the licensing stage, this does not mean the title insurance agent/agency could not slip into risky business practices or commit an escrow theft subsequent to licensure. As such, it is important for regulators, title underwriters and title agencies themselves to implement tools in order to prevent escrow theft throughout a title insurance agent/agency's active business operations. A common tool used to prevent escrow theft is auditing requirements. These audits may be conducted by independent entities, title underwriters or regulators themselves.

2. Establishing Title Agency Business Practices

Title, escrow and settlement service provider owners can reduce opportunities for escrow and title insurance premium theft by employees by establishing and enforcing accounting safeguards and sound business practices. Title underwriters can likewise require good practices by way of their contractual agreements with title, escrow and settlement service agencies. For all but the smallest title agencies, certain processes can be established, such as required use of dual signatures, separation of duties for book-keeping, reporting and check-writing, file documentation requirements, internal audits, background checks for newly hired employees, mandatory use of trust accounts to separate escrow and premium funds from operational accounts, restrictions on investment of trust account funds into accounts that are guaranteed, required lock-up of certain documents and notary stamps, clear communication of expectations surrounding ethical practices, and ensuring employees of whistleblower protections.

3. Title Agency Owner Arranged Independent Annual Review

In the absence of a statutory requirement, larger agents may consider an Independent Annual Review (IAR). An IAR of a title agent's escrow, settlement, closing and security deposit accounts must be completed by a CPA who also shall be qualified in the following manner:

- Depending upon state requirements, the independent reviewer may or may not be an employee of a title insurance company nor may the reviewer be an employee of or hold an ownership interest in:
    - The business entity being reviewed.
    - Any affiliates of the business entity being reviewed.
    - Any owners of the business entity being reviewed.
    - Any financial institution or its affiliate in which one or more escrow accounts subject to review under this rule are held.

The IAR can be based on agreed-upon procedures as defined in the Statements on Standards for Attestation Engagements issued by the American Institute of Certified Public Accountants. Where no exceptions are found as a result of applying the procedure, the statement "no exceptions" should be noted. Where a procedure cannot be completed because the required information is unavailable, the statement "information unavailable" should be noted and explained in detail. The procedures can include, but are not limited to the following:

- Obtain from the title agent a listing of all title agent depository institution accounts existing at any time during the review period, including operating and other non-fiduciary accounts.
    - Report as specific findings all non-IOTA escrow accounts.
    - Report as specific findings all non-IOTA escrow accounts in which any interest, in the form of cash or earnings credits, is retained by the title agent.
- Test the title agent's three-way reconciliations.
    - Tie reconciliation and any supporting schedules.
    - Compare depository institution balance per reconciliation with depository institution statement.
    - Compare book balance per reconciliation with control account, such as checkbook balance.
    - Compare reconciled balances to the open escrow trial balance of the same date.

- Review title agent's open escrow trial balance for the two monthly periods.
- Verify deposits in transit.
- Verify outstanding checks by tracing to the subsequent month's depository institution statement.
- Report the amount and the title agent's description of other reconciling items.
- Verify the title agent has a voided checks procedure.
- Determine the timing of the preparation of the three-way and depository institution reconciliations for each of the two months tested.
- Review escrow depository institution account statements for the sample months for the presence of negative daily balances, if provided on the statement, and depository institution charged for non-sufficient funds or overdraft charges.
- For each escrow account, select a haphazard sample (as defined in the American Institute of Certified Public Accountants Audit Sampling Guide) of 20 canceled checks and/or outgoing wire transfers per month for the sample two-month periods and report the following:
    - Checks or wire transfers $1,000 or greater payable to the title agent or to its affiliates or owners which do not correspond to fee amounts reflected in the documents in the related file.
    - Checks or wire transfers with no file reference.
    - Any checks on which the check date is more than 60 days prior to the depository institution clearing date.
    - Endorsements not consistent with the payee and/or alternations to canceled checks if canceled checks or images of checks are available.
    - Checks signed by someone other than authorized check signer.

  List all states for which the title agent conducts settlements, and have the title agent complete and certify the annual review supplementary form as prescribed by the commissioner for listing required insurance coverage information.

i) Independent Review Findings

As a result of an IAR, findings and/or exceptions may be identified by the CPA. Findings can be a useful tool to help a regulator determine if there are any inconsistencies in the title agent's depository accounts. Since the CPA only performs testing to a sampling of data from the compliance period, a finding should be further evaluated by a regulator to determine if a larger problem exists. The following findings should be further evaluated by a regulator:

- Three-way reconciliation not completed by title agent.
- Negative escrow trial balances.
- Other reconciling items such as out-of-balance accounts.
- No voided check procedure.
- Checks or wire transfers to the title agent that do not correspond with closing file.
- Outstanding checks over 30 days.
- Deposits in transit over 30 days.
- Negative daily balance in escrow account.

