



# NEWSDIRECT



Newsletter of the Nontraditional Marketing Section

NUMBER 38

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## Credit Insurance In Connection With Real Estate Loans

by Bill Burfeind

**T**he Consumer Credit Insurance Association (CCIA) is a national trade association of insurance companies engaged in the business of insuring consumer credit transactions. Our members account for more than 80% of the national premium volume written for these lines of insurance. Since its incorporation in 1951 as an Illinois corporation, CCIA has been dedicated to preserving and enhancing the availability, utility, and integrity of insurance and insurance-related products delivered through financial institutions or in connection with financial transactions.

CCIA shares the concern over marketplace practices that have brought about an unprecedented level of home mortgage foreclosures. Collectively, the practices are referred to as predatory and are said to include financed single premium credit insurance. But keeping the whole picture in perspective, the heart of the matter is how loans are



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## Chairperson's Corner Negative Discoveries

by James B. Smith, Jr.

**H**ave you ever encountered a negative discovery? In the 1700s people thought that a great continent existed between Antarctica and Southeast Asia, making the Indian Ocean a lake. The legendary continent was thought to be a promising empire with natural wealth of incalculable size. When Captain James Cook proved that Great South Land did not exist, he experienced one of the greatest negative discoveries of all times.

A negative discovery is much less welcomed than an affirmative discovery. It is far easier to enjoy an affirmative discovery than to prove that some long-admired fixture of the imagination does not exist. Moreover, we are inclined to forget or underestimate the difficulty of a negative discovery.

Isn't this also true in the world of business? Negative discoveries in the insurance industry waste time when poorly designed products or ill-conceived distribution decisions are pursued. Popular opinions and good intentions may ultimately lead to a negative discovery.

What are some examples of negative discoveries in a nontraditional distribution insurance channel such as bancassurance?

- Negative Discovery #1: Due to financial modernization legislation, banks will acquire insurance companies. Banks certainly have the financial resources to purchase insurance companies, but they may not have the financial incentives. The chairman of a mega-bank has said that the returns from insurance companies do not

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## Chairperson's Corner

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meet the minimum hurdle requirements for his bank. However, he said that the lack of a desire to buy an insurer should not be interpreted as a disinterest in insurance because his bank is earning substantial commissions as a distributor of annuities.

- **Negative Discovery #2:** Banks will sell insurance for a lower commission. Consequently, the product will create higher profits for the insurer and/or the product will offer greater value to the insured. The negative discovery occurs when it is realized that banks are just as eager for commissions as any other distribution channel. If the bank's market share is huge, the bank may even prefer a product that has less value to the consumer — but not embarrassingly uncompetitive.
- **Negative Discovery #3:** It's easy to sell insurance through

banks. Banks have access to many customers, and it will be easy to sell insurance to them. However, if bank platform personnel are utilized in the sale of the insurance, the negative discovery may be languishing sales because the insurance product is competing with a large number of other financial products. The average bank employee may be required to promote 40-50 financial products. Success may be found once it is discovered that bank employees may need to serve as a referral source, rather than as insurance agents.

- **Negative Discovery #4:** Banks have an in-depth understanding of their customers. Banks have a wealth of information about their customers, but they do not necessarily have a wealth of knowledge. Within current legal guidelines, banks can generally access information on deposits, loans, and credit card transactions. Using demographic and psychographic information, the buying habits of their customers can be gleaned. Unfortunately, banks have had a poor record of

consolidating and interpreting customer data.

I'm certain that you can think of many more examples of negative discovery, but let's move on.

Sometimes we do not want to recognize that our current path is leading to a negative discovery because we feel uncomfortable with such thoughts. Further, other people in our companies may resist the discussion because of the momentum of the current path.

John Donne articulated such thinking in the following poem:

"As I was going up the stair,  
I met a man who wasn't there.  
He wasn't there again today.  
I wish, I wish he'd go away."

Often the menace to progress is less the result of ignorance than illusionary wisdom. Let's identify the negative discoveries that may appear at the end of our current path, and solve for a way to overcome them. This may require courage, as well as critical thinking skills.

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*Editor's Corner**New Role for Actuaries:  
The Regulatory Actuary**by Christopher Hause*

**T**hose of you who are familiar with these pages have noted that a large amount of activity in our industry is spent on compliance with regulatory activity. That is one of the reasons that we are dedicating a fair portion of this issue of NewsDirect to emerging regulation.

