"More Sinned Upon Than Sinning"

Credit Insurance: A System With Advantages

by Joel Huber

In the course of conducting four studies of consumers' attitudes toward credit insurance and reviewing many more, I have been struck by the fact that consumers actively favor credit insurance. This generally positive response on the part of consumers appears in sharp contrast to the attitude of some regulators and reformers who have an almost religious zeal in restricting its availability. More insidious still is the defensiveness on the part of those who offer credit insurance. Instead of actively defending its value to both their customers and to society, they adopt a low profile, hoping that in their silence, the criticism will go away.

The purpose of this paper is to put forth the somewhat novel proposition that the consumers' liking for credit insurance is not based on ignorance of alternatives and inept financial management but instead flows from rational economic motives. Further I will suggest that the reformers' zeal against credit insurance represents a misplaced attack on those who use credit—an insidious attack that inflicts particular hardships on lower income consumers.

* * *

Two studies have had direct bearing on consumers' perception of the pricing of short-term credit insurance (i.e., under three years). A survey conducted by Montgomery Ward described to customers their coverages and the cost of their policies and asked whether the cost was high, reasonable, or low. Out of 310 respondents in a national survey, 4 percent indicated that the cost was high, 77 percent said it was reasonable and 16 percent said it was low.[1] Similarly, in the recent Federal Reserve Board survey, 709 respondents were asked a similar question about their credit insurance coverage.[2] Of those responding, 18 percent said the coverage was expensive, while 52 percent said it was about right and 30 percent said it was inexpensive.

Thus it appears generally that fewer than 20 percent of consumers view credit insurance as expensive relative to the values it creates. This finding does not mean that the consumers have carefully considered the supply costs and determined that credit insurance is offered at a low price relative to its costs—that is the job of the state regulatory agencies. The results simply indicate that a great many people view the benefits of the coverages as being greater than their costs.

* * *

Until recently there have been no published studies on the effect of price on penetration, the percentage of customers that accept a given policy. In an attempt to remedy this lack of knowledge, a survey was designed whereby each respondent was asked to purchase insurance in connection with a hypothetical retail credit obligation of approximately $500.[3] To measure price sensitivity the new hypothetical packages were offered to different consumers at different rates. The estimated price elasticity was approximately one-half. That is, as price went up by 50 percent, penetration dropped by 25 percent while, conversely, a price decrease of 50 percent resulted in a 25 percent increase in penetration. Thus, it appears that although many consumers liked the insurance (average penetration was 62 percent), as the price increased their likelihood of purchase decreased.

Finding that the penetration of credit insurance is sensitive to price has implications on the

see Huber, next page

These comments by Joel Huber are excerpted, with permission, from a report presented by Huber to the 1980 annual meeting of the Consumer Credit Insurance Association (CCIA). The CCIA distributes this report as a brochure called, "If Credit Insurance Has So Many Friends, How Could It Have So Many Enemies?" Huber is Associate Professor in the Fuqua School of Business, Duke University.

Payne, *continued*

to reducing the rates. "Let's see what the 1981 changes will do," they argued. Car dealers claimed that these were hard times for small businessmen and that credit insurance profits were the margin which enabled many to weather the economic storm. Only the N.C. Consumers Council and N.C. Legal Services attorneys argued that the rates were unfair. The bill as originally written died in committee, but a committee substitute formed the basis for action the next year.

In 1984, the legislature established a credit insurance and interest rates study commission, which was to report to the 1985 session. The commission held only two meetings. Even though I co-chaired the study commission, my view was in a minority. As a whole, the commission concluded that "there was no need for further legislation regulating credit insurance."[4] The commission report expressed the sentiment of the insurance and financial industries which had controlled the legislative debate over credit insurance. "Consumers are not required to buy credit insurance. If they find it too expensive, they may refuse it," the commission report concluded.

In 1985, reform efforts took a new tack. I introduced House Bill 1290, which would give all power and authority to the commissioner of insurance to establish "fair and reasonable" credit insurance rates. In 1984, Jim Long had been elected commissioner. He had run on a platform of bringing a new spirit of cooperation to the Department of Insurance. Virtually all parties were optimistic about Long's tenure after the 12-year Ingram administration.

