To your credit or to your debt?

Credit Insurance

The credit insurance system involves a complex relationship among consumers, the insurance industry, and lending institutions (banks, auto dealers, small loan companies, and merchants). A consumer buys credit insurance from a lender as part of a loan or installment purchase. The lender sells the credit insurance policy for an insurance company, functioning like an insurance agent. For making this sale, the lender receives about 50 percent of the premium price as a commission. This commission system results in credit insurance rates at the maximum rates allowed. Since 1975, these rates have been specified in state law. Before 1975, the commissioner of insurance regulated the rates.

Insurance is regulated at the state level. Among the 50 states, North Carolina ranks ***last*** *in the portion of credit insurance premiums used to pay off policy claims. A combination of factors have resulted in this ranking, including who sells and buys this insurance, how high the rates are, and who regulates the rates. How can these factors be adjusted to bring North Carolina in line with the rest of the country?*

by Bill Finger

His chair squeaks as the credit manager turns to his adding machine. He murmurs over your credit application, making notations beside your net worth column. You look at the pictures and plaques on the wall and nervously concentrate on being at ease.

You want what this money will buy, your first new car. You have driven a bargain with the salesperson, contingent of course upon your credit report, and you've mustered your nerve to talk eyeball to eyeball about interest rates. Your spouse is beside you, holding your hand in excitement, on the verge of a major new purchase. The credit manager's approval—plus a stack of papers to sign—are the only things standing between you and driving your new car out of the lot.

The credit manager completes his calculations and swivels back to face you. "Good news. You get your loan." Then the phone starts ringing for the third time since the cubicle door closed on you. Grabbing his coffee cup, the manager adds, "If you want credit insurance with your loan, you sign here."

You shuffle through the forms, wondering what they mean. You see the monthly payment figure he quoted earlier, with check marks for your signature. You stare at the long forms with tiny print, sweat dripping down the small of your back. The manager swings back, off the phone again.

"Got your John Hancock on all those lines?" he asks with a swift smile, standing up and reaching for the door. You and your spouse finish the job. The breeze from the large reception area welcomes you away from the forms and into your new car. Driving home, you're not thinking about what you just bought with that last signature on the credit forms. You are like most consumers who borrow money for a new car, new living room furniture, appliances, or your child's college education. You don't read the fine print on your loan application forms—the part about credit insurance.

The credit insurance system involves a complex relationship among consumers, the insurance industry, and lending institutions—banks, auto dealers, small loan companies, and others. A consumer can buy credit insurance with a loan or an installment sale. The lender, also called the creditor, sells the insurance to the consumer, known as the debtor. The lender buys the insurance for all his customers in a package, usually from a single insurance company. For selling the insurance policy to the customer, the lender gets a commission, much like an insurance agent.

The subtleties of this multi-level system receive little day-to-day regulatory oversight in North Carolina. Since 1975, the maximum rates that lenders can charge have been included in the statutes, not set by the commissioner of insurance. The commissioner sets the rates for other regulated lines of insurance. While the statutes specify *maximum* rates, these amounts are usually the *standard* rates.

"The majority of credit (life insurance) business is written at 80 cents (per $100 of insurance per year), the statutory rate," says Dan Boney, senior vice-president, Durham Life Insurance Company. "There's not competition to force the rates down. The competition comes in the services provided and the commissions paid by the insurance companies to the creditors."

Only five other states have credit life insurance rates higher than North Carolina—Alabama, Louisiana, Mississippi, Oklahoma, and South Carolina (see Table 1). Moreover, North Carolina has the nation's lowest "loss ratio" (tied with South Carolina), according to the National Association of Insurance Commissioners—29.67 percent (see Table 2). To explain "loss ratio" simply, companies paid out an average of only 29.67 cents in claims and related expenses for every dollar of premiums earned on credit insurance policies.

Another way to think of a loss ratio, from a consumer's point of view, is a "payback ratio"—i.e., measuring the ratio in terms of what is "paid back" to the consumer, not "lost" by the insurer. In other words, North (and South) Carolinians got less for their credit insurance dollar than did people in any other state, about 30 cents for


Carol Majors

every dollar. In 1986, the maximum credit life insurance rate in South Carolina will drop from $1.00 to 85 cents per $100 of insurance; this will effectively raise the state's loss ratio above that of North Carolina.

"Credit insurance is etched in stone," says William Hale, deputy commissioner of insurance and head of the department's legal division. "The rate levels are spelled out in the statutes. There's nothing we can do about it."

In neighboring Tennessee, a similar situation existed in 1979 when the newly elected governor, Lamar Alexander (a Republican), took office. Alexander appointed John C. Neff as Tennessee Commissioner of Commerce and Insurance. After a five-year crusade against high credit life insurance rates, Neff succeeded this year in getting the Tennessee rates reduced from 75 cents to 66 cents per $100. But more importantly, says Neff, the legislature transferred authority for establishing credit insurance rates from the legislature to the commissioner, effective in 1989.

"Credit insurance is the biggest known ripoff since the beginning of time," says Neff, a Republican. "There's no reason why Tennessee citizens should be charged a price by the legislature that rips off the public. We pointed out to the public that we had a 32 percent loss ratio in this state (for credit insurance). Under auto and homeowners, (the loss ratio) was about 65 percent or higher. And health insurance can run up as high as 90 percent."

North Carolina has a situation similar to that of Tennessee. The rates are high and are controlled by the legislature. In 1985, newly elected Commissioner of Insurance Jim Long took office, ending the stormy 12-year tenure of John R. Ingram. The question is whether Long will choose—or be able—to work towards lowering the credit insurance rates in North Carolina. State legislatures set credit insurance rates in only nine states, including North Carolina and Tennessee.[1] Will North Carolina remain in this small minority of states? More importantly, will North Carolinians continue to get the smallest return in the country for their credit insurance dollar?

What is Credit Insurance?