When a title agent submits their filing, they have the opportunity to provide an explanation for each finding/exception that was identified. While an explanation may be useful to determine the extent of a potential problem, further evaluation may need to be completed. Quite often, a title agent may need to provide to the regulator a more detailed explanation, copies of bank statements, closing files and other documents in order to fully determine if a larger problems exists.

4. Software and Information Technology Solutions

In recent years, title underwriters and IT vendors have developed integrated software solutions that offer real-time interaction between title underwriters and title agents. Solutions that integrate such title and escrow activities as policy orders, policy and endorsement issuance, search functions, accounting and administration of escrow and settlement funds can help reduce administrative costs for title agents, improve record retention, reduce inadvertent mishandling of funds

and provide a less expensive method for title underwriters to audit and oversee activities of title agents. These commercially available programs can provide much-needed controls for title underwriters and title agencies.

5. Programs Sponsored by Industry Trade Organizations

State, regional and national title insurance and settlement provider trade organizations can offer a great deal of assistance to title agencies, title underwriters, consumers and regulators through educational programs, vetting programs, and best practice standard setting programs. The National Association of Independent Land Title Agents (NAILTA) and the American Land Title Association (ALTA) are two national trade organizations that may provide assistance.

ALTA has recently developed Title Insurance and Settlement Company Best Practices that provide a voluntary way for industry to improve positive and compliant settlement services. The best practices do not encompass all aspects of title or settlement activity, but touch upon such issues as ensuring licensing, escrow account controls and reconciliation, privacy, legal compliance, title policy production, liability, and fidelity coverage. ALTA's best practices are available at: www.alta.org/bestpractices/docs/ALTA_Title_and_Settlement_Company_Best_Practices.pdf.

IV. Mitigating Escrow Theft Once a Theft Has Occurred

a. Closing Protection Letters

The most common delivery mechanism for title insurance policies is through independent title insurance agents who often serve as policy-issuing agents for one or more title insurers. The relationship of title insurance agents and title insurers differs from agent/insurer relationships in other lines of insurance. Title insurance agents are authorized by a title insurer to issue title policies. Title insurance agents may also provide settlement services or escrow functions in a real property transaction, which, depending on state laws, may be excluded from the agent/insurer relationship. For the settlement service function, the agent may be considered the settlement agent of the lender. However, when settlement agents collect and disburse funds for a real estate transaction, lenders want to safeguard their funds. Closing protection letters satisfy lenders' need for safeguarding funds.

A closing protection letter (CPL) is an indemnification agreement where a title underwriter indemnifies a mortgage lender or purchaser against actions of the settlement agent in connection with real estate closings. Title insurers may issue closing protection letters as an ancillary part of the real estate transaction when a title insurance policy is to be issued. A closing protection letter typically provides protection in two situations. First, closing protection letters protect against fraud, dishonesty or negligence of the settlement agent as it relates to the status of title. If the settlement agent misappropriates funds and fails to satisfy a previous lien, the title insurer is liable for the actions of the agent in the agent's settlement service function. Second, closing protection letters protect against the failure of the settlement agent to comply with the written closing instructions of the lender to the extent they relate to the status of the title. State laws can vary as to whether a CPL is a form of title insurance that can be issued by a monoline title insurer or whether a CPL (or similar product) is a different form of insurance or indemnity that cannot be issued by a monoline title insurer. State laws also differ on the permissibility and use of closing protection letters and associated fees. Check your state law to determine how CPLs are defined in your state.

The NAIC *Title Insurers Model Act* contains provisions in Section 6 which permit title underwriters to issue closing or settlement protection if not contrary to existing laws. The provisions only permit such closing or settlement protection for actions of the title underwriter's named title agent and prohibit the title underwriter from providing coverage which purports to indemnify against any other improper actions.

Some regulators have expressed the opinion that any premium charged for closing protection letters should be remitted in full to the underwriting carrier and that appropriate reserves must be established for the coverage. At least one consumer

advocate expressed the opinion that lenders who require such coverage should pay the CPL premium rather than the real estate buyer.

Generally a closing protection letter does not provide coverage for sellers, but in a limited number of states, they are offered to include limited protection. In summary, closing protection letters provide an indemnity against specified acts or omissions of settlement agents related to the use of funds or the handling of documents in connection with a real estate transaction.

b. Title Underwriter Liability and Strict Liability

A few states have adopted requirements that hold title underwriters responsible for the escrow and settlement activities of their appointed title insurance agents. An example of such language, located in the Nebraska Title Insurers Act, follows:

> "A title insurer is liable for the defalcation, conversion, or misappropriation by a title agent appointed by or under written contract with such title insurer of escrow, settlement, closing, or security deposit funds handled by such title agent in contemplation of or in conjunction with the issuance of a title insurance commitment or title insurance policy by such title insurer. However, if no such title insurance commitment or title insurance policy was issued, each title insurer which appointed or maintained a written contract with such title agent at the time of the discovery of the defalcation, conversion, or misappropriation shares in the liability for the defalcation, conversion, or misappropriation shares in the liability for the defalcation, conversion, or misappropriation in the same proportion that the premium remitted to the title insurer by such discovery of the defalcation, conversion, or misappropriation bears to the total premium remitted to all title insurers by such title agent during the twelve-month period immediately preceding the date of the discovery of the defalcation, conversion, or misappropriation."

