

WHEN CONV

SORTING OUT THE COMPLEXITIES OF CREDIT INSURANCE

BY GARY FAGG

Debt protection products blur the line between banking and insurance, while analysis of their protected events blurs the actuarial lines between life, health, and property & casualty insurance.

IN ABOUT 1910, Arthur Morris visualized extending credit to working-class people based solely on their earning capacity, a radical concept at the time. He started a few banks and then franchised the concept. Ultimately, there were about 200 Morris Plan Banks throughout the United States. You can often find Morris coin banks and other memorabilia for sale on eBay.

As a lender, Morris's primary concern was collateral. His collateral was the borrower's ability to work—death, disability, and unemployment meant impaired collateral. In 1917, he formed the Morris Plan Insurance Society, a life insurance company. His first product was individual term life insurance in an amount comparable to the borrower's debt.

One franchise was in Springfield, Ohio. Instead of Morris's insurance products, the lenders devised their own form of loan protection. If a borrower paid \$1 extra per \$100 loaned, they wrote on the preprinted loan document: "If the borrower dies during the term of the debt, the debt is canceled." They tracked the financial results by keeping the \$1

fees tucked in a cigar box in the vault. When a borrower died, they took money from the cigar box and paid off the debt. There was no actuarial analysis—one rate for all ages (up to 65) and both sexes.

Their debt cancellation concept was a success. But in 1925, a bank examiner became aware of the practice. "That's insurance!" he admonished. "Only an insurance company can offer insurance." In meetings with the insurance department, everyone recognized that this single-rate life insurance product was more akin to group insurance than individual insurance. The Credit Life Insurance Company was formed; they issued the first group credit life policy in 1926. Today's credit life insurance for installment lending remains remarkably like that original policy.

Another early credit insurer, Old Republic Life Insurance Company, introduced the first monthly indemnity credit disability product. Again, one rate per \$100 was charged for all loans and all borrowers. The product set was established: If you die, credit life insurance pays off your debt; if you're disabled, credit disability insurance pays your monthly payment.

WORLDS EDGE



Following World War II, consumer goods production flourished. To facilitate purchases, consumer goods lending became commonplace. Credit insurance became readily available to protect the borrower. Either a property and casualty (P&C) insurer or a life insurer could issue credit disability insurance, but only a life insurer could offer credit life insurance, so it was logical to use a life insurer for both. Credit insurance became the province of the life insurance industry and life insurance regulation.

Little Plastic Cards

As regulation of credit insurance expanded in the 1960s, studies of loss experience supported the emerging concept of prima facie rates. (A prima facie rate is a maximum rate that, on its face, is reasonable and can be used without further justification.) In 1964, the industry produced the first recognized mortality study, and in 1968, a landmark credit disability study was released. In both studies, the mathematical formulas describe “frequency times severity,” but those exact words never appear. All

of the committees’ actuaries were life insurance actuaries.

If a consumer bought a refrigerator, borrowed the money to pay for the purchase, and pledged the refrigerator as collateral, the lender would insist that the collateral be protected by property insurance, such as homeowners’ insurance. An alternative to satisfy this requirement, credit property insurance, arrived in the 1960s. It was first-dollar, all-peril homeowners’ protection on that refrigerator. A P&C insurer was generally needed, although a few life insurers have been permitted to issue credit property over the years. Certainly it was time for the P&C actuaries to arrive on the scene. But not yet. The pricing was one rate per \$100 of covered property countrywide.

In 1964, a banker wrote the Office of the Comptroller of the Currency (OCC). In return for a fee, he asked, can I amend my lending agreement and tell my borrower, “If you die during the term of the debt, the bank will cancel your

debt?" The OCC responded that the bank had that power, and that such contracts "are a lawful exercise of the powers of a national bank and necessary to the business of banking." When the OCC invoked those critical words from the 1864 National Bank Act, debt cancellation contracts became a banking product. In that two-paragraph letter, the OCC removed the product from the purview of the state insurance regulatory system.

Later that year, the OCC ruled that banks could ask health questions and have eligibility standards based on age. These rulings didn't go unnoticed. The 1964 NAIC *Proceedings* document some strong opposition. State insurance commissioners and state attorneys general opined debt cancellation contracts were insurance. Several attorneys general opined that national banks were still subject to state insurance laws. Then everything got quiet; if any banks implemented the concept, they remained below everyone's radar screen.

