Credit Insurance in Texas:
Better Rate Regulation Needed to Protect Consumers

A Report by the Center for Economic Justice[1]

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What is Credit Insurance?

Credit insurance refers to a group of insurance products or coverages that are sold in conjunction with a loan or credit agreement. Credit insurance makes payments for the consumer to the lender for a specific loan or credit agreement in particular circumstances. The common types of credit insurance sold in Texas include:[2]

Credit Life pays off the consumer's entire debt on a specific loan or credit card account if the borrower dies during the term of the coverage.

Credit Disability pays a limited number of monthly payments on a specific loan or credit card account if the borrower becomes disabled during the term of coverage.

Credit Involuntary Unemployment pays a limited number of monthly payments on a specific loan or credit card account if the borrower becomes involuntarily unemployed during the term of coverage.

Credit Property pays an amount, generally, sufficient to pay off the entire debt on a specific piece of property serving as collateral for the loan if the property is lost or damaged. Unlike the first three credit insurance products, credit property insurance is not directly related to an event affecting a consumer's ability to pay his or her debt.

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[1] The Center for Economic Justice is a Texas nonprofit corporation dedicated to protecting the interests of low-income and minority consumers.

[2] This report does not discuss two other types of credit insurance – credit GAP and credit nonfiling insurance. *Credit GAP* pays an amount sufficient to pay the difference between the amount remaining on the loan (or lease) and the amount paid from other insurance. Credit GAP is typically sold in conjunction with longer-term automobile loans or leases. In these types of situations, the value of the vehicle (which is the amount paid by the normal collision or comprehensive automobile policy) declines faster than the remaining principal on the loan or lease. *Credit nonfiling* pays off the loan in the event the lender fails to make appropriate filings to protect the collateral.

These products are similar in a variety of ways.

Reverse Competition: The credit insurance policy is a group policy sold to a lender who then issues certificates to individual borrowers. Because the lender purchases the policy, credit insurers market the product to the lenders and not to the borrower -- the ultimate consumer who pays for the product. This market structure leads insurers to bid for the lender's business by providing higher commissions and other compensation to the lender. Greater competition for the lender's business leads to higher prices of credit insurance to the borrower. This form of competition, which results in *higher* prices to consumers, is called *reverse competition*.

Lender is Primary Beneficiary of Credit Insurance: In addition to receiving significant compensation from commissions and other sources, lenders benefit from credit insurance because the credit insurance protects the lender's loans and provides claim payments to the lenders. In most cases, the payments made under a credit insurance policy go the lender and not to the borrowers. Credit insurance guarantees loan payments to the lender if certain events either affect the consumer's ability to pay or, in the case of credit property, if certain events eliminate the collateral supporting the loan agreement.

Coercive Sales and Unfair Claims Practices: Although this report focuses on credit insurance rates and overcharges, the sale of credit insurance is marked by sales practices in which consumers are coerced and/or deceived into purchasing unwanted and unneeded credit insurance. In addition, credit insurance is sold to consumers who are clearly not eligible for coverage. If these consumers do not make a claim, the credit insurer keeps the premium. If a claim is made, the credit insurer then checks the consumer's eligibility and denies the claim. This practice is called "post-claims underwriting." In the past year, three major credit insurers across the country have agreed to stop such unfair practices and pay major fines.

Problems With Credit Insurance

Background

Credit insurance is big business. In 1995 and 1996, insurers earned over $11 billion in premium for credit life, credit disability, credit unemployment and credit property insurance countrywide and about $800 million in Texas alone. Table 1 shows Texas credit insurance sales for these four coverages from 1993 through 1996. Data for credit GAP and credit nonfiling insurance are not available.