This stricter standard of liability placed on title underwriters can provide incentive for more thorough insurer audits of its title agents, and more thorough and quick resolution of problems that might arise. However, title underwriters point out that widespread use of such requirements could be unsustainable at current or similar premium levels. This standard can also add barriers for small or new title agencies obtaining contracts with title underwriters. Such requirements seem to be more acceptable in jurisdictions where problems are less prevalent or where transactional volume is low. Additionally, not all closing and settlement activities are performed by title agents that are affiliated with the title underwriter.

c. Establishing Escrow Theft Reserves

One proposal to help minimize the impact of escrow theft is to establish a pre-funded escrow theft reserve, which would be used to reimburse victims of escrow theft. Pre-funding such an account would most likely be accomplished through a per-policy or per-transaction fee, payable into a state-operated fund. Attempting to establish an appropriate size fund may be difficult since the impact of escrow theft varies widely by incident. Currently, many escrow thefts are reimbursed by title underwriters. Depending upon the source of such a reserve fund, having such a fund could possibly also reduce incentives for title underwriters to closely monitor title agent and settlement service providers. In at least one state, title underwriters are required to hold reserves for losses independent of title insurance.

V. Conclusions/Recommendations

This paper points out that no single remedy exists to address the problems relating to escrow and title insurance premium theft. The goal of the paper is to raise the level of awareness and discuss some potential safeguards to reduce or prevent the occurrence of such problems.

The ability to reduce or diminish opportunities for such misappropriations lies jointly with regulators, title underwriters, trade associations, title agency owners and individual title agents and escrow service providers. Consumer education can also play a role in helping to identify potential problems.

While the methods outlined in this paper are by no means exhaustive, it is the goal of the NAIC Title Escrow Theft White Paper (C) Subgroup that the paper will serve as an initial tool for addressing the problem, promoting discussion and improving consumer protection.

PROJECT HISTORY

TITLE ESCROW THEFT AND TITLE INSURANCE FRAUD WHITE PAPER

1. Description of the Project, Issues Addressed, etc.

The Title Insurance (C) Task Force appointed the Escrow Theft White Paper (C) Subgroup in March 2012 to draft a white paper concerning issues of escrow theft. The Title Escrow Theft and Title Insurance Fraud White Paper is intended to raise awareness and to be available as a tool for regulators to research methods for combating and preventing escrow theft, title insurance premium theft and other forms of fraud associated with title insurance and closing services.

The Escrow Theft White Paper (C) Subgroup adopted the white paper Aug. 7, 2013; the Title Insurance (C) Task Force adopted it Oct. 1, 2013; and the Property and Casualty Insurance (C) Committee adopted it Dec. 17, 2013.

2. Name of Group Responsible for Drafting the Model and States Participating

The Escrow Theft White Paper (C) Subgroup drafted the white paper. The Subgroup was chaired by Nebraska and made up of representatives from California, Indiana, Kansas, Missouri, Ohio and Utah.

3. Project Authorized by What Charge and Date First Given to the Group

The project was authorized by a charge of the Title Insurance (C) Task Force that appointed an Escrow Theft White Paper (C) Subgroup to "produce a white paper that examines ways to mitigate the impact of title insurer and agent insolvencies on policyholders, including the use of Closing Protection Letters." The charge was first given to the Subgroup in March 2012.

4. A General Description of the Drafting Process (e.g., drafted by a subgroup, interested parties, the full group, etc). Include any parties outside the members that participated.

The Subgroup drafted the white paper over a series of eight open conference calls between April 2012 and August 2013. Multiple drafts of the paper were publicly exposed and numerous comments were submitted and considered by the Subgroup. Parties submitting comments and participating in the process in addition to the Subgroup members included Kentucky, Michigan, Nevada, Oregon, Texas, Washington, the American Land Title Association (ALTA) and Demotech.

5. A General Description of the Due Process (e.g., exposure periods, public hearings, or any other means by which widespread input from industry, consumers and legislators was solicited).

Open conference calls were held to discuss each draft of the white paper, and numerous written and oral comments were received and considered. An effort was made to incorporate and address as many comments as possible.

6. A Discussion of the Significant Issues (items of some controversy raised during the due process and the group's response).

There were no significant issues or items of controversy.

7. Any Other Important Information (e.g., amending an accreditation standard).

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