As the 1960s closed, consumers began to receive little plastic cards from retailers and banks that promised the convenient availability of purchasing power without the need for cash, and the ubiquitous credit card industry was born. Credit insurers took notice quickly. Cards began to offer credit life insurance (if you die, the insurer will pay off your balance) and credit disability insurance (if you become disabled, the insurer will pay your *minimum* monthly payment). The programs were underwritten by life insurers.

Often, credit insurance premiums on credit card balances were too small to support the fixed processing costs. About 1975, Montgomery Ward added the contingency of involuntary unemployment to the product set. Montgomery Ward designed the prototype that led to the industry's spectacular growth over the next 25 years. Adding involuntary unemployment required bringing a P&C insurer into the mix. The final design was a package concept that required two insurers, two master policies, and two certificates. Retailers subsequently added credit property insurance to the package.

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Close Call

The package almost failed in its early days. We have never seen the original actuarial work, but it's unlikely that the margins were adequate for the recession of 1981-82. The insurers hung on, because it was now clear that open-end, credit card lending was the future of lending. In the mid-1980s, several insurers filed revised credit card packages. That actuarial work is still avail-

able. Involuntary unemployment insurance rates were developed using countrywide or state-by-state population data. The actuarial memoranda weren't complex, but the recession experience supported substantial rates. The package regained its financial footing and slowly became a staple of credit card offerings. (At its peak in 2000, premium volume was \$1.5 billion; 25 percent of all credit insurance sold.)

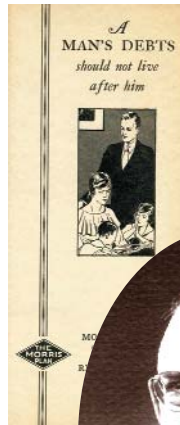
Meanwhile, the installment lending world was trucking along with the standard credit life and disability product set. Following a regulatory change in Arkansas in the mid-1980s, First National Bank of Eastern Arkansas proposed to offer a debt cancellation product. It queried the Arkansas Insurance Department, "Will you regulate this product as insurance?" The first response was no, but the department reconsidered and declared its intent to regulate the product as insurance.

The bank sued the commissioner. It won the case in circuit court and in the subsequent appeal to the 8th Circuit U.S. Court of Appeals. The U.S. Supreme Court chose not to review the case. The courts ruled that debt cancellation contracts were a banking product, and that federal law preempted state insurance laws. A few banks quietly took advantage of the concept.

Without fanfare, Provident Bank began to replace credit insurance on its credit cards with debt protection products in the early 1990s. Advanta Bank followed in late 1994 on its credit cards. Advanta challenged the state insurance structure head-on by introducing the product in New York, Pennsylvania, and Texas—states that had the most restrictive credit card credit insurance rules. There were few, if any, objections.

Several banks requested further rulings from the OCC in the 1990s. In the rulings, the OCC reconfirmed the 1964 rulings, expanded the concept to the contingencies of disability and involuntary unemployment, and opened the door to any risk affecting a borrower's ability to repay debt. It expanded the protection possibilities by recognizing debt suspension/deferment contracts that froze the debt.

In 1998, the rumors started: "Citi's going debt suspension; Citi's going to do it." In January 1999, Citibank released Credit Protector in 48 states, and the rush was on. In 2002, virtually all new credit card solicitations contain an offer for debt protection products, not credit insurance. The entire focus is on the involuntary unemployment protection. The offer is based on "Protect Your Credit Rating." Death protection, to the extent it's offered, is the last in the list of benefits.



10 REASONS... WHY CREDIT LIFE INSURANCE IS EXTREMELY PROFITABLE FOR YOU

1. It requires no out-of-pocket cost to you.
2. Borrowers are extremely receptive to the program.
3. It does not require a medical examination or written application.
4. It is controlled with ease and simplicity, entirely by your own organization, with no disruption of your present routine.
5. It enables you to accept many borderline loans which might otherwise be rejected.
6. It enables you to offer a diversified loan service and maintain necessary reserves to control competition.
7. It protects the borrower, the institution, the collateral... creating a feeling of confidence and security.
8. It eliminates both the expense and the necessity of legal collection procedures if borrower should die.
9. It promotes valuable good-will with all classes of borrowers, creating favorable word-of-mouth advertising.
10. It gives you one of the most appealing business-related features connected with personal loan financing.