There are three types of credit insurance—credit life, credit accident and health, and credit property insurance. Lenders (i.e., creditors) sell credit insurance to consumers. The policies last for the term of the loan, and policy benefits go first to the creditor to pay off the debt. Consumers benefit primarily by having the debts paid off to the creditor, the "first beneficiary." Occasionally, a borrower's "secondary beneficiary" (a spouse, for example) will also receive some cash payments.

Table 1. Credit Life Insurance, States with the Ten Highest and Ten Lowest Rates, 1984

States (Ranked by Highest Rate)	Rate (per $100 coverage)[1]	States (Ranked by Lowest Rate)	Rate (per $100 coverage)[1]
1. Alabama	$1.00 (tie)	1. Wisconsin	$ .40
Louisiana	1.00 (tie)	2. California	.40 - .50
South Carolina	1.00 (tie)	3. New Hampshire	.42 - .47
4. Mississippi	.90	4. Arizona	.44
5. Oklahoma	.85	5. New Jersey	.44 - .64
6. **North Carolina**	.80	6. Vermont	.44 - .70
7. Arkansas	.75 (tie)	7. Utah	.49
Georgia	.75 (tie)	8. Washington, D.C.	.49
North Dakota	.75 (tie)	9. Connecticut	.50 (tie)
Tennessee	.75 (tie)	Massachusetts	.50 (tie)
		Rhode Island	.50 (tie)
		Texas	.50 (tie)
		Wyoming	.50 (tie)

FOOTNOTE

[1]Rates shown are maximum allowed rates, either by statute or regulation. Some states show a range of rates because the state has different rate structures for different classes of creditors. California, for example, has five classes of creditors.

Table prepared by Marianne Kersey

Source: The Cost of Personal Borrowing in the United States, Financial Publishing Company, Publication No. 830, January 1984, with loose-leaf updates (varying dates for different states), Part VII, page 55ff.

Credit life insurance functions essentially as a term life insurance policy. "Term life" refers to a life insurance policy that covers a specified period of time; a couple often buys term life policies to cover their childraising period. Unlike standard term life policies, almost all credit life policies decrease in face value as the outstanding balance on the loan declines. If a borrower (i.e., debtor) dies during the term of a loan, a credit life policy pays the lender the balance of the loan in a lump sum. Credit life policies for "single" life coverage cost 80 cents per $100, per year. "Joint" life policies, which cover both husband and wife, cost $1.33 per $100.[2]

> *"Credit is a matter so subtle in its essence, that, as it may be obtained almost without reason, so, without reason, may it be made to melt away."*
>
> *—Anthony Trollope*

Term life policies are generally less expensive than credit life policies, according to the N.C. Department of Insurance. While term life and credit life are similar, there are two important distinctions. First, term life policies are based on age; credit life policies are not. Second, term life policies are "underwritten to eliminate bad risks," says Boney of Durham Life. Usually, anyone can purchase a credit life policy.

Credit accident and health insurance is essentially a disability policy for the borrower. It pays the creditor in the event a borrower becomes disabled during the life of the loan and thus cannot pay his debt. A number of types of credit accident and health (A&H) insurance are available, depending upon the number of retroactive days the policy will cover and other variables. For 12-month coverage, a 14-day retroactive policy costs $2.42 per $100 of insurance, the 11th highest rate in the country (see Table 3).[3]

Credit property insurance is the most recent type of credit insurance to develop. If the collateral for the loan is damaged during the life of the loan, credit property insurance pays a lump sum benefit to the lender equal to the

Table 2. Credit Life and Accident and Health Insurance, States with Ten Highest and Ten Lowest Loss Ratios, 1983 (Premiums and Losses in thousands of dollars)

State (Ranked by Lowest Loss Ratio)	Earned Premium	Incurred Losses	Loss Ratio
1. **North Carolina**	$112,701	$33,442	29.67 (tie)
South Carolina	58,553	17,373	29.67 (tie)
3. Mississippi	41,055	12,213	29.75
4. Minnesota	52,703	16,026	30.41
5. Alabama	65,378	20,038	30.65
6. Arkansas	18,899	5,994	31.72
7. Louisiana	94,618	30,624	32.37
8. South Dakota	10,376	3,361	32.39
9. Oklahoma	49,521	16,235	32.78
10. North Dakota	11,177	3,685	32.97

State (Ranked by Highest Loss Ratio)	Earned Premium	Incurred Losses	Loss Ratio
1. Maine	$ 11,241	$ 7,871	70.02
2. New York	116,296	76,483	65.77
3. West Virginia	36,711	22,183	60.43
4. Washington, D.C.	2,258	1,314	58.19
5. California	149,612	85,867	57.39
6. Pennsylvania	148,102	83,381	56.30
7. New Jersey	59,031	31,323	53.06
8. Maryland	37,715	19,907	52.78
9. Michigan	96,059	49,972	52.02
10. Vermont	5,168	2,681	51.88

Source: National Association of Insurance Commissioners, September 1984, the latest published data.

Table prepared by Marianne Kersey

Table 3. Credit Accident and Health Insurance Premium Rates, States with the Ten Highest and Ten Lowest Rates, 1984

States (Ranked by Highest Rate)	Rate (per $100 coverage)[1]
1. New York	$3.15
2. California	3.00 - 2.43
3. Rhode Island	2.74
4. Kentucky	2.69
5. Oregon	2.65
6. West Virginia	2.65 - 2.30
7. New Hampshire	2.64 - 1.90
8. Michigan	2.61 (tie)
North Dakota	2.61 (tie)
Hawaii	2.61 (tie)
11. North Carolina	2.42

States (Ranked by Lowest Rate)	Rate (per $100 coverage)[1]
1. Vermont	$1.54 - 2.37
2. Arizona	1.82
3. Utah	1.84
4. New Hampshire	1.90 - 2.64
5. South Dakota	1.98
6. Maryland	2.00 (tie)
Nebraska	2.00 (tie)
New Jersey	2.00 (tie)
South Carolina	2.00 (tie)
10. Pennsylvania	2.13

FOOTNOTE

[1]Rates shown are maximum allowed rates, either by statute or regulation, chosen under a 12 month term, 14-day retroactive policy, a standard used in virtually all states. Some states show a range of rates because the state has different rate structures for different classes of creditors. This appears confusing in the case of New Hampshire, which appears in both lists above. New Hampshire has four classes, including a rate of $2.64 for finance companies and $1.90 for banks and motor vehicle dealers.

