A Short History of Loans and the Lender's Title Policy

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Lending practices date back as early as the first human civilizations. The roots of modern lending models are found in these ancient forms, and many of the fundamental concepts of these early practices provide valuable insight into today's practices. The lender's title insurance policy fits into this history as a relatively new, yet essential, element of the loan transaction.

Ancient Babylonian clay tablets, some dating as early as 2000 B.C., included pledges such as: "two shekels of silver have been borrowed by [borrower]. He will pay Sun God's interest. At the time of harvest he will pay back the sum and the interest upon it."[1] Note that this basic transaction involves transferring funds with the obligation to repay the funds in addition to interest that is compensation to the lender for the use of the funds.

Egyptian records take this notion a step further. Some records show the promise of a husband to his wife that, in the event he should take another spouse instead, he will pay a sum of money, or the original spouse may have all of the husband's property. This assurance is one of the first illustrations of the idea of pledging property in support of a promise to fulfill an obligation.[2]

Roman law continued to build on these concepts and introduced a number of models, each varying in how rights to the property and possession were handled. Since the concept of "pledging," as being independent from "ownership," had not been fully developed, early forms of borrowing required the actual transfer of property. The earliest Roman law required the transfer of ownership of property to the lender on the condition the property would be given back once the debt was paid (fiducia).[3] The original owner had little recourse if the lender did not keep their end of the bargain because ownership had already transferred.

Later came the concept of "pignus" whereby the lender obtained legal possession of the property but could neither "make use of it" nor "dispose of [it] to obtain satisfaction" for the loan.[4] These conditions could be negotiated, however, through additional, agreed-upon terms such as ownership rights being transferred to the lender in the event of default. The last model under Roman law allowed for a pledge to be established by agreement (hypotheca) as opposed to the actual "delivery" of property. The owner could establish an agreement with the lender without conveying ownership (fiducia) or giving up possession (pignus).[5]

The hypotheca model allowed the borrower to retain ownership and possession, but the lender had the right to foreclose and seize the property (usually subject to additional agreements that were more favorable for the borrower such as extensions in time). In other words, the lender had to go through the action of foreclosure before they were able to take possession of the property.[6]

Due to a number of factors, including the fall of the Roman Empire and the onset of the dark ages, Germanic laws prevailed and the loan transaction came to be known as a "gage" - something deposited for the performance of an agreement.[7] These Germanic laws tended to be similar to the earlier Roman laws in which

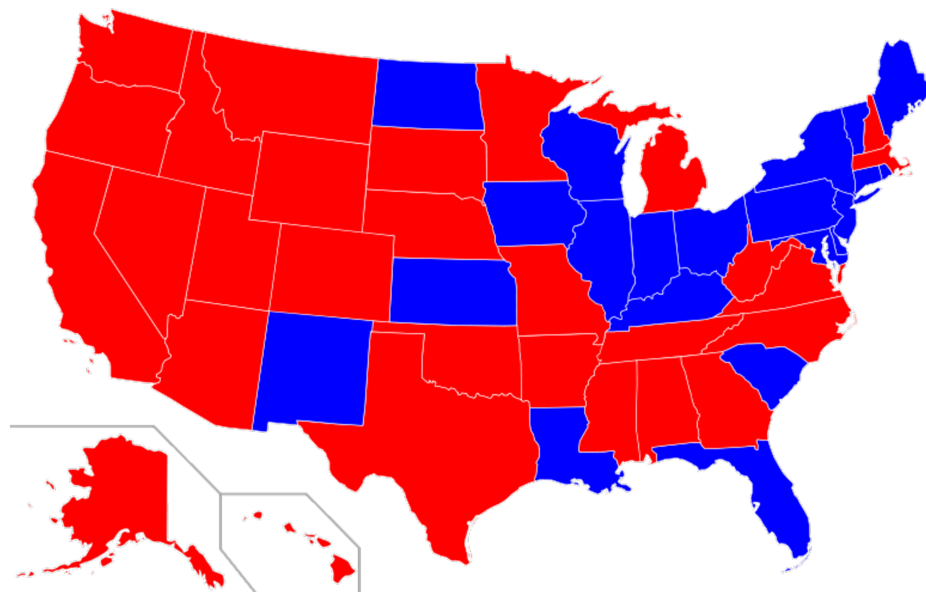
there was a transfer of property (fiducia). Both of these models involved terms which seemed to favor the lender over the borrower.

English common law was rooted in Germanic law and the gage "…provided for the transfer of title to the lender subject to the right of the borrower to redeem by fulfilling all the terms of the mortgage agreement."[8] In fact, the lender was considered to be the owner with right of possession, which allowed them to collect rents, and the borrower simply had the right to 'satisfy' the mortgage and reacquire the land once the debt had been paid.

Incidentally, the term "mortgage" is derived from "mort" meaning "dead' and "gage" which represents the aforementioned transaction. The original use of the term referred to a type of transaction arising in the early 11th century in which the lender would take possession of the property, collect income from the property, and keep that income in addition to the debt payments made by the borrower. In other words, the property was "dead" to the borrower since they were restricted from enjoying any income. It would not be until after 1600 A.D. when courts insist that income collected from the property be applied to the debt.[9]

The English common law involving the transfer of title in a "gage" eventually became the basis for early American law. Over time, however, many of the early American courts refused to recognize the English common law and ruled that the mortgage created a lien only (the right to have the land sold at public auction in default).[10] These rulings lead to the prevalence of two general concepts in the US: lien theory and title theory.[11] Lien theory asserts that the mortgage is a lien only on the property which remains titled in the owner, and title theory involves the lender (or trustee) holding title to the property. Depending on which approach is at play, there are implications with respect to the lenders options in the event of default. (See Figure 1 for a map of lien v. title states.)

