Adopting Restatement Mortgage Subrogation Principles:
Saving Billions of Dollars for Refinancing Homeowners

This document represents a draft summary of a working paper that discusses how title insurance costs can be significantly reduced in home refinance transactions.

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Adopting Restatement Mortgage Subrogation Principles: Saving Billions of Dollars for Refinancing Homeowners

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In eras of declining interest rates, millions of residential mortgage loans may be refinanced. When this occurs, it is customary for the refinancing lender, as a condition for making the loan, to obtain a title examination and a new mortgagee’s title insurance policy. This requirement is expensive, and the cost is invariably paid by the borrower. We propose to show in this article that in the vast majority of refinancings this expense can be substantially reduced or even eliminated. We argue that this result can be achieved through a proper understanding and use of the doctrine of equitable mortgage subrogation and related concepts articulated in the Restatement (Third) of Property: Mortgages, adopted by the American Law Institute in 1997.1

Part I of this Article2 describes the most recent wave of refinancings and estimates the costs involved in providing mortgagee’s title insurance. Part II3 focuses on traditional subrogation and related principles as they operate in the mortgage refinancing context and shows how the Restatement approach greatly reduces the risk of loss of mortgage priority for mortgage lenders. Part III4 describes and advocates use of two simple changes to current residential mortgage documents that would greatly strengthen their usefulness in the context of subrogation. Part IV5 discusses the value that title insurance adds to a refinancing lender’s position and considers whether, under a modern concept of mortgage subrogation, lenders might elect to forego their current requirement that title insurance be issued. Part V6 describes how direct assignment of refinanced mortgages could serve as an alternative to subrogation, and evaluates whether such a change in present practice is feasible. Part VI7

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1Restatement (Third) of Prop.: Mortgages §§ 7.3, 7.6 (1997).

2See text at notes 11-29 infra.

3See text at notes 30-76 infra.

4See text at notes 77-109 infra.

5See text at notes 110-134 infra.

6See text at notes 135-144 infra.

7See text at notes 145-177 infra.
examines conditions in the mortgage and title insurance markets, and argues that the pervasive adoption of the subrogation principle should either reduce title insurance premiums substantially in refinancings or, alternatively, cause major mortgage lenders to eliminate the need for title insurance completely. Finally, Part VII8 considers whether state judicial adoption of the Restatement’s mortgage subrogation principles is the best course of action, or whether Congress should enact the Restatement approach by legislation.

**Part I: The Costs of Refinancing**

Beginning in April 2002 the United States experienced an astonishing decline in residential mortgage interest rates. The 30-year fixed-rate mortgage, usually considered the standard or bell-weather of the industry, had been near 7%9 since the beginning of 2001,10 but in April 2002 it began a remarkable plunge, reaching a low of 5.21% in June 2003. It has remained near or below 6% to the present. Adjustable rate mortgages,11 which nearly always carry rates lower than fixed-rate loans, experienced a similar decline, falling through 4.5% in mid-2002 and ultimately reaching a low of 3.36% in March 2004; they remain near 4% at this writing.

Some perspective on the extraordinary nature of these rate reductions is gained by considering the historic data on average new home mortgage yields published in the annual Economic Report of the President. Since the commencement of that data series in 1963, the lowest reported yield prior to 2000 was 5.81% in 1965 – more than one-half of a percentage point higher than the June 2003 low.12

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8See text at notes 178-183 infra.

9Data are based on the Freddie Mac Primary Mortgage Market Survey (PMMS). Currently 125 lenders across the nation (thrifts, commercial banks and mortgage lending companies) are surveyed each week. Rates given are for conventional financing on conforming mortgages with loan-to-value (LTV) rates of 80 percent or less. The effect of points and fees charged by lenders is not included. The data are available from 1992 onward on a continuously-updated basis at http://mortgage-x.com/general/historical_rates.asp. “Conforming” loans are those eligible for purchase by Fannie Mae and Freddie Mac. The upper limit of conforming loans is radjusted annually by these two government-sponsored enterprises. For example, in 2000 the limit for single-family homes was $252,700. By 2004 it had been increased to $333,700. A history of recent conforming loan levels is found at http://mortgage-x.com/library/loans.htm.

10The 7% level was considered relatively low but not unusual; rates had fallen to the 7% range in late 1993, February 1996, and through the period from the beginning of 1998 through mid-1999.

11The data reflect 1-year adjustable rate mortgages indexed to constant maturity U.S. Treasury debt with a 1-year maturity.