Source: The Cost of Personal Borrowing in the United States, Financial Publishing Company, Publication No. 830, January 1984, with loose-leaf updates (varying dates for different states), Part VII, page 55ff.

Table prepared by Marianne Kersey

amount of the damage or the amount outstanding on the loan. The collateral can be the property financed by the loan or some other property, such as a piece of art. Credit property insurance usually accompanies small loans for furniture or other household property. But traditional physical damage insurance covers loans for automobile purchases, not credit property insurance. Rates for credit property insurance range from $1.00 to $1.50 per $100 of coverage per year, depending upon the type purchased.[4]

National comparisons of credit property rates are difficult because of various reporting systems. In North Carolina, for example, the Department of Insurance reports aggregate data on credit life and A&H policies, but the N.C. Banking Commission's annual report contains the best data on credit property policies.

Credit insurance provides a benefit to the lender and to the borrower. For the lender, this insurance guarantees payment of a loan even though a debtor has died or become disabled, or the collateral has been damaged—events that could make a loan difficult to collect. Originally, lenders—not insurance companies—developed this form of insurance and did not charge their customers for that service.

From its beginning in 1937, for example, the State Employees' Credit Union provided credit life insurance at no cost on loans to its members. "It was not free, but the membership absorbed the cost," says R. S. "Bobby" Hall, executive vice-president of the credit union. In 1983, the cost reached $600,000, explains Hall. "We decided we had to have specific pricing for specific services, including fees for some checking accounts and for credit life policies." The

"Creditors have better memories than debtors; and creditors are a superstitious sect, great observers of set days and times."

—Benjamin Franklin

credit union, today with 200,000 members, asked for bids and took the lowest one, from Pilot Life Insurance Company.

Consumers also benefit from credit insurance. It can cushion the financial strain caused by death, disability, or damage to the collateral.

This is especially true if the borrower does not carry life insurance, disability insurance, or property damage insurance.

"It's a comforting feeling that if Mr. Jones gets hit by a car, Mrs. Jones will not have to pay off his loan," says Tennessee Commissioner Neff. "(Credit insurance) is a socially desirable product."

Not only is it desirable, it also is big business. In 1984, North Carolina consumers paid $139 million dollars in credit life and A&H insurance premiums. Yet they received only $40 million in benefits.[5] Of the $139 million collected in premiums, about half went to the insurance companies to cover claims, expenses, and profits. The other half, *some $69.5 million, went to the lenders* who sold the policies, as their commissions. The lenders also benefited through the $40 million in benefits; these benefits paid off loans which might have been difficult to collect without the life and A&H credit insurance coverage.

*Normal free-market competition results in **lower prices**; the credit insurance commission system results in **higher prices.***

Credit insurance can be a "socially desirable product" or "the biggest ripoff since the beginning of time," as John Neff puts it. Four distinct, yet related, variables determine at which point on Neff's spectrum a credit insurance policy would fall—who sells it, who buys it, how high the rates are, and who regulates it.

Who Sells Credit Insurance?

Banks, auto dealers, mobile home dealers, small loan companies, and other lenders sell credit insurance, functioning in essence as insurance agents. These lenders do not have to be licensed as insurance agents in North Carolina. A 1975 statute exempts them: "The enrollment of debtors under a group policy issued to a creditor and authorized under this Article shall not constitute the issuance of a policy of insurance."[6]

"Those people ought to be licensed because they are selling insurance," says Fran DiPasquantonio, an attorney with the N.C. Department of Insurance. "They aren't enrolling someone into an employee benefit plan. Nobody regulates them. Who is going to hold them responsible? The department needs to control these salesmen."

Industry officials do not agree with the assessment by DiPasquantonio. "The industry believes the current statutes provide sufficient regulatory authority over the industry," says Boney of Durham Life.

Lenders usually sell credit insurance at the maximum rate allowed by the North Carolina statutes, 80 cents per $100 for credit life policies. "I would think that's the prevailing rate for credit life," says Wade Isaacs, executive vice president of the North Carolina Automobile Dealers Association. For selling the insurance, the lender gets a commission from the insurance company that holds the policy. The higher the price for the insurance, the higher the commission the lender will receive.

"It's generally acknowledged that a creditor, the agent selling the insurance, can make at least 50 percent on the sale," says James C. Gulick, director of the consumer protection section of the N.C. Attorney General's Office.

Asked if he agreed with the figure, Wade Isaacs answered, "Fifty percent sounds about right."

The higher the price, the more money the lender makes. This results in two important phenomena. First, insurance companies compete to offer the *most expensive* policies to lenders in an effort to get the lenders to sell their policies. The National Consumer Law Center and others call this process "reverse competition." Normal free-market competition results in *lower* prices; the credit insurance commission system results in *higher* prices.

Second, since a lender makes a commission of some 50 percent on every policy, there is a tremendous incentive to sell credit insurance. Credit insurance, by the nature of the product, is sold in conjunction with credit transactions.

The federal "truth-in-lending" law offers some protection from "tying" the purchase of credit insurance to the approval of a loan or an installment sale.[7] This law requires the creditor 1) to give a written disclosure that the credit insurance is not required, and 2) to obtain a separate signature of the consumer authorizing the credit insurance to be included with the transaction. If the creditor fails to do this, then the credit insurance must be included as part of the finance charge. This increases the interest rates that the creditor has to disclose and reduces the amount of other interest charges that the creditor can charge.