Bill Burfeind, of the Consumer Credit Insurance Association, gives us the industry position on the "predatory lending" issue that is emerging on a local, state and federal level. This is one of my favorite examples of a negatively charged moniker given to a movement, calling to mind a large voracious animal, preying on a much smaller and helpless victim. As usual, there are at least two sides to any issue. Bill continues his excellent service to our industry by presenting the credit insurer's point of view.

Rick Campbell, the Managing Partner of Mitchell, Williams, Selig, Gates & Woodyard, P. L. L. C. in Little Rock, provides us with a very concise history of the "Small Face Amount" activities at the NAIC level. This movement was formerly championed by a regulator who has left office, so it is very helpful and timely to get an idea of the current status and direction.

I, on the other hand, want to take this opportunity to jump on my soapbox about the amount of time (and my clients' money) that I personally spend helping companies comply with regulation. That volume of time does not even compare with the unreimbursed time and energy spent trying to keep abreast of emerging regulation, so that we are in a position to

help. This time can be especially unproductive if the emerging issue fails to be enacted.

Many times I question regulators as to the intended target of certain regulation. For instance, making its way through the NAIC now is a revision to the Actuarial Opinion and Memorandum Regulation. This revision eliminates the small company

*"In the final analysis, I believe it is largely an unappreciated role, that of protecting the insurance-buying public, that the fine men and women who regulate our industry have assumed."*

exemption for Asset Adequacy Analysis.

I believe that, as a minimum, a few things should be done with any "Section 7" actuarial opinion. The first is a reserve adequacy test. The second is an analysis of the assets backing the reserves. Comments should be recorded as to the quality, yield and liquidity. Other observations can be made with regard to the apparent investment strategy. This can be compared to the stated investment strategy for consistency. The last is a memorandum to management as to

the emerging issues that may have an effect on their business. This includes regulatory, economic and risk-related issues.

*Chris Hause*

In the grand scheme, elimination of the "Section 7" probably will not lead to significantly more security for customers of small companies who are already doing sufficient analysis of reserve adequacy and cash flows. Is it correct to say that the increased requirements are not "aimed at my clients?" What is the benefit of this increased regulation?

I have heard it said that many a regulation is aimed at the lowest performers, the mavericks and renegades of our industry. These are the ones who offer deceptive and confusing contracts, do not establish proper reserves, and do not take time to properly insulate themselves against risk. This leaves the whole industry at risk of loss of credibility, integrity and viability. Therefore, I believe that corralling these mavericks is worth the many hours we spend complying with well-intended regulation.

In the final analysis, I believe it is largely an unappreciated role, that of protecting the insurance-buying public, that the fine men and women who regulate our industry have assumed. They protect our consumers from deception and the economic uncertainty of a failed company. These are things any of us would support. I also believe that we owe it to our companies and our consumers to help in this process, to make it as effective as possible.

I would love to visit more, but I have to go figure out my Triple-X X-factor Monte Carlo testing program. The darn thing says my reserves still aren't high enough.

## Credit Insurance In Connection With Real Estate Loans

from page 1

presented to consumers by a relatively small number of lenders in the subprime market. Credit insurance properly presented neither causes nor contributes to the incidence of foreclosure. Indeed, it advances the public interest objective of preserving home equity. Credit insurance is an important and valuable option for consumers when they seek to protect their ability to repay loans, including loans in which borrowers offer their homes as security.

## Credit Insurance—A Valuable Consumer Option

Home ownership represents the largest investment most consumers will ever make. Credit insurance is an option available to consumers to preserve this most important asset for themselves and their families. The consumer's ability to make timely mortgage loan payments is most threatened by death, disability, or unemployment. Often a death is preceded by a period of disability and unemployment. In fact, HUD estimates disability causes 46% of conventional mortgage foreclosures. In the absence of savings or other insurance, it is credit insurance benefits that maintain a timely repayment schedule and pay off the balance in the event of death.

Credit insurance consumers generally have low to moderate incomes and, accordingly, higher levels of financial insecurity than do those with substantial incomes or wealth. Absent abundant savings, the purchase of insurance is a cost-effective way to address financial insecurity. Even so, too

many consumers have little or no insurance.