12Economic Report of the President (2004) at Table B-73, at http://www.gpoaccess.gov/eop/. Because of variations in methods of data collection and computation over time, and because the historic data in the Economic Report of the President are yields (incorporating the effect of points and
The inevitable result of these drastically lowered interest rates was a wave of residential mortgage refinancings that far eclipsed in number those of any previous period. Refinancing volume began accelerating in early 2001 and reached a sustained peak during May and June of 2003.\textsuperscript{13} During most of that two-month period, about three-quarters of all mortgage loan applications were for refinancing.\textsuperscript{14} The Mortgage Bankers Association’s Refinancing Index, with a base of 100 in March 1990, was above 8,000 for most of the same two-month period.\textsuperscript{15} When refinancings dropped slightly in the first week of July, 2003, Jay Brinkmann, MBA’s vice president of research and economics, commented “While there was a decline, it was a decline from unbelievably high levels to merely extraordinarily high levels.”\textsuperscript{16}

The dollar amount of mortgage originations resulting from refinancing was also exceptional. During the three-year period 2001-2004, refinancing loans totaling more than $5.4 trillion were originated.\textsuperscript{17} Given an average refinanced mortgage amount of $130,000,\textsuperscript{18}

fees) rather than promissory note rates, the historic data are not strictly comparable with the current Freddie Mac PMMS data.

\textsuperscript{13}The data are charted in a presentation by Doug Duncan, Senior Vice President and Chief Economist, Mortgage Banker’s Ass’n, given at MBA’s National Secondary Market Conference, Washington DC, April 21, 2004, at http://www.mortgagebankers.org/present/2004/Secondary/MBA DuncanNational Secondary Presentation final.pdf

\textsuperscript{14}See Mortgage Bankers Ass’n press releases for the period, at http://www.mortgagebankers.org/marketdata/. The highest single period was the week ending March 14, 2003, when refinancings represented 80.5% of all residential loan applications.

\textsuperscript{15}Id.


\textsuperscript{17}Financial Services Fact Book 137 (2004), at http://www.financialservicesfacts.org/financial2/mortgage/mortgages/, reporting the following data on one-to-four-family residential financing (dollars in billion):

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Volume</th>
<th>Percent</th>
<th>Refinancing</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$2,243</td>
<td>55.00</td>
<td>$1,234</td>
</tr>
<tr>
<td>2002</td>
<td>$2,852</td>
<td>59.00</td>
<td>$1,683</td>
</tr>
<tr>
<td>2003</td>
<td>$3,810</td>
<td>66.00</td>
<td>$2,515</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td></td>
<td>$5,431</td>
</tr>
</tbody>
</table>

\textsuperscript{18}Id. at 138, reporting an average loan amount of $128,800 for residential mortgages refinanced in 2001 or early 2002. We have rounded this figure upward to $130,000 to reflect estimated inflation.
there were about 41 million home mortgage refinancings during this period. If no households had refinanced more than once during 2001-2003, this would represent 58 percent of all homeowners and 92% of all homeowners with regular or home-equity mortgages. This indicates the massive size of the refinancing activity.

The thesis of this article is that the doctrine of subrogation, properly understood and applied, has the potential to eliminate or greatly reduce the expense of proof of title to mortgage lenders in refinancing transactions. Hence, it is useful to estimate the amount of that expense. This is no easy task. Mortgage lenders nearly always require a new title insurance policy, paid for by the borrower, when they refinance an existing loan. However, there is no national uniformity in title insurance methods or rates. In many areas of the nation, title insurance is written by agents who also perform the necessary search of the records and charge an “all-inclusive” rate. In other areas, attorneys or abstracters act as title insurance agents and may make a separate charge for their services in examining the records. Rates tend to be similar among title companies in a given locality, but vary widely throughout the nation. There is no national data base of title insurance rates.

The issue is further complicated by the use of “reissue rates” by many title companies. A reissue rate is a discounted rate, made available if the same title company has previously issued a policy on the same property during some fixed previous time, such as five or ten years. The discount may reduce the insurance premium to 40% to 60% of the standard rate.

in house prices and loan amounts during the remainder of the 2001-2003 period.


20There were 72,238,000 homeowner households in the United States as of 2003; Financial Services Fact Book (2004), at http://www.financialservicesfacts.org/financial2/mortgage/homeown/.

21Insurance Information Institute, Financial Services Fact Book (2004), at http://www.financialservicesfacts.org/financial2/mortgage/mortgages, indicating that in 2003, 45,471,000 households had regular or home-equity mortgages.