"North Carolina law goes even further," says Gulick. Consulting a number of statutes related to consumer loans, finance issues, and insurance, Gulick explains that the additional protections under state law are complicated and interrelated. For example, "Under state law, it is explicitly illegal to require credit life, accident, health, or loss-of-income insurance as a condition of a *consumer credit sale*," says Gulick, distinguishing between a credit sale and a direct loan.[8] "In any event, requiring such insurance without including its cost in the finance charge violates the federal truth-in-lending law."

"Private credit is wealth."
—Junius
(Nom de plume of an 18th Century letterwriter opposed to the policies of King George III)

Despite the protections of the federal and state laws, Gulick says there is some illegal coercion to buy credit insurance in North Carolina. "Based on the complaints we have received, such illegal coercion is a live problem," says Gulick. The consumer protection section did not keep a log of complaints by category in the past, so there is no way to determine the number of such complaints, says Gulick. "But we intend to see how widespread the issue is. It's up to the state to put up or shut up on this issue. And we intend to put up."

While these legal protections are significant, *Consumer Reports* magazine recommends that the truth-in-lending law "should be amended to require that the cost of credit insurance be reflected in the finance charge, whether or not the insurance is bought voluntarily. Consumers would then be made aware of the true cost of credit from different lenders." [9] The 1979 magazine report links its proposal to the issue of reverse competition. "Such a provision would also give banks, car dealers, and finance companies incentive to shop for an insurance company that will sell credit insurance inexpensively rather than for a company promising the highest sales commission."

Since no such provision exists in the federal law, commercial lenders in most states, including North Carolina, generally sell credit insurance at the maximum rate allowed in the state. A significant exception to this pattern is the price of credit insurance purchased through credit unions, which are nonprofit lenders. The State Employees' Credit Union, for example, currently offers a credit life policy for 39 cents per $100 of insurance, compared to the 80-cent rate offered by most banks, auto dealers, and other lenders. The credit union does not subsidize that rate. It can sell at such a low rate because it took the *low* bid offered by insurance companies for its credit business, not the *high* bid, which commercial lenders take. The credit union charges only enough commission to cover its administrative costs.

Consumers who do not belong to a nonprofit credit union, however, must cope with the reality of 50 percent commissions and pricing by reverse competition. "There is a great profit incentive to sell it," says Gulick. "When there's money to be made, some people are not willing to live within the rules. And the more money, the greater the temptation."

Who Buys Credit Insurance?

Credit is sold to a captive market—those persons borrowing money or making an installment purchase. A consumer can buy credit insurance only through the creditor making the loan. Credit insurance *per se* is not available through regular insurance agents. (Conceivably, a person *could* borrow money from one lender and purchase credit insurance from a second lender; as a practical matter, this rarely, if ever, happens.)

In 1984, small loan companies made *118,500 loans* of $3,000 or less; *97 percent of these loans included credit life insurance,* according to the North Carolina Banking Commission. In addition, 92 percent of these loans included credit accident and health insurance.[10] The same year, so-called "small" loan companies made *330,800 loans* of $10,000 or less; 85 percent of these loans carried credit life policies and 61 percent included credit A&H policies.[11]

No data is available on the percentage of loans by North Carolina bankers and auto dealers that include credit insurance. Various surveys are available on national percentages, however. For example, a 1979 Federal Reserve Board marketing study found that when banks loaned money, credit insurance was included with 60 percent of the loans for new cars, 66 percent for used cars, 61 percent for durables and recreation, 59 for personal loans, and 56 percent for home additions and repairs.[12]

These figures show only one side of the coin, the percentage of those who bought credit insurance. What about the other side, the percentage *who know whether they bought this insurance*? "It's commonly alleged that consumers are browbeaten into buying credit insurance," says *Consumer Reports*. "The credit insurance industry denies the allegation."

Determining where the truth lies is difficult. Several surveys do speak to the issue, however. In a 1977 Federal Trade Commission survey, 2,004 consumers responded on the credit insurance issue. Nearly half of the respondents (45 percent) said they did not understand that they did not have to buy it. Of those who bought credit insurance, 41 percent said they wanted it, but 31 percent said they were "given the impression that it was required to obtain the loan." Another 8 percent said they were told "it was required to obtain the loan," and 7 percent said they "thought it would improve my chances of getting the loan."[13]

Virtually all analysts agree that low-income persons generally purchase credit insurance more often than do other income groups. This is true for two reasons. First, higher income persons have more adequate insurance portfolios. For example, homeowners fire insurance policies of any significant size almost always contain a personal property section. With such a policy, credit property insurance would not be needed on a furniture or appliance installment purchase. Similarly, higher income persons are more likely to have substantial life insurance policies, including term policies. Consequently, such persons would tend to rely on their existing life insurance policies to cover debts in case of death, not a credit life policy.

Secondly, higher income persons are more likely to understand the credit insurance transaction. In an intimidating setting with long forms and small print, credit insurance is difficult to understand. Generally, middle-income and high-income groups are more educated consumers of insurance. For example, those persons who have priced term life insurance policies through traditional insurance agents will realize that credit life policies are not as good a buy as regular term life policies (more on this comparison below).

The fact that low-income persons buy credit insurance more often than other groups is not necessarily bad. In fact, credit insurance offers protections to low-income groups which might be proportionately much more valuable to them than to other groups. Without property insurance on personal belongings, without disability insurance, and without term life policies, low-income persons might well benefit from credit insurance. But the value of credit insurance depends upon fair prices.

How High Are the Rates?

Explaining exactly how much a person spends for credit insurance is difficult because of the many variations in the length of the loan, the interest rate of the loan, and other factors. But understanding a few key parts of the credit transaction, together with some specific figures, will illustrate what a significant part of a credit transaction that credit insurance can be.