We argued that returning regulations to the commissioner was good policy, for two reasons. First, the General Assembly is ill-equipped to set rates and could not consciously and consistently determine a fair rate. Second, we argued that no one should have anything to fear from the commissioner establishing rates, because they must be "fair and reasonable."

The insurance industry and creditors presented unified opposition to the bill. "Two strong reasons bring us to this conclusion," said Wade Isaacs, executive vice-president of the North Carolina Automobile Dealers Association. "First, the General Assembly is considered to be more responsive to the citizens of this state. And secondly, our sensitive concerns over the performance and practices of the previous insurance commissioner will not be quickly dispelled." Dan Boney of Durham Life Insurance Company, a

Huber, *continued*

way credit insurance is regulated. The reverse competition argument holds that since creditors can force insurance on credit customers, then there is motivation to charge very high prices for the coverage to increase commissions. If, however, as the survey suggests, the consumer is sensitive to insurance prices, then the creditor cannot charge arbitrarily high rates without losing significant penetration.

> *"Ah, take the Cash, and let the Credit go, Nor heed the rumble of a distant Drum!"*
>
> *—Edward Fitzgerald*

Thus, although consumer surveys hardly resolve the many complex aspects of the reverse competition issue, they do point to an image of a customer that is quite different from that of a helpless pawn.

* * *

The reaction of consumer advocates to these kinds of surveys is that the consumer is being irrational. But there are a number of good reasons why credit insurance benefits both the purchasers and the society at large.

When one goes into debt, the primary risk is that one will have to default. Such default exposes the debtor to possible legal procedures by the creditor and to a lessened ability to borrow in the future. The problems in making payments are particularly likely to happen to those who expressed the greatest demand for credit insurance—those with lower incomes who are insecure about their future. To the extent that credit insurance protects one's ability to pay against events (such as sickness or disasters) that are out of control of the debtor, credit insurance provides protection for both the debtor's person and family against the hardship that default could bring.

Credit insurance also *simplifies* the credit process. It has been argued that term insurance may be cheaper to purchase than credit insurance for the same coverage. Without commenting on the issue of relative prices, consider how much major credit life insurance company, took the same position. Finally, Isaacs invoked the old axiom, "if it ain't broke, don't fix it." Despite this opposition, the House defeated the bill by a vote of only 50 to 42 in a roll-call vote on June 19, 1985.

While the auto dealers, insurance industry, and other financial institutions stood together in 1985 over credit insurance, they had their differences over a related insurance matter. With the deregulation of the finance industry, financial institutions had broadened their reach to include the sale of insurance products. Segments of the insurance industry, particularly the agents, opposed this trend. Specifically, the insurance agents, along with consumer groups, objected to what is called "tying."

Selling an insurance policy to a borrower at the time of a loan approval, where the purchase appears to be a part of the approval of the loan, is called "tying." Making the purchase of an insurance product a condition of a loan approval is illegal under state and federal law (see main article for more on this point, including the citations to the relevant laws). But the word "tying" has come to refer to a lender's selling an insurance product, even if done in a legal way. Specifically, insurance agents' associations opposed tying the sale of homeowners insurance policies to mortgage loans.

In 1985, Rep. George Miller (D-Durham) introduced House Bill 1188, which forbade lenders from selling certain kinds of insurance policies. To focus on the relatively few lenders tying homeowners policies to mortgage loans, the bill specifically exempted other types of tying, including credit insurance. But even this narrow bill created confusion and some ill will between traditional allies. Insurance company lobbyists could side openly neither with their banker colleagues nor with their perennial friends,

"Pass the hat for your credit's sake, and pay—pay—pay!"
—Rudyard Kipling

see Payne, next page

easier credit insurance is than a term policy. First, credit insurance covers the precise amount of the loan, so that one does not have too little insurance in the beginning of a declining balance loan and too much at the end. Second, credit insurance is solely for the credit. In a credit life policy for example, there is no question of the benefits being used for a purpose other than paying the obligation. Finally, with credit insurance one does not need to go through the complex and indefinite calculations of how much insurance one has or ought to have; the additional liability is automatically covered. Thus credit insurance simplifies in the sense of limiting the additional problems and worries that can accompany being a debtor, and it is that comfort and simplicity that I believe lies at the base of consumer support for credit insurance.

