

The Secured Lender

A NEW TWIST ON TITLE INSURANCE

risk

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Before July 2007 the market was awash in liquidity with far too much money chasing too few deals. Perhaps we should say too few well-structured deals.


the basics

Title insurance now available when "reliance collateral" is personal property

Risk managers now able to shift risk of current loan quality meltdown

Title Industry had developed competing ALTA-type of real estate title policy forms to benefit lenders

Before July 2007 the market was awash in liquidity with far too much money chasing too few deals. Perhaps we should say too few well-structured deals: Hedge funds and private-equity partnerships in competition with or financed by banks, were seeking to deploy vast sums of money from the constant flow of contributions from pension plans, endowment funds and foreign investors. In the wake of this competition, relaxed covenant packages and historically low-risk pricing, there has been very little room for error.



Attorney Scott McPhee of the Los Angeles office of Morrison Foerster LLP, who represents Countrywide as well as other leading lenders, stated, “Loan markets have suffered in recent years with ‘excess capital’ which has led to greater competition for loan originations and relaxed underwriting standards”. McPhee referred to such relaxed underwriting standards as having an impact on credit quality, loan pricing, potential legal fees, reliance collateral, default rates and ultimately, recoveries.

It has been noted over the last two years of Quarterly Senior Loan Surveys that underwriting standards continued to trend downward. Implicit in these findings, loss-given-default exposures had risen. At a recent Standard & Poors (S&P) symposium on CLOs and commercial loans, it was suggested that the recovery rates on the S&P migration tables would need to be recalibrated to reflect an increased level of risk.

S&P further proffered that the next cyclical downturn could be more severe than recent experience. Bruce Fraser of the Los Angeles office of Sidley & Austin, who represents Wells Fargo Bank as well as other major lenders, stated, “The current and expected unstable future economic conditions will likely result in increased loan defaults, which will cause greater reliance on credit quality and risk management tools”.

The exposure to operational risk has also escalated substantially and has made many institutions more vulnerable to losses from failed or inadequate internal processes, people and systems. From the perspective of risk managers, supervisors and shareholders, the consequences of such failures are severe. As we will discover, one of the risk management tools that bridges credit and operational risk for secured commercial & industrial (C&I) loans has been used by bankers for years within their real estate portfolios.

The Basel Committee on Banking

Supervision’s Consultative Document on Operational Risk stated: “The primary mechanism currently used for mitigating operational risk exposure is insurance.” Title insurance has been used by risk managers to shift risk in the past, in what has become an essential component of real estate secured lending business and mortgage-backed securitization market.

Traditionally, real estate lenders for both commercial and residential transactions, as well as investors, have used title insurance to minimize documentation errors and to manage problems associated with challenges to lien priority. Lenders have benefited from the related improvement in credit quality, secondary market value and liquidity.

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

Many believe it was the secondary market, with the advent of Fannie Mae and Freddie Mac, that led to not only the importance of title insurance for individual loan originations, but the investment community’s need for enhanced, high-quality, real estate related “securities”. In short, the advent of mortgage-backed securities relied on the efficiency and efficacy of title insurance as a fundamental risk-management tool.

While title insurance is a cornerstone of the real estate lending practice, traditional real estate title insurance has evolved over the last few years to become an accepted risk-management tool for secured lenders primarily within the private equity space.

However, there is one significant difference: it is now available to lenders in which “reliance collateral” is personal

property as defined by Article 8 and Article 9 of the Uniform Commercial Code. Morrison Foerster’s McPhee, stated “both lenders and investors benefit from strengthened collateral positions, and shifting risk, as it relates to lien perfection and priority, makes sense”.

The title industry has essentially adopted the standard American Land Title Association (ALTA) real estate title insurance policy form to provide the benefits of title insurance to commercial lenders securing loans with non-real estate collateral. In a few short years the nation’s leading title insurers have produced newly available “UCC Insurance Policies” in amounts covering an estimated \$350 billion in secured lending.

Sidley & Austin’s Fraser stated, “Historically title insurance has played an important role in the business of loan origination by insuring perfection and priority of collateral and by protecting lenders from fraud, forgery and documentation defects”. Fraser added that “UCC insurance is the natural evolution of this concept in light of the growing need to establish the strength and quality of commercial loan assets, particu-

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larly for rating agencies in asset-backed securitizations”.

The original concept of applying the benefits of real estate title insurance to the commercial finance market segment was simple: If every bank in the United States originating real estate-secured loans requires real estate title insurance, would those lenders originating nonreal estate secured-loans not also gain from the risk protection benefits of title insurance?

As the concept evolved, UCC insurance, available from the nation's leading real estate title insurance companies, became a relatively new development in the financial markets. Similar in many respects to traditional real estate title insurance, UCC insurance was introduced specifically to insure the lender's security interest in non-real estate collateral for validity, enforceability, attachment, perfection and priority.

Additionally, UCC insurance was developed to address fraud, forgery, insure the lending gap and provide cost-of-defense coverage in the event of a challenge to the lender's security interest. From a secondary market perspective and portfolio management standpoint, the policies are designed for the life-of-loan and are assignable.

Articles 8 and 9 of the Uniform Commercial Code, refer to “personal property” which includes inventory, furniture, fixtures, equipment, accounts receivables, deposit accounts, general intangibles, securities and pledges often crucial to the mezzanine lending markets.

More significantly from a lender's perspective, UCC insurance overcomes limited “UCC search vendor” indemnification in connection to search office errors and omissions, indexing inconsistencies and financing statement inaccuracies. “My firm has recommended UCC insurance for certain loan originations in order for our clients to benefit from

the additional protection of their lien position”, according to Sidley & Austin's Bruce Fraser.

Most commercial loan documentation defects that lead to a lender's security interest being set aside are clerical in nature: incorrect name of borrower, search of the wrong jurisdiction, wrong state of filing, the lack of filing the appropriate documents, an error in the collateral description and the like. Moreover, it is often junior staff at either the bank or the law firm that was responsible for perhaps the greatest risk to the lender: the loss of reliance collateral.

Loans with documentation problems are usually not an issue until they default. The strong loan market has probably masked a number of commercial loan defects, particularly since there have been limited defaults in recent years. Documentation defects that will directly affect value and recoverability of collateral have been kept somewhat below the surface by the simple fact that many of the affected loans are not in default. Morrison Foerster's McPhee added, “The transaction itself benefits from the efficiency and attention to detail required in the process of obtaining UCC insurance as a closing requirement.”

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

Risk management is, of course, everyone's business within the bank. However, risk managers are specifically charged with the responsibility to anticipate, identify, quantify and manage risk across each of their increasingly complicated portfolio of businesses.

And, as stated by Sidley's Fraser, “The strong economy in recent years may have led lenders to fail to price-to-risk, particularly the legal risks associated with equity and other personal property collateral. UCC insurance imposes a discipline and provides a product that can significantly reduce these legal risks.

In a complex and threatening environment, evidenced by the recent eruption of subprime related credit quality and liquidity issues, hazards to the bank's capital are elevated. With a high level of both loan and M&A activity over the last three years, the opportunity for human error poses an additional but undiagnosed danger.

Risk managers are now able to shift commercial loan risk one might associate with the potential broadening of the current consumer and residential loan quality meltdown by utilizing a basic, traditional and newly available solution: Time-tested title insurance with a new twist. **TSL**

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