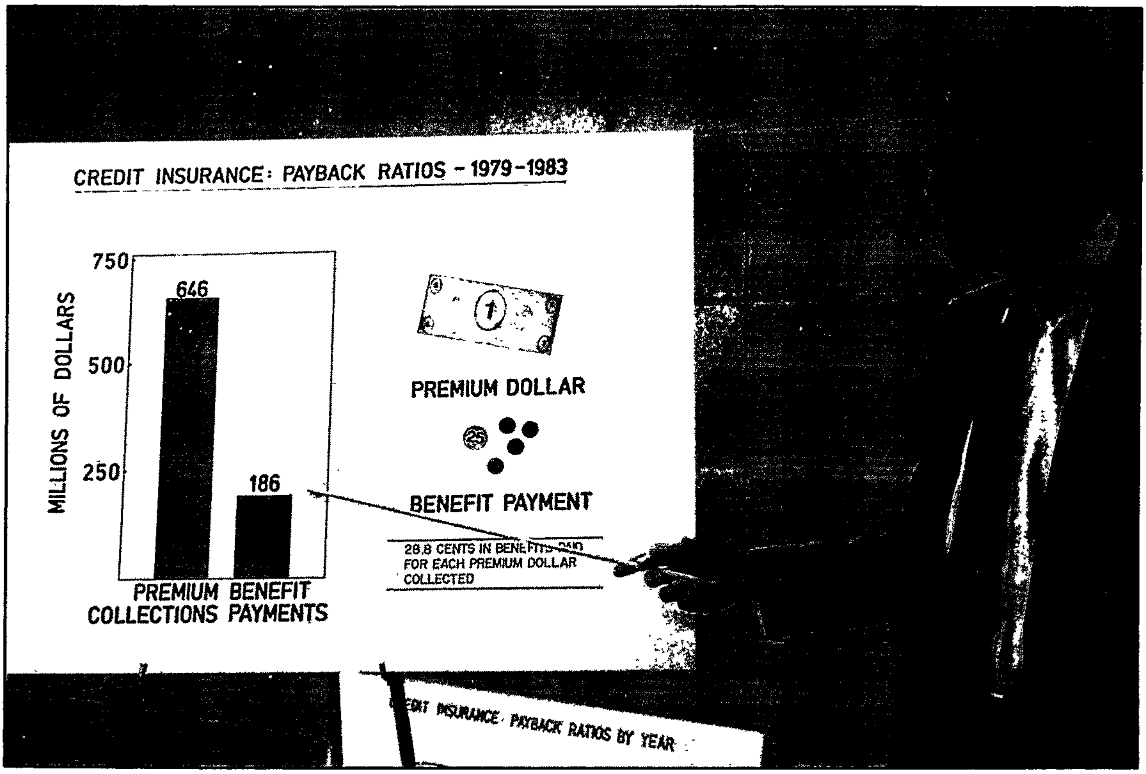
First, credit insurance policies can vary extensively in total cost, depending upon the length of time of the loan and the amount covered by the policy. To some extent, this is self-evident. The larger the loan and the longer the loan period, the higher the cost of credit insurance. But this point is not as simple as it looks.

"A $500 loan for six months with a 50-cent-a-month charge (for credit insurance) is a different ball game than a four-year loan for a car or mobile home," says Duke University Professor Joel Huber. Credit insurance on such small, short-term loans makes credit more available to people, says Huber, who has conducted polls for Montgomery Ward and other retailers. The amount of credit insurance on such small loans does not seem offensive to the buyer, adds Huber (see article on page 43 for more).

Mike Calhoun, an attorney with N.C. Legal Services, points out, however, that small loan companies include credit insurance on their loans far more frequently than do banks and auto dealers, which generally lend the larger amounts of money. "Even for a relatively small loan, the additional charge for insurance is substantial when all three types of credit insurance are included," says Calhoun. For example, consider a person who borrowed $3,000 at 21 percent for three years. If the loan had all three kinds of credit insurance, the total additional charge for credit insurance would be $720, calculates Calhoun, or *24 percent of the loan amount itself.*

Another critical point to note is that in most cases, the *total* of the credit insurance premium must be paid in advance for the entire life of the loan. If you can't pay the premium, you borrow it. Hence, you borrow money for the purchase or loan amount *and* for the entire cost of credit insurance.

For example, if you add credit insurance to a four-year, $10,000 loan at 15 percent to purchase a new car, you would have to pay $596.65 for credit life insurance, as shown below. The calculation assumes the maximum 80-cent rate is charged.[14]



Carol Majors

N. C. Legal Services attorney Mike Calhoun makes presentation before 1984 Credit Insurance and Interest Rates Study Commission.

Credit Life Premium	$446.66*
Extra Interest Charged on This Premium *(premium is added to loan amount)*	149.99
Total Charge for Credit Life	$596.65

(*$223.33 to the lender as commission, assuming a 50 percent rate.)

Spending nearly $600 for credit life coverage on a $10,000 loan may seem like a lot. But the cost seems even higher when comparing credit life coverage to a traditional term life insurance policy. In 1981, James H. Hunt, a consulting actuary and former commissioner of insurance for Vermont, developed such a comparison. He found that a person 40 or 45 years old could purchase far more coverage through a traditional term life policy. Regular term life coverage remains at a constant level over the life of the policy while credit life policies decrease to cover only the outstanding loan (principal and interest). A 40-year-old, for example, could buy more than twice as much coverage through a traditional policy than through a five-year credit life policy, at year one of the loan. By the fifth year, the traditional policy provided 12 times the benefit that the credit life policy provided.[15]

While Hunt's analysis reveals dramatic cost differences, insurance industry spokesmen object to the nature of such an analysis itself. "I don't feel it's a fair comparison between annual renewal term (life policies) versus credit (life policies)," says Dan Boney of Durham Life Insurance Company. "It's like comparing apples and oranges." Boney points out that anyone can buy a credit life policy, regardless of age, but that term life policies are based on age. Also, underwriting can eliminate bad risks in term life policies, says Boney, but not with credit life.