22Because there were multiple refinancings by some households, these numbers overstate somewhat the number of households that refinanced.

23Charles Kovaleski, President-elect, American Land Title Ass’n, Should You Refinance?, at http://www.alta.org/consumer/questions.cfm#refi (“When you refinance your home, you are in effect taking out a new loan. Your lender is going to require that you purchase lender's title insurance to protect their investment.”) See also Fannie Mae, Refinancing Costs and Requirements, at http://www.fanniemae.com/homebuyers/findamortgage/refinancing/requirements.jhtml.

24The agent represents the underwriter, the entity that actually issues the insurance policy.

25See Kenneth R. Harney, Refinancing’s Magic Words: Reissue Rate, Washington Post, June 8,
Title underwriters’ approaches to the concept of the reissue rate vary widely from one part of the nation to another, and consumers are sometimes unaware of the availability of reissue rates and therefore do not receive their benefit.\textsuperscript{26}

Despite these variations, it is possible to make a reasonable estimate of title insurance costs in residential mortgage refinancings. Where an “all-inclusive” rate is available, our estimate of the cost for an average $130,000 refinancing is approximately $400.\textsuperscript{27} Given the


\textsuperscript{27}One national title insurance underwriter, First American Title Ins. Co., provides an internet “calculator” that can be used to determine premium rates. See http://titlefees.firstam.com/Titlefees.asp. The following rates were calculated from that web site on the basis of a loan of $130,000 refinancing a previous loan made five years earlier, and having a current balance of $130,000 (so that there is no “cash out” in the refinancing). They take “reissue” discounts into consideration where available.

\textbf{All-inclusive rate states (sample):}

- Arizona (Maricopa County) $541
- California (Los Angeles County) $360
- Illinois $330
- Michigan (Wayne County) $337
- New York (Westchester County) $382
- Nevada (Clark County) $279
- Oregon $689
- Utah $471
- Washington (King County) $313
- Average of the foregoing $411

\textbf{States in which a search fee is separately charged:}

- Florida $362
- Massachusetts $195
- Minnesota $161
- Missouri $166
- Ohio $364
- Average of the foregoing $250

The average rate of the “separate search fee” states has little meaning, since there is no basis for determining the additional search fee, but it seems likely to be at least $150 on average.

The estimate in the text is borne out by LendingTree.com, an internet mortgage loan service, whose web site gives an overall national estimate of $450 to $600; see http://www.lendingtree.com/stmrc/refiarticle5.asp?bp=. See also Pete Boisseau, Radian Continues to Spread Incorrect Cost-Savings, 81 Title News, September/October 2002. This article is a criticism of
roughly 41 million residential refinancings during 2001-2003, the amount spent on title services protecting refinancing lenders during that period was approximately $16 billion! This sum was, from the viewpoint of consumers, a deadweight loss, since no consumer has any independent need or desire for a new title insurance policy when refinancing; the expenditure is merely a condition of obtaining the new loan. As we will show below, this expenditure was largely unnecessary even from the viewpoint of the lenders who insisted on it, and it acted as a significant drag on the economic benefit that refinancing generated.

The foregoing analysis suggests that title assurance costs for refinancing residential mortgages are very significant. Of course, residential mortgages are only part of the story; loans on commercial, industrial, and agricultural property are also refinanced when interest rates fall. While restrictions and fees on prepayment act as an impediment to refinancing such loans to a much greater extent than with respect to residential loans,28 there can be no doubt that nonresidential refinancings are quite common. These loans are typically much larger than residential loans, with correspondingly higher title assurance costs.

Title assurance costs act as an impediment to refinancings. In some cases, they may enough to cause a mortgagor to forego refinancing altogether, perhaps in the hope that a further reduction in interest rates will make the transaction worthwhile in the future. In other cases, the refinancing transaction may go forward, but the economic benefit to the mortgagor is reduced by the title assurance expense. In general the cost of title assurance, like all transaction costs, makes the transaction less efficient.29

The question we address here is simple: is there a feasible way to reduce the cost of title assurance in mortgage refinancings? We believe that the answer is yes. Our purpose is to suggest a simple change in the law – a change that would harm no one, and that is already in effect in some states – that would drastically reduce the cost of assuring to refinancing lenders that they are receiving mortgages with the priority they expect and desire. This change involves the doctrine of mortgage subrogation and related principles.


29The classic study of transaction costs and their impact on market efficiency is Ronald Coase, The Nature of the Firm (1937).