A recent life insurance industry study concluded that 25% of US households have **NO** life insurance. [*Americans' Financial Insecurity*, Prepared for The Life and Health Insurance Foundation for Education (LIFE) by Roper Starch, October 1998.] Additionally, 75% agree they need more life insurance and 96% agree that providing for dependents is the most important reason. But, the study notes, "life insurance isn't on the top of people's list of financial concerns.... The most important is paying current bills." Meeting the monthly

*"Credit insurance is not a lending provision; it is valuable insurance for home borrowers. Credit insurance can assure repayment of a home loan in the event of death, disability, or unemployment."*

mortgage payment is listed as the first critical day-to-day challenge.

Making that monthly mortgage payment is crucial to providing for dependents. Both lender and borrower are counting on a stream of income to make this payment. The biggest risk of interruption to income is unemployment, disability, or death. For those consumers who have no insurance, or wish to supplement existing insurance, credit insurance is affordable, available, and convenient. Credit insurance is not a lending provision; it is valuable insurance for home

borrowers. Credit insurance can assure repayment of a home loan in the event of death, disability, or unemployment. Indeed, in the real estate secured market segment—more than 60% of the credit life and credit disability premium dollars paid by consumers are returned to consumers as life and disability insurance benefits.

## The Purchase of Credit Insurance Is Voluntary

It's important to differentiate good insurance products from bad lending practices. Selling insurance products, or any other goods or services for that matter, without consumer informed consent, is a bad lending practice. Informed consent is the key to a prudent decision. Both Federal and State law and regulation provide for informed consent.

The Federal Truth-In-Lending Act, implemented by the Federal Reserve Board Regulation Z, promotes the informed use of credit by requiring disclosures about the credit transaction terms and costs. As required by Regulation Z, loan documents prominently disclose that credit insurance is not required to obtain credit, and will not be provided unless the consumer signs for it. It's clear that the purchase of insurance is optional; that there is an additional charge for the coverage; and, the borrower has indicated election of the coverage in writing.

The Federal Reserve Board has twice examined allegations of coercion or tie-in sales. The 1977 survey concluded:

"The relatively low proportion of loan customers, especially those of retailers and commercial banks, who perceive pressures, either explicitly or implicitly, to make the joint purchase (of the loan and the credit insurance) is not consistent with the hypothesis that

involuntary tying is widespread. This conclusion is given further support by the very high rate of approval of the service and by the high proportion of customers who do not regard the service as expensive. Rather, the high frequency of purchase of credit insurance together with the consumer attitudes are more consistent with the hypothesis that the joint purchases are voluntary.” [Eisenbeis, Robert A., and Paul R. Scheitzer. *Ties Between the Granting of Credit and Sales of Insurance by Bank Holding Companies and Other Lenders*. Staff Study 101. Board of Governors of the Federal Reserve System. 1979.]

A 1985 survey reached a similar conclusion:

“These findings are consistent with the view that creditors in general do not subject borrowers to undue pressure to purchase a product (credit insurance) that they do not want. Overall ... the results suggest that the widespread abuses alleged by industry critics are not perceived by most borrowers as important concerns.” [Cyrnak, Anthony W., and Glenn B. Canner. *Consumer Experiences with Credit Insurance: Some New Evidence*. Federal Reserve Board. 1987.]

The most recent comprehensive study of credit insurance consumer attitudes was conducted by the Credit Research Center in 1993. [Barron, John M., Ph.D., and Michael E. Staten, Ph.D., *Monograph 30 Credit Insurance Rhetoric and Reality*. Krannert Graduate School of Management: Purdue University. 1994. **Note:** The Credit Research Center has relocated to Georgetown

University.] A copy of the study has been provided the Federal Reserve Board for independent review, but a couple of relevant findings are as follows:

“Purchase patterns for credit insurance are readily explainable without reliance on seller coercion as a factor.”

“We estimate that marketing/coercion alone accounts for a maximum of 3.4% of credit life insurance sales.”



“Borrower awareness of the insurance purchase appears to rise with the size of the loan to be insured (and corresponding rise in the premium). Thus, borrowers erred more frequently in their recall of the insurance purchase on consumer loans, relative to auto and *home equity* loans.”

In addition to the loan document disclosures, the credit insurance purchaser receives evidence of coverage in the form of a policy or certificate explaining the terms and conditions. Also, credit insurers routinely provide a “free look” for up to 30

days whether or not required by state law. This means that the credit insurance purchaser can cancel and get a full refund of the premium.