"Insurance on the life of the Debtor in favor of the Creditor"

The Credit Life Insurance Co.
120 SOUTH LIMESTONE STREET... SPRINGFIELD, OHIO

CONSUMER Credit INSURANCE

is Bought by MILLIONS

because

IT PROVIDES SECURITY WHEN IT'S NEEDED MOST

TERMINOLOGY	
Debt Protection Products	Credit Insurance
Cancels, Waives	Pays
Contract, Addenda	Policy
Fee	Premium
Financial Institution	Insurer
Protected Borrower	Insured
Protected Event	Contingency, Insured Event
Protection	Insurance, Coverage

Anything but Insurance

Meanwhile, the installment lending world trudged along with its separate offerings of single-premium credit life and disability insurance. Enthusiasm for the offerings dropped steadily. Lending representatives disliked asking health questions and telling long-term customers that they were beyond the maximum age. Consumer advocates criticized the product. Automobile dealers' "finance-and-insurance" offices, once a primary producer of the product, morphed into "finance-and-anything-but-insurance" offices. Extended service contracts, rust proofing, VIN etching, and other aftermarket products slowly took precedence in the aftermarket offerings.



Real-estate-secured lending began to dominate bank and finance company installment lending. Lenders included single-premium credit life and disability insurance as an option. These high-dollar single premiums are added to the loan and financed. Ultimately, this practice has been labeled a predatory lending practice. North Carolina outlawed financing single premiums, and a 2002 Federal Reserve Board rule effective Oct. 1, 2002, effectively bans single premiums on real-estate secured-lending.

Faced with the North Carolina change in 2000, Bank of America directed its staff to start with a clean slate. Determine what protection borrowers wanted, what protections lending representatives supported, what protections matched the bank's mission, and what protections the systems could process. Single-premium credit insurance for all loans was off the list quickly; then credit insurance was eliminated entirely. Health questions and age limits were on every group's hit list. From consumer focus groups, it became clear—a borrower taking out a new loan has one primary economic concern: "How am I going to make these payments if I lose my job?" In spite of the lowest unemployment levels in 50 years, borrowers had unprecedented concern about job loss; no employer or employee is safe today from changing technology, changing corporate financial fortunes, or corporate acquisition.

Bank of America's final product set contained three pack-

ages; single and joint protection is available for each package.

- Involuntary unemployment and accidental death
- Disability and accidental death
- Involuntary unemployment, disability, and accidental death

By late 2001, substantially all Bank of America lending had converted from credit insurance to monthly-fee debt protection products. Faced with the Oct. 1, 2002, deadline, about 50 banks have decided to convert to monthly-fee debt protection products. A few have chosen to begin with a credit life and disability look-alike product, but most are moving to the Bank of America product set. Additional banks are converting to monthly premium credit insurance initially but have scheduled a later conversion to debt protection products. We

believe the ultimate product set for protecting debt will be involuntary unemployment and accidental death.

In credit card products, the list of protected life-altering events is growing diverse. Unpaid family leave was introduced as a P&C insurance product and has been added to debt protection packages. Divorce protection has been added: If you become divorced, the bank will cancel four monthly payments. Skilled nursing homecare has been added: If you enter a skilled nursing home, the bank will cancel your monthly payment for up to 12 months. One subprime banker asked, "Can we cancel the monthly payment if your spouse is incarcerated?" We all laughed a little, but she was serious: "No, that's a real problem for our borrowers." These are real life-altering events that happen to real people.

The bank has the ability to craft a set of protected events for particular groups. For military personnel, involuntary unemployment isn't a problem. Job relocation, unusual medical situations, and other facets of military life are unique and can be protected by a specifically crafted set of protected events.