Despite such arguments, *Consumer Reports* arrived at the view that "credit insurance makes economic sense only in a few special circumstances. A person 50 years old or more, *living in a state with a low maximum rate*, might reasonably buy credit life if an existing insurance program was inadequate" (emphasis added). Joel Huber and others argue, however, that the convenience of buying credit life at the time of obtaining the credit provides a service to persons who would not normally shop for a separate insurance policy. In either case, a person must contend in North Carolina with the fifth highest rates in the country for credit life and the lowest payback ratio among the 50 states.

The rates for credit accident and health (A&H) are not as high in North Carolina, compared to other states (see Table 3). Analysts of credit insurance attribute this to fewer claims. "People have a stronger work ethic in North Carolina," says N.C. Legal Services attorney Mike Calhoun, who favors a lowering of credit rates. "People here simply don't like to stay out of work, or can't afford to, or whatever. So they don't make as many claims on their credit A&H policies."

Boney of Durham Life, who supports the current credit insurance rates, echoes Calhoun. "We do better on credit disability here than say in West Virginia," says Boney. "We lost a lot of money in West Virginia. People must be sicker there because of the mining, I suppose. In North Carolina, people just don't seem to be as sick as much."

If North Carolinians make fewer claims on their credit disability policies than do people in other states, why don't rates reflect this fact even more? In most types of insurance, such as automobile or homeowners insurance, underwriters would adjust rates according to the risk factor. But with credit insurance, underwriting plays little role in the rates charged to consumers. In North Carolina, credit insurance rates simply rise to the maximum allowed by the statutes.

The value in offering credit A&H coverage to all consumers at the same rate is that a person's health does not affect the rates. Credit A&H policies do not cover pre-existing conditions for the six months immediately preceding and following the policy date.[16] But pre-existing conditions are not nearly the factor they can be in regular health insurance policies. Moreover, "People generally don't have to submit to physical exams to get credit insurance," says Isaacs of the Automobile Dealers Association.

The importance of underwriting is clear in most kinds of insurance. With auto insurance, for example, companies offer various rates depending upon various classes of risks. People who commute to work, for example, pay more than do people who use their car only for personal use.[17] Companies selling auto insurance determine their rates not only by the various classes of risks but also by the amount of premiums they think they need to meet their losses—the critical loss ratio calculation. In other words, for insurance rates to be meaningful, *they must be viewed in conjunction with the loss ratio that results from those rates.* The fact that North Carolina has the lowest loss ratio in the country for credit insurance—calculated over a period of years—becomes the overriding factor when viewing credit insurance rates (see Table 4).

From the insurance industry's point of view, this low loss ratio is a plus. The lower the loss ratio, the more money the industry (and the lenders) makes. As Dan Boney puts it, "We have a favorable loss ratio here."

Consumers, on the other hand, prefer the term "payback ratio." A low payback ratio means that a small portion of the premium dollar comes back to the consumer. Hence, having the lowest payback ratio in the country—29.7 percent—puts North Carolina consumers at the bottom in terms of benefiting financially from credit insurance policies.

In 1954, the National Association of Insurance Commissioners (NAIC) adopted a model act for regulating credit insurance. This model act recommended a payback ratio of 50 percent. According to the Consumer Credit Insurance Association, 39 states have some kind of loss ratio benchmarks which generally track the NAIC recommendation, either passed by the state legislature or issued through a departmental rule. While many states do not treat these benchmarks as mandatory, they at least have an established goal. North Carolina is one of 11 states that have no loss ratio benchmarks. In the late 1970s, the NAIC went a step further in its proposed model statute, raising the recommended loss ratio from 50 to 60 percent.

Top Ten Credit Life and Accident and Health Insurance Writers in North Carolina, 1984 (in millions of dollars)

1.	Northwestern Security Life Ins. Co.	$16.4
2.	Durham Life Ins. Co.*	13.7
3.	First Protection Life Ins. Co.*	8.0
4.	Sturdivant Life Ins. Co.*	6.8
5.	Union Security Life Ins. Co.	6.5
6.	Superior Life Ins. Co.	6.2
7.	Globe Life Ins. Co.	5.6
8.	Occidental Life Ins. Co. of N.C.*	5.0
9.	Old Republic Life Ins. Co.	5.0
10.	Integon Life Ins. Corporation*	5.0
	Total for Top Ten	$78.2
	Total for North Carolina	$139.4

*Indicates a company based in North Carolina.

Source: Annual Statements filed by companies with N.C. Department of Insurance.

Who Regulates Credit Insurance?

Until 1975, the N.C. Commissioner of Insurance regulated credit insurance rates. But in 1975, Commissioner of Insurance Ingram attempted to lower the rates dramatically, in line with the NAIC recommendations, and the legislature responded by setting the credit insurance rates directly in the statutes. In recent years Rep. Harry Payne (D-New Hanover) and others have attempted on several occasions to lower the rates, with no success (see article on page 42 for more on the legislative history).

The two basic choices in regulating credit insurance rates are through the statutes or through the commissioner's office. Having the commissioner regulate the rates does not necessarily mean lower rates. Of the 10 states with the highest credit life rates, four (Louisiana, North Carolina, South Carolina, and Tennessee) have their credit life rates set by statute. Placing regulation of rates under the insurance commissioner, however, usually does allow for more deliberate assessments by actuaries through a judicatory hearing process than does the horse-trading atmosphere of a state legislature.

"A commissioner's office represents a great deal of flexibility," says John Walker, general counsel for the Consumer Credit Insurance Association. "On the other hand, if you get a commissioner who's unreasonable, that can be a problem."

In 1985, the legislature had a chance to transfer the regulation of credit insurance from the legislature back to the commissioner. With Jim Long as commissioner, Rep. Payne, the sponsor of the bill, thought such a proposal had a chance. But the insurance and financial industries had such strong feelings about the commissioner's office, left over from the Ingram years, that Payne's proposal never had a chance.