Table 1
Texas Credit Insurance Earned Premiums, 1993-1996
($ Millions)

	1993	1994	1995	1996
Life	$121.6	$123.9	$144.6	$155.7
Disability	$136.1	$144.5	$171.5	$191.3
Unemployment	$8.7	$14.7	$25.4	$33.1
Property			$48.2	$18.5
Total	$266.4	$283.1	$389.7	$398.5

Various types of lenders sell credit insurance, including banks, credit unions, auto dealers, finance companies, department stores, furniture and appliance stores. The oldest credit insurance, credit life insurance, was originally sold to lenders who spread the cost of the credit insurance across all loans. Over time, credit insurance came to be sold as group policies to lenders, with lenders then issuing certificates to individual borrowers. The borrower pays a premium for the insurance, out of which the lender earns a commission for selling the insurance.

Credit Insurance Primarily Benefits the Lender

In this report, the term "lender" is used interchangeably with the term "creditor." Creditors benefit mightily from the sale of credit insurance. First, the creditor is the primary beneficiary of the credit insurance products. The primary function of the credit insurance products is to insure that the loan will be repaid despite destruction of the collateral or impairment of the borrower's earning ability. In other words, the credit insurance protects the lender's loan. While credit insurers tout the alleged "peace of mind" for consumers who purchase credit insurance, credit insurance allows creditors to protect their loans without fear of having to initiate debt collection activities in difficult and unpleasant circumstances. Such circumstances include a consumer's death or a consumer becoming disabled or unemployed.

Second, the lender receives significant compensation from the insurance company in commissions or other forms for selling the product. Table 5, below, shows that creditor compensation averaged over 38% of the premium dollar for all coverages over a two-year period. For at least one credit insurer, creditor compensation exceeds 90% of the premium. Further, since a number of creditors own the insurance companies issuing the credit insurance policies, the creditor realizes great profits due to low loss ratios.

Third, the insurance premium itself is often financed, resulting in additional interest payments and additional commission to the lender. Much credit insurance is sold on a single premium, gross calculation basis. In this approach, the credit insurance premium is based upon the total amount of payments by the borrower – principal and interest. When the credit insurance premium is rolled into the loan, the loan payments not only increase by the credit insurance premium, but also by the interest on the credit insurance premium. And then the credit insurance premium increases to cover the interest payments on the credit insurance.

Reverse Competition Leads to Poor Value for Consumers

While consumers may have the choice to purchase or not purchase certain credit insurance products, a consumer generally has no choice of which credit insurer he or she will purchase from. The creditor, and not the consumer, chooses which insurer will provide the coverage and what coverages will be offered. In this type of market structure, insurers will bid the price of the product up by giving greater commissions and other compensation to the lender as incentives to sell the insurance. This situation, in which the price is being driven up to attract lenders to sell the product, is referred to as "reverse competition." Since the lender does not pay for the insurance, there is no market incentive or competition driving the price down. Instead, competition among insurers for the lender's business drives the price of the credit insurance up.

Low Loss Ratios Mean Massive Overcharges for Texas Consumers

The regulation of credit insurance in Texas has not ensured a fair value for consumers. The percentage of premiums paid out in benefits, or *loss ratio*, indicates the overall value of the product for the consumer. Credit insurance has continually had low loss ratios, indicating it is not a good deal for consumers. While the loss ratios for credit life and credit disability insurance are low, the loss ratios for credit unemployment and credit property insurance are unconscionably low, as shown in Table 2.

Table 2
Texas Credit Insurance Loss Ratios, 1993-96

	1993	1994	1995	1996
Life	39.3%	41.2%	39.3%	40.2%
Disability	52.7%	50.8%	49.1%	51.1%
Unemployment	24.3%	17.5%	17.5%	14.5%
Property			38.5%	18.5%
Total	45.6%	44.9%	42.1%	42.3%

Compared to loss ratios for other group policies or to loss ratios for private passenger automobile insurance, reasonable minimum loss ratio standards for credit insurance would be 60% for credit life, 70% for credit disability and 75% for credit unemployment and credit property insurance. Using these loss ratios as minimum standards, the excess premiums were over $450 million from 1993 to 1996, as shown in Table 3. It is reasonable to assume that excess premiums were another $150 million in 1997, bringing the five-year total of excess credit insurance premiums – for just these four coverages – to over $600 million.