Shifting from the perspective of the individual debtor to society at large, there are several reasons why society benefits when the individual buys a policy. First, credit insurance is countercyclical. Credit insurance, particularly accident and health, has higher claim rates during times of depressed economic activity. As such the coverage acts to transfer cash from periods of high economic activity to low periods, thus moderating fluctuations in the business cycle.

Second, it induces further stability in that it reduces the risks of personal bankruptcies and defaults that can cause a strain on the credit system. In a related benefit, by paying debts that might otherwise be difficult to pay, credit insurance represents an increase in the debtors' current payments to assure future stability. As such, credit insurance reflects the values of thrift and conservative financial management that should be particularly encouraged in today's society.

* * *

While it is risky to try to infer why a person dislikes anything, the degree of venom associated with attacks on credit insurance make it important to try to understand its sources. I have seen three possible reasons for disliking credit insurance. First, there are some abuses, although they provide reason to dislike the abuses, not the coverage. Second, the reformers may be projecting their own needs into those they seek to help, with the attendant distortion of regulatory policy. Finally, credit insurance certainly suffers from its association with credit and, thus may be considered at fault for helping what some believe to be bad.

see Huber, next page

Payne, *continued*

the insurance agents. The bill pitted lending institutions against insurance professionals in one of the more spectacular lobbying struggles of the 1985 session. Rep. Miller, with a decade of legislative experience, nurtured the bill out of the House Insurance Committee. But the votes weren't there on the House floor. The bill was compromised to be equivalent only to a warning, which passed the legislature.[5]

But dissension within the ranks has persisted. Insurance agents must "make every effort to see that financial institutions do not continue to unfairly coerce consumers," said former state Sen. William D. ("Billy") Mills. Mills, who served seven legislative terms, raised the issue after his recent election as president of the Carolinas Association of Professional Insurance Agents (CAPIA). In the press release announcing his election, Mills added, "Banks have coercive power to intimidate consumers by tying the purchase of insurance to credit transactions." Currently the chief executive officer of Seashore Insurance Associates, Mills favors an "outright prohibition against banks selling insurance because such a measure would protect consumers."

Mills and CAPIA are addressing the specific issued raised by Rep. George Miller's bill, tying homeowners insurance to a mortgage loan. But the risks and the needs for consumer protection are the same for credit insurance transactions. A union between consumers and insurance agents could provide the clout necessary to counter the strength of the banks, lenders, finance companies, and merchants' associations in the legislature. However, CAPIA appears somewhat like the banking industry, fighting over business turf. It appears that CAPIA simply doesn't want to lose the homeowners business to the mortgage lenders. If CAPIA added to its concerns the lowering of credit insurance rates (while still allowing the banks to sell credit insurance), then it would gain more credibility as a consumer advocate.

The most significant actor in the credit insurance issue is Jim Long, who, by definition, is Mr. Insurance in North Carolina. With a close relationship with the legislative leadership, easy access to the press, and wide respect from both consumers and the insurance industry, Long could heighten consumer awareness of the problem even as he directs efforts to solve the problems. Long has taken the clear position that

Huber, *continued*

Consider first the abuses. The 10 year-old Hubbard study lists a number of abuses, some of which are undoubtedly with us today.[4] However, it is significant that many are not, reflecting the progress due to regulation. For example, there are certainly *some* creditors who charge more than they could for credit insurance as there are *some* loan officers who intentionally leave their customers with the impression that the coverage is required. However, it is important to remember that credit insurance is regulated by the states in which it is offered. If the price is too high the state has power to enforce lower rates. And, indeed through just such a process the average price of credit insurance has declined in the last 10 years. Similarly, the states can and do define the process by which insurance is offered. If voluntary tie-ins are a problem, the states have remedy power. It appears, however, that the reformers are against more than abuses and have as their target the product itself. One reason for this may be simple projection. That is, consumer surveys have shown that the strongest support for credit insurance comes from those segments that have low incomes and high levels of financial insecurity. To the extent that the reformers are quite dissimilar from these groups, they may well be projecting from their own needs to those they are attempting to help, and concluding that credit insurance is not needed.