The Answer Is "Both"

When these protected events are subject to insurance regulation, are they life insurance or P&C insurance? As befitting our current system of state regulation, get ready for 51 variations. All-cause death is unique; it's a life insurance product in all jurisdictions. Disability insurance and accidental death insurance can be either life or P&C. Involuntary unemployment insurance is mostly P&C, but a growing number of states permit a life insurer to issue the coverage. Unpaid family leave is likely P&C, but sometimes it's a rider to involuntary unemployment insurance. Divorce insurance has been approved in a few states as a P&C product. No insurer filed a skilled nursing home credit type product, but it would seem to be health insurance. And as for spouse incarceration . . . who knows?

Glossary of Debt Protection Products and Credit Insurance (“You” is the borrower.)

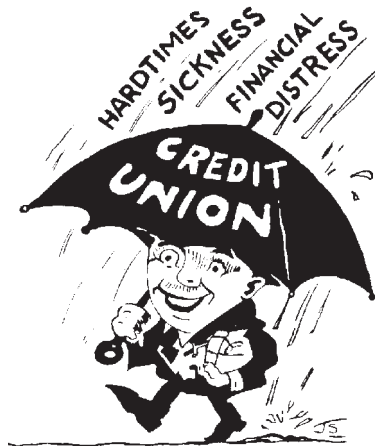
Protected Event	Debt Protection Product	Protection	Credit Insurance	Coverage
Death or Accidental Death	Debt Cancellation	“If you die, the bank cancels your debt.”	Credit Life	“If you die, the insurer pays a benefit equal to your debt; accidental death coverage is not permitted.”
	Debt Suspension	“If you die, the bank waives your monthly payments for x months.”		
	Payment Holiday	“If you die, the bank waives the requirement to make a payment for x months, but interest accrues.”		
Disability or Accidental Disability	Debt Cancellation	“If you become disabled, the bank cancels your monthly payment for up to x months.”	Credit Disability	“If you become disabled, the insurer pays a benefit equal to the required monthly payment on your debt; accidental disability coverage is not permitted.”
	Debt Suspension	“If you become disabled, the bank waives interest and the requirement to make a monthly payment for up to x months.”		
	Payment Holiday	“If you become disabled, the bank waives the requirement to make a payment, but interest accrues.”		

The state-by-state variations in “life versus P&C” present problems for actuaries who sign actuarial opinions of insurance companies or who provide the actuarial support for policy filings.

Most credit insurance actuaries are life actuaries, or once were. Fundamentally, all of the protected events can be analyzed using P&C risk concepts. The pricing analysis for the disability risk is to determine the frequency of disability times the severity; severity is the monthly payment times the expected continuance of loss. For monthly premium products, the whole reserving issue is about loss reserves. Standard loss reserving techniques perform adequately.

Having mastered the disability risk, it's a straightforward step to the involuntary unemployment risk. Substitute the frequency of involuntary unemployment and the appropriate continuance patterns, and the pricing is set to go. Unpaid family leave, stay at a skilled nursing home, and other continuing monthly benefit programs follow the same procedures. For programs canceling the outstanding balance (death protection) or a fixed number of benefits (divorce), the analysis becomes even simpler, frequency times the benefit.

The concepts are straightforward, but the application provides challenges. While traditional actuarial modeling techniques applied to historical patterns of death and disability are sufficient, the involuntary unemployment risk demands dynamic modeling. Not only is the underlying risk capable of dra-



matic movements over short time periods, national risk analysis may not work. Most banks operate within a limited geographical span; even the “national banks” tend to operate in pockets scattered around the country. Community banks and credit unions present a clear concentration of risk, as do most automobile dealers. These concentrations of risk pale in comparison to employer credit unions. The first credit union to convert to debt protection products, including offering involuntary unemployment protection, was the United Airlines Credit Union. Get ready for some serious modeling.

There was a cute pizza commercial in Dallas about 10 years ago. Jerry Jones, owner of the Dallas Cowboys, was courting Deion Sanders. During a meeting, Jerry asked Deion, “What do you want on your pizza, pepperoni or sausage?” Deion said, “Both.” “Well, Deion, are you going to play baseball or football?” Deion said, “Both.” “Are you going to play offense or defense for the Cowboys?” Deion said, “Both.” “OK, Deion, what's it going to take: \$15 million or \$20 million?” Deion said, “Both.”

Are life or P&C actuaries best suited to price and reserve the protected events of credit insurance or debt protection products? The actuarial educational system must make sure that the answer is “Both.”

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