"Jim Long is a fine man, but you could get another Ingram in there," says Wade Isaacs with the Automobile Dealers Association. "It's better to have a body like the General Assembly that would act on it thoroughly."

Long supports the Payne proposal in theory, but wasn't ready for such a fight in 1985. "We just couldn't get it done in the '85 session," says Long. "We had so many other things to do to get things going. But I'm in favor of the department setting the rates."

In addition to rates being regulated by the legislature and by routine orders of a commissioner of insurance, at least two other noteworthy efforts have been used to regulate rates—quasi-judicial decisions and banking department regulations. In Virginia, First Protection Life Insurance Company applied to the State Corporation Commission for a higher rate than that allowed by the Virginia codes and rules. The State Corporation Commission held a hearing on the request on April 8 and 9, 1981, and ruled against the company, finding that "the rate of 72 cents per $100 of single premium declining term coverage insurance is excessive and should be reduced from 72 cents to 49 cents" and that the rate of 49 cents "should enable both FPL (the insurance company) and automobile dealers to earn a fair return."[18]

On May 10, 1984, the Massachusetts Banking Department took an unusual step which has effectively lowered credit insurance rates far below the maximum level in Massachusetts of 50 cents per $100 of loan amount, which is set by statute. The banking department rule requires banks to seek at least three bids and *accept the lowest qualified bid.* Under this system, insurance companies set rates in competition with each other. "The results so far are dramatic. Relatively low Massachusetts rates have been reduced by more than 40 percent," reports the National Consumer Law Center (NCLC). "Previously, in nearly every instance, the insurance was sold at the maximum rate. However, when the first contracts were put out to bid, agents and insurance companies bid 28 cents per $100 and less." The Massachusetts regulation applies only to state chartered banks. "But if this approach should be adopted throughout the country, it could save consumers more than a billion dollars a year," reports the NCLC.[19]

Legal services attorney Mike Calhoun says the Massachusetts approach benefits consumers because "it turns the free enterprise system right side up again with respect to both price and competition."

Conclusion

Credit insurance can provide a valuable protection, all analysts agree. But when is it a sound purchase for consumers? Most analysts agree that certain consumers can nearly always benefit from credit insurance, such as older persons for whom term life policies would be very expensive. Beyond such small groups, however, the analysts fall into distinct camps.

Representatives of banks, auto dealers, small loan companies, and mobile home businesses praise credit insurance as a valuable protection for those borrowing money. And in candid moments, they also admit that in North Carolina, it is a lucrative business.

Table 4. Credit Insurance Loss Ratios in North Carolina, 1979-1984

Type of Credit Insurance	1979	1980	1981	1982	1983	1984	1979-84[1]
Life[2]	26.4	28.1	29.0	26.1	28.7	27.2	27.6
Accident & Health[2]	32.3	35.2	35.5	33.4	31.0	31.0	33.0
Property[3]	12.8	20.2	19.8	16.1	13.7	18.9	16.6
TOTALS[4]	27.2	30.1	30.6	27.9	28.1	28.0	28.6

FOOTNOTES

[1]The six-year averages shown in this column were compiled by adding the losses incurred for each year and dividing that total by the sum of the premiums earned for these six years.

[2]For credit life and accident and health insurance data, see "Master Summary," for the years 1979-1984, N.C. Department of Insurance. Dividing the "direct losses incurred" by the "direct premiums earned" yields the ratios shown here.

[3]For credit property insurance data, see "Annual Report of the Commissioner of Banks of the State of North Carolina on Consumer Finance Licensees," for the years 1979-1984. These booklets report credit property insurance sold through "consumer finance licensees" (commonly known as "small loan companies"). Data on credit property insurance sold by retail merchants are not available through any central source, but most credit property insurance is sold through small loan companies. During the 1979-1984 period, the law changed regarding how lenders classified themselves, whether making loans of $1,500, $3,000, $5,000, or $10,000 or under. Hence, data on two pages of the reports must be added together for some years: pp. 20 and 24 (1979), pp. 20 and 24 (1980), p. 20 (1981), p. 18 (1982), pp. 11 and 22 (1983), and pp. 11 and 23 (1984).

[4]The averages shown in the "totals" line, for the individual years, were compiled by adding the losses incurred for each type of credit insurance and dividing that total by the sum of the premiums earned for the three types.

Table prepared by Bill Finger

It is a "good system," says Wade Isaacs. Regarding the commission system, Isaacs says credit insurance is "just like any other product. (Commissions) give them an incentive to sell their product." Concerning the fact that credit insurance sells at the maximum rate, Dan Boney observes, "We are not in a marketplace that competes in lowering the rates."

Marketing experts such as Joel Huber at Duke University also view credit insurance as a product that most consumers like. "People appear to like the idea of credit insurance when it is described to them and to be remarkably satisfied with the policies they currently have," says Huber.

Most consumer advocates view credit insurance skeptically, especially when sold at maximum rates. The higher the loan amount, the greater the hardship on the borrower, says Mike Calhoun. "When people borrow enough to buy a mobile home, for example, they should definitely get insurance through a regular agent."

Consumer Reports goes even further. Credit insurance might "be better than nothing for a person with a health problem . . . or for the person who just can't afford conventional life insurance," concludes the magazine. "For most consumers, however, credit insurance makes no economic sense."

One point is clear, however, despite the sharp differences in these two camps of thinking. Consumers in North Carolina, compared to the other 49 states, receive the least financial benefit from credit insurance purchases. North Carolina has the lowest loss ratio among the 50 states, according to NAIC. And the 29.7 percent figure for 1984 represents a pattern, not a particularly low point for a single year, as Table 4 shows.

The question in North Carolina, then, becomes: How can the loss ratio in North Carolina be brought more in line with the rest of the country? And secondly, who will take the lead on this issue?

"I think credit insurance will be a very significant issue by the 1987 session of the General Assembly," says Commissioner Long. "The loss ratio is so low because of the reverse competition involved in the commission system. The rate structure definitely needs to be addressed."