Figure 1: Lien v. Title Theory States



Blue indicates states that follow the lien theory of mortgages
Red indicates states that follow the title theory of mortgages

In addition to the variances in legal theory, market changes and government action began to shape the modern loan transaction. During the Great Depression, the banking system failed. Most home mortgages at the time were "short-term (three to five years), no amortization (payments of principal and interest over time), balloon instruments at loan-to-value ratios below fifty to sixty percent."[12] Since refinancing was not available, and many borrowers, now unemployed, were unable to make mortgage payments, many homes were foreclosed, causing the housing market to plummet. Because there was little faith in the backing of the US government, few loans were issued and few new homes were purchased. In 1934, the federal banking system was restructured. The National Housing Act of 1934 created the Federal Housing Administration or FHA (which was eventually merged with the Department of Housing and Urban Development's (HUD) Office of Housing in 1965). The FHA regulated the rate of interest and the terms of mortgages that it insured. These new lending practices increased the number of people who could afford a down payment and monthly amortized payments on a mortgage.

Fannie Mae was created in 1938 in order to buy mortgages from lenders and free up capital that could go to other borrowers.

> *Although Fannie Mae began with just $1 billion in purchasing power, the agency helped usher in a new generation of American home ownership, paving the way for banks to loan money to low- and middle-income buyers who otherwise might not have been considered creditworthy.*[13]

Fannie Mae ensured liquidity in the market and established what is considered as the "secondary market." With the advent of new types of lending structures and the rapid growth of the secondary mortgage market, title companies provided solutions surrounding researching title, identifying and eliminating title-related matters, and issuing policies which covered title-related losses. Essentially, title insurance companies relieved some of the burden of performing certain functions while contributing to the streamlining of loan transactions.

Just as the modern amortized mortgage is essentially an American invention, so too is title insurance. First introduced in the late 1800s, title insurance came about as the result of a Pennsylvania case (Watson v. Muirhead) which involved a buyer losing his property due to a prior lien that had been identified but erroneously evaluated as being invalid.

The standard loan policy was first introduced in 1929 by the American Title Association (the predecessor to the American Land Title Association (ALTA)).[14]

As loans were made more attractive and available to the average American, the lending industry expanded significantly and title insurance became a requirement of the most lenders beginning in the mid-late 1900s. Policy forms continued to evolve but have retained several basic covered risks.

Regardless of whether the property is located in a title or lien theory state, these covered risks relate to the rights the lender has with respect to the insured property relative to the rights of others.

A standard policy insures loss or damage suffered as a result of the owner being something other than what is represented on the policy, the invalidity of the lien, and claims against the title that are not otherwise set out on the policy. Costs of defending the title with respect to a covered risk are also included. The policy has several key sections including the covered risks, the exclusions, the conditions, Schedule A, and Schedule B. The covered

risks, exclusions, and the conditions are preprinted on the policy jacket whereas the schedules contain transaction-specific information and are inserted at the time of the transaction. Schedule A includes the names of the parties involved, the policy amount, the description of the insured property, and several other items. Schedule B contains the exceptions to coverage which are different from exclusions in that they are transaction-specific. These exceptions are essentially rights that have already been distributed in the property's history and other matters which have an impact on the title including easements, restrictive covenants, outstanding ownership interests, and other liens and encumbrances.

Additional types of coverage are available in many markets through the use of endorsements and "expanded" policy products. Conversely, reduced coverage is also generally available for liens such as equity liens where standard coverage may not be desirable.

The lender's policy is not a guarantee of good title—it is a contract for indemnification for losses related to the specific covered risks. For the lender, losses cannot be contemplated until a foreclosure is imminent.

It is important that the title company's claims department is notified at the first sign of a potential loss. The title company is able to then evaluate the circumstances and determine a course of action. The title company has the option to file suit to quiet the title and remove the defect, pay the claimed amount to the holder of the adverse interest in exchange for release or waiver of the adverse interest, or pay the insured directly for the losses.

If the insurer elects to pay the insured directly, the policy only requires that payment be in the amount of the actual loss or the face amount of the policy, whichever is less; therefore, if actual loss is less than the policy amount, the insurer does not pay the face amount of the policy. Instead, the insurer measures the damages as being the extent to which the value of the property is diminished due to the title being other than as insured.

Although the lender's title insurance policy is a relatively new development when compared to the ancient origins of lending practices, the product has become essential to the success of a loan transaction as it has evolved to its current form.

[1, 2] qt in Cherrington, Homer V., Phd & Pease, Robert h. M.B.A. Mortgage Banking. McGraw-Hill Book Company, Inc. United States. 1953.

[3, 4, 5, 6] http://www.perseus.tufts.edu

[7, 8, 9, 10, 11] Cherrington, Homer V., Phd & Pease, Robert h. M.B.A. Mortgage Banking. McGraw-Hill Book Company, Inc. United States. 1953.

[12] Monroe, Albert. "How the Federal Housing Administration Affects Homeownership." Harvard University Department of Economics. Cambridge, MA. November 2001.

[13] http://www.time.com/time/business/article/0,8599,1822766,00.html

[14] Gosdin, James L. Title Insurance: A Comprehensive Overview. ABA. 2007