Table 3
Excess Texas Credit Insurance Premiums, 1993-1996
($ Millions)

	1993	1994	1995	1996
Life	$42.0	$38.9	$49.8	$51.4
Disability	$33.7	$39.6	$51.1	$51.7
Unemployment	$5.9	$11.3	$19.5	$26.7
Property			$23.5	$13.9
Total	$81.6	$89.7	$143.8	$143.7

While the low loss ratios are on average far too low, the loss ratios for particular companies are shocking. Over the period 1992 to 1996, the loss ratios for two of the largest Texas writers of credit property insurance were less than 6% (Forum Insurance Company) and less than 3% (Allstate Insurance Company). With creditor compensation ratios of over 90%, more than 30 times as much of the premium dollar went to Sears as the creditor than to consumers in claim payments for credit property insurance sold by Allstate in Texas.

Table 4
Texas Credit Property Loss Ratios for Selected Companies

Forum Insurance Company

Year	Earned Premium	Incurred Loss	Loss Ratio
1992	$40,737	$4,481	**11.0%**
1993	$1,096,313	$138,833	**12.7%**
1994	$2,779,358	$197,779	**7.1%**
1995	$4,748,797	$263,199	**5.5%**
1996	$4,405,787	$131,824	**3.0%**
Total	$13,070,992	$736,116	**5.6%**

Allstate Insurance
Company

Year	Earned Premium	Incurred Loss	**Loss Ratio**
1992	$2,300	$840	**36.5%**
1993	$1,077,721	$426,362	**39.6%**
1994	$2,896,045	-$324,922	**-11.2%**
1995	$3,997,363	$103,016	**2.6%**
1996	$5,726,024	$156,159	**2.7%**
Total	$13,699,453	$361,455	**2.6%**

Excessive Lender Commission and Other Compensation

Credit compensation consists of commission and other compensation, such as profit sharing. Table 5 shows the credit compensation ratios in Texas by coverage for 1995 and 1996. On average, compensation to creditors for 1995 and 1996 was almost as much of the premium dollar (about 38%) as payments to consumers (about 42%). For credit unemployment and credit property insurance, creditor compensation greatly exceeded claim payments to consumers.

Table 5
Texas Credit Insurance Creditor Compensation
(Commissions and Other Compensation as Percentage of Earned Premium)

	1995	1996
Life	43.3%	40.7%
Disability	34.1%	35.0%
Unemployment	36.1%	50.3%
Property	34.4%	35.1%
Total	37.6%	38.7%

While credit insurers argue that lenders will not sell the product unless the lenders can cover the costs of offering the credit insurance, it is unclear what the substantial costs, if any, of offering credit insurance are. The calculation of premium and provision of reports is performed automatically by computer as part of the overall loan transaction, so the additional cost of providing credit insurance in this area is minimal. Credit insurers explain that a virtue of credit insurance is that the product is simple to understand and easy to explain, often taking only a minute or two. Thus, the additional cost of providing credit insurance in this area is also minimal. Given the benefit to the lender of greater security on the loan, it is unclear why any commission need be paid to the creditor, let alone the exorbitant commissions and other compensation actually paid. In fact, the excessive compensation paid to lenders is a result of reverse competition and is not related in any way to costs incurred by lenders.

Gross Versus Net Coverage

Credit insurance is generally sold in one of two ways – as a single premium to cover the total amount of debt or on a monthly basis to cover the outstanding balance on a credit card or revolving loan debt. A consumer purchasing credit insurance in conjunction with an installment loan, such as an auto loan, will likely be offered a single premium product. With the single premium product, the consumer pays a single premium up front for credit insurance to cover the entire term of the installment loan. The insurance premium is generally financed by rolling the premium into the loan agreement. The insurance premium is based upon the total of the original loan principal and interest payments, the amount of the insurance premium and the interest on the insurance premium. This type of insurance is called gross coverage because it covers all principal and interest amounts. In contrast, net coverage applies only to principal amounts.