There are three options for addressing the current rate structure in North Carolina. All of them have some possible benefits and some limitations. Long's task, in conjunction with related departments—such as the North Carolina Banking Commission—is to decide upon the option that will be fairest to both consumers and to the insurance and lending industries.

1. Lower the rates in the statutes. Both Tennessee and South Carolina lowered their rates this year. Given the experience of the last 10 years, however, this seems unlikely to occur in North Carolina. In the 1975, 1981, 1983, and 1985 sessions of the legislature, the combined influence of the insurance and financial lobbies defeated the reform efforts of consumer advocates (see article by Representative Payne).

2. Transfer rate regulatory authority to the commissioner of insurance. Both Representative Payne and Commissioner Long favor this option. Credit insurance rates have been set by statute for only 10 years, a relatively short time. Prior to 1975, the commissioner regulated rates. Returning to this system would be returning to the system favored by the legislature for all but the anomaly of the Ingram era. In doing so, the state would join 41 other states that set rates through administrative rules, not by statute.

3. Require competitive bidding through administrative rules. In Massachusetts, the banking department has effectively lowered credit insurance rates substantially by requiring a bidding process for credit insurance offered by state chartered banks. A similar procedure might be possible in North Carolina as well. Such an approach would return to the traditional free enterprise value of market competition.

Spokesmen for the insurance and financial industries would prefer that no change take place. As Wade Isaacs puts it, "If it ain't broke, don't fix it."

But the credit insurance rate structure in North Carolina is no longer based on competition in the marketplace or fairness to consumers. The credit insurance rate structure is based on the maximum rate that can be charged. The legislature put this rate in the statutes during the stormiest years in the state's history regarding insurance regulation—the Ingram years.

Now that the storm has passed, the time is at hand for another assessment of the credit insurance system. In the minds of many, the credit insurance system *is* partially broken, if not badly fractured. ☐

FOOTNOTES

[1]According to John Walker, general counsel for the Consumer Credit Insurance Association, the nine states are: Hawaii, Iowa, Kentucky, Louisiana, Massachusetts, Missouri, North Carolina, South Carolina, and Tennessee.

[2]NCGS 58-349(c) and (d).

[3]NCGS 58-350(d).

[4]NCGS 58-359(b).

[5]"1984 Master Summary," N.C. Department of Insurance. The $139 million comes from the "direct premiums earned" category. The $40 million comes from the "direct losses incurred" category.

[6]NCGS 58-352.

[7]15 USC 1601ff.

[8]Gulick interprets NCGS 25A-17(c)(ii) as going beyond the federal truth-in-lending law for *credit sales.* This prohibition would not appear to exist *with regard to loans,* says Gulick, except in connection with a second mortgage loan made according to NCGS 24-14. In interpreting the state statutes, Gulick considers a loan as borrowing money directly from a lender and a credit sale as getting the credit through the same business selling the product.

[9]"Credit Insurance: The Quiet Overcharge," *Consumer Reports,* July 1979, pp. 415-417.

[10]"Annual Report of the Commissioner of Banks of the State of North Carolina for the year ended December 31, 1984, on Consumer Finance Licensees," page 11.

[11]*Ibid.*, page 22. Note that loans made under this reporting category might also be less than $3,000 (see NCGS 53-176). In 1984, the average loan amount in this $10,000-or-less category was $1,941, according to data on page 22.

[12]Robert A. Eisenbeis, "A Report on the Federal Reserve Board's Credit Insurance Marketing Study," reprinted in the Consumer Credit Insurance Association (CCIA) Proceedings, April 1979, Table 2, page 5. Eisenbeis, then associate research officer, Division of Research and Statistics of the Federal Reserve System, includes excellent footnotes with his report. Eisenbeis was one of the principal authors of the longer study on which this CCIA report was based: "Tie-ins Between the Granting of Credit and Sale of Insurance by Bank Holding Companies and Other Lenders," *Staff Reports,* No. 101, Board of Governors of the Federal Reserve System, February 1979.

[13]Letter to U.S. Senator William Proxmire, chairman, Senate Committee on Banking, Housing, and Urban Affairs, from Lewis H. Goldfarb, assistant director for credit practices of the Bureau of Consumer Protection, Federal Trade Commission, February 5, 1979, Attachment C. For further information, see "Tie-ins of the Sale of Insurance by Banks and Bank Holding Companies," hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 96th Congress, 1st Session, June 14, 1979.

[14]Calculations such as the example given are extremely complicated, depending upon the method of computing and charging interest. The example given here is based on a "single premium basis" method, where the premium is collected up front and is financed as part of the loan. "An increasing number of (credit insurance) policies are based on a daily accrual basis," says Dan Boney of Durham Life Insurance Company. Under this system, says Boney, "the interest and insurance premium are collected monthly, as earned, thereby eliminating the finance charge on the insurance premium."

[15]Hunt based his comparisons on a five-year, $7,500 loan, at 18 percent. He first found the monthly payment necessary to cover the cost of credit life insurance and then determined how much traditional term life insurance that monthly payment would buy. He based his analysis on the monthly premiums of Fidelity and Guaranty, a subsidiary of United States Fidelity and Guaranty Insurance Company. A 40-year old could buy $29,218 of term life—compared to the credit life policy coverage of $12,169, at the beginning of year one, and declining to $2,434 at the beginning of year five. A 45-year old could buy $17,030 of term life. Mr. Hunt conducted this analysis for Legal Services of North Carolina.

[16]NCGS 58-350(a).

[17]For more, see "Auto Insurance Regulation: A System Out of Kilter?" by Steve Adams, *North Carolina Insight,* February 1985, pp. 28-56.

[18]State Corporation Commission, Commonwealth of Virginia, Case No. INS810004, April 21, 1981, page 2.

[19]"NCLC Reports: Consumer Credit & Usury Edition," Volume Three, May/June 1985, page 23.