The final reason why credit insurance may be disliked flows paradoxically from the fact that it facilitates the credit process. Credit has reflected poorly on both its supplier and user ever since Biblical times when Jesus threw the money lenders out of the temple. Having to borrow indicates an inablity to save and exposes the borrower to the threat of repossession and other less palatable remedies, while being a creditor raises the specter of usury and control over the lives of debtor families.

* * *

To summarize, the studies of consumer attitude toward credit insurance have indicated a remarkably strong liking for the coverage. Furthermore, differences in liking depend quite rationally on the price of the coverage, the degree to which the consumer has other insurance coverage, the family income level, and their perceived financial insecurity. The source of this liking is seen as coming from the way in which credit insurance lessens the risk of being a the commissioner should regulate credit insurance rates. "The legislature doesn't set any other insurance or utility rates," says Long. "Why should it set credit rates?"

Those who seek to reduce credit insurance rates have never intended to lower them beyond the point of business profitability to both the insurance company and the extender of credit. Part of the dilemma of credit insurance is the need for a massive education campaign. Over time, the consumer must understand the excessive profit margin in this product and either force the reduction of rates or simply purchase less credit insurance—to the detriment of both consumer and lender.

In the short run, the means to address the problems of credit insurance will have to come from Commissioner Long. Whether Long can be successful in adjusting the rate structure depends on public awareness—on how many supporters he might have behind him. This truly is a function of heightened public awareness and the realization by merchants and businessmen that in the long run, a fair—but not excessive—profit will be in their best interest. Public awareness is growing. If it continues, we can look forward to a new day and a fair bill in 1987. □

FOOTNOTES

[1]Chapter 660 of the 1975 Session Laws (SB 660), codified as NCGS 58, Article 32.

[2]*State ex rel. Commissioner of Insurance v. Integon Life Insurance Company*, 220 S.E. 2d 409 (N.C.C.A. 1975).

[3]Chapter 759 of 1981 Session Laws (HB 1156), amending NCGS 58, Article 32 and NCGS 53-189(a).

[4]"Report of the Credit Insurance and Interest Rates Study Commission," Report to the 1985 General Assembly of North Carolina, February 15, 1985, page 6.

[5]Chapter 679 of 1985 Session Laws (HB 1188), codified as NCGS 58-51.5.

Carol Majors

debtor. From the perspective of society, moreover, credit insurance is seen as a force that helps stabilize the business cycle, that reduces the number of personal and creditor failures, that limits the need for various creditor remedies, and finally that reinforces the value of thrift by increasing current payments to insure future stability.

If the above reasoning is accepted, then certain implications follow for reformers, regulators, and suppliers of credit insurance. In any regulated industry reformers serve a valuable function in keeping both the regulators and the industry honest. However, it has been increasingly unclear to me, as an outside observer, whether those that label themselves consumer advocates really act in the consumer's best interest or in a rather narrow and hyper-rational conception of that interest. The consumer has spoken for credit insurance in purchase decisions and in surveys. Thus, while reformers should be making certain that the insurance is available to consumers at the lowest possible price, where terms are made as clear and fair as possible, I do not believe it is the consumer advocate's role to tell the consumer what to like. In short, the reformers should go after abuses that may still remain but not the product itself.

Given both the personal and the social benefits of credit insurance, the regulators should be trying to increase its availability. To be sure, at the same time it is their obligation to see that it is priced fairly and presented in terms that allow free choice and increased understanding on the part of the consumer. But rather than passively waiting for firms to present plans, regulatory commissions could take the lead in suggesting credit insurance plans that would benefit both the creditor and their customers.

Finally, suppliers of credit insurance, both creditors and insurance companies, should stop being defensive about their product and realize that credit insurance is a mutually beneficial service. Rather than quietly acquiescing to attacks, the industry should be proud of credit insurance and let others know it. □

FOOTNOTES

[1]Internal survey conduced by Montgomery Ward Company, 1975. Copy is available from Joel Huber at Duke University.

[2]Internal survey conducted by the Federal Reserve Board, 1978. Copy is available from Huber.

[3]The Cambridge Report, sold to participating companies, unpublished. Copy is available from Huber.

[4]Charles L. Hubbard, editor, *Consumer Credit Life and Disability Insurance*, Ohio University Press, 1973.