For monthly outstanding balance (credit card) credit insurance products, the consumer pays a premium each month based upon the outstanding balance on the credit card or other revolving loan amount. Monthly outstanding balance insurance is generally sold on a net basis. However, with credit property insurance, which covers specific pieces of property and not necessarily the total outstanding balance, consumers typically will pay premiums based upon amounts greater than coverage provided. (See discussion of phantom coverage under Credit Property, below.)

The gross single premium calculation leads to excessive premium charges for consumers. Rather than basing the premium on the remaining principal amount, the premium is based upon all principal and interest, including the insurance premium and associated finance charges. Thus, the premium calculation is based upon an amount greater than the consumer is liable for to the lender.

Credit Life and Credit Disability Insurance

The Commissioner is charged with establishing presumptive rates for credit life and credit disability insurance that are just, reasonable, not excessive and not inadequate. (*Texas Insurance Code* Article 3.53 §8 A(2)). Further, the State Board of Insurance established by regulation (28 *Texas Administrative Code* §3.5202) that the benefits for credit life and credit disability insurance shall not be considered reasonable in relation to the premium charges unless a loss ratio of 50% for credit life and 60% for credit disability is reasonably anticipated.

Table 2, above, shows that credit insurers did not even achieve the modest loss ratios established in the insurance regulations. Credit life and disability rates are clearly excessive and should be lowered.

CEJ calls upon the Commissioner to take the following actions to stop excess credit life and credit disability insurance rates:

1. Hold a rate hearing for credit life and credit disability insurance and lower rates significantly;
2. Eliminate gross premium calculations on single premium credit life and credit disability policies; and
3. Revise 28 *TAC* §3.5202 to increase the minimum loss ratios for credit life and credit disability.

Credit Unemployment Insurance

The Commissioner is charged with ensuring that credit involuntary unemployment rates be reasonable, adequate, and non-confiscatory. (*Texas Insurance Code* Arts. 21.79E, 5.14 and 5.15). Further, *TIC* Art 5.15 authorizes the Commissioner to withdraw approval of

previously approved filings that no longer meet the statutory requirements.

By any measure of reasonableness, the premiums for credit unemployment insurance in Texas have been unconscionably excessive for several years. Table 2, above, shows, that credit unemployment loss ratios have declined from 24% in 1993 to 14% in 1996. And with 1997 unemployment rates at their lowest levels in over 20 years, the 1997 credit unemployment insurance loss ratios were likely lower than in 1996! Almost three times as much of the premium dollar goes to the lender as commission and other compensation than to the consumer in claim payments. Credit unemployment rates are unconscionably high and should be lowered immediately.

CEJ calls upon the Commissioner to take the following actions to stop excess credit unemployment insurance rates:

1. Immediately take action to disapprove existing credit unemployment insurance rate filings.
2. Promulgate a regulation for credit unemployment insurance that prohibits premium calculations on a gross basis and establishes a minimum loss ratio of 75%.

Credit Property Insurance

Credit property insurance is currently "regulated" as inland marine insurance pursuant to 28 TAC 5.5002. In fact, under current provisions, credit property insurance is not regulated. There is currently no requirement for credit property insurance rates or forms to be filed with the Department or for the rates and forms to be approved by the Department.

In addition to the problems common with other credit insurance coverages, credit property insurance premiums are excessive for additional reasons.

Phantom Coverage

As with other credit insurance coverages, credit property insurance is sold in conjunction with term loans and with open-end (credit card) financing. On credit card loans, credit property insurance premiums are typically based upon the monthly outstanding balance on the credit card – such as 42 cents per $100 of outstanding balance. However, the credit property insurance only provides coverage for personal property. Because charges for meals, services, finance charges and other non-covered items show up in the outstanding balance, credit card consumers pay excessive premiums based upon non-existent coverage – phantom coverage.

Data from the National Association of Insurance Commissioners allows a breakout of credit property insurance associated with credit cards from credit property insurance associated with term loans. The category of "Other" in Table 6 shows credit property insurance sold with credit card loans produced loss ratios of 9.7% and 5.9%. (See appendix on data sources for detailed discussion of NAIC Credit Insurance Experience Exhibit data.)

Table 6
Credit Property Insurance in Texas
By Type of Coverage

	1995		1996	
	Loss Ratio	Compensation Ratio	Loss Ratio	Compensation Ratio
Fire and EC	47.9%	35.0%	66.3%	16.2%
Other	9.2%	32.5%	5.9%	40.1%
Total	38.5%	34.4%	18.5%	35.1%

Excessive Creditor Compensation

As described above, the compensation paid to creditors is excessive in relation to the activities performed by the creditor, but the high commission levels paid for credit property and credit unemployment insurance are particularly excessive. Because credit property is typically sold as part of a package of credit insurance coverages, the cost to the creditor of offering the additional coverage is minimal once the system is set up to sell the basic life and disability coverages. Thus, there is little or no need for additional creditor compensation for credit unemployment and credit property insurance. Yet, the compensation ratio for credit unemployment and credit property insurance is even higher percentage than for life and disability.

CEJ calls upon the Commissioner to take the following action to stop excess credit property insurance rates:

1. Promulgate a rule to regulate credit property insurance, including prior approval of credit property insurance rates and forms, prohibition on phantom coverage, elimination of gross premium calculations and establishment of a minimum loss ratio of 75%.

Appendix: Data Sources and Technical Notes

Data for credit life and credit disability loss ratios comes from the Texas Department of Insurance compilation of credit insurance experience, 1991-1996.

Data for credit unemployment and credit property loss ratios and for all creditor compensation ratios come from the NAIC Credit Insurance Experience Exhibit.

Data for Allstate and Forum Insurance Companies comes from the Texas Department of Insurance credit property survey (see below) for 1993 to 1995 and from the NAIC Credit Insurance Experience Exhibit for 1996.

Part 4 of the NAIC Credit Insurance Experience Exhibit covers Credit Property Insurance. The exhibit includes four categories – fire and extended coverage; auto physical damage; forced placement; and other. Credit property insurance, defined as insurance covering perils to consumer goods purchased on credit or pledged as collateral for a consumer loan, is captured in both the fire and extended coverage and other property categories. Insurers who report experience in the other credit property insurance category are asked to describe the experience. The descriptions included in these exhibits include:

- for accidental loss to personal property charged to cardholders account;
- non-standard fire and EC on credit card purchases;
- inland marine;
- personal property;
- other property insurance;
- purchases made on revolving charge accounts
- non-filing

The other property experience of First Colonial Insurance Company was excluded because this experience was identified as 100% non-filing insurance. The other property experience of American Security Insurance Company (47% non-filing, 53% personal property) and of Standard Guaranty Insurance Company(25.3% non-filing, 74.7% personal property) were included. No description of the other property insurance entries were available for North American Fire and Casualty Insurance Company, Peninsula Insurance Company, Independent Fire Insurance Company, Independent Reciprocal Exchange, Thomas Jefferson Insurance Company and Household Insurance Company. The other credit property experience of these insurers was included in the compilations.

We have verified that the other credit property experience described by some insurers as inland marine is credit property insurance by comparing information reported to the Texas Department of Insurance with the data reported in the credit insurance experience exhibit. The Texas Department of Insurance requested information from a number of credit insurers in January 1996:

> *The Department seeks to better understand the credit property insurance product sold in Texas. Although we are unable to precisely define credit property, we can identify coverages that are not credit property – credit life, credit accident and health and credit involuntary unemployment. For the purposes of this request, we are also <u>not</u> referring to forced-placed (or creditor-placed) insurance. As example of creditor-placed insurance would be automobile vendors single interest – coverage placed by a creditor for an automobile loan in the event the debtor fails to secure physical damage insurance on his or her own.*

The request for information sought copies of the credit property insurance master policy and certificates used in Texas, a description of the rates for the coverage and a report of earned premium, incurred losses and paid losses by year. An examination of the responses to the Texas call for information confirms that other credit property insurance, reported as inland marine, is credit property insurance.