Given the consumer protections already in place it’s doubtful that credit insurance “packing” is a pervasive practice. Nevertheless, to ameliorate remaining concerns, credit insurers would be amenable to a requirement for a post-closing notice in connection with real estate secured loans. The notice could be mailed immediately after closing; recite pertinent cost and coverage information; and, provide cancellation instruction. Being received and reviewed in the privacy of the home after the loan process has concluded, such a procedure would validate the voluntary purchase and eliminate concerns about coercion or abusive sale practices.

## Consumers Need The Financed Single Premium Purchase Option

Credit insurance in conjunction with home equity loans is typically a financed single premium product. Since most home equity loans are repaid or refinanced within five years—a survey of leading lenders in one state found 90% of such loans repaid or refinanced within 48 months—credit insurance on home loans is usually offered for a truncated period. This means the initial term of insurance is for a shorter period than the full term of the loan, which keeps the insurance cost affordable. When a consumer repays the loan before the end of the period of insurance, the unearned premium is refunded in accordance with state insurance laws.

## Credit Insurance In Connection With Real Estate Loans

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There is consumer value in a financed single premium. While other premium payment modes might be available, financing the insurance premium over the full term of the loan makes the coverage affordable to many consumers. For example, a \$50,000 / 25 year loan at 12% will have a monthly payment of \$526.61 without credit insurance. With financed single premium credit life insurance for five years the monthly loan payment becomes \$549.98 (National average prima facie rates used). For the additional \$23.37 a month, the home equity is secured against the untimely death of the borrower. In contrast, if that credit insurance premium were to be collected on a level monthly outstanding balance (MOB) basis, the loan payment becomes \$566.01, an additional \$16.03. The ability to finance the single premium helps keep the coverage more affordable to many budget conscious credit insurance consumers.



Another consumer value of financed single premium is continuity of coverage (persistency in insurance speak). Having pre-paid the single premium for the full term of coverage, the coverage remains in force even if the loan payments become erratic or delinquent. With MOB the borrower is essentially purchasing 30 days of coverage at a time. Since premiums are collected with each loan payment and continuation of coverage depends on premium payments being made in a timely manner, MOB coverage will

often lapse when or soon after loan payments become delinquent. Given that death and disability are often preceded or accompanied by budget-busting medical bills, this is an important consideration for credit insurance consumers and public policy decision makers.

Also, it is important to note that unlike rates for products like ordinary term life insurance, single premium credit insurance rates will not rise as an individual ages. Generally, there is one rate for everyone, regardless of age or medical condition. Indeed, while credit life insurance may be subject to some evidence of individual insurability, it is offered without the more extensive underwriting criteria typical of term or other forms of life insurance.

These factors make credit insurance especially attractive to middle aged and older consumers/borrowers, who constitute the majority of equity home mortgage borrowers. Typically, the majority of such borrowers are above the age of 45—an age when uniform rates with little or no underwriting requirements are a clear benefit to those seeking life or disability insurance.

That's important when people take a loan using their homes as collateral, because our homes are usually the largest investments and the largest assets we have. Credit life, disability, or unemployment insurance on a home loan assures that if the insured borrower dies, becomes disabled, or loses a job, his or her family is able to maintain ownership of the home, keep a roof over their heads, and continue building equity wealth.

Any examination of financed single premium credit insurance should recognize the following advantages

credit insurance offers consumers:

- Credit insurance is not a loan requirement. It is a valuable, optional, affordable choice for consumers seeking to protect themselves when they borrow.
- Federal and state laws require that consumers be told credit insurance is a choice that is not required to obtain a loan.
- Credit life, disability or unemployment insurance on a home loan assures that a loan will be repaid in the event a borrower dies, becomes disabled, or loses a job.
- Consumers get a “free look” at credit insurance—they can cancel the insurance within a set period, usually ranging from 10 days to as many as 30 days, and get a full refund.
- After the free look period consumers can still cancel at any time and receive a proportionate refund of the credit insurance premium.
- States strictly regulate credit insurance rates, which are periodically adjusted to pass on to consumers the savings of good group claim experience.

Single premium credit insurance is an affordable, fair consumer option to protect home loans. In no way is it a questionable lending practice indicating a loan was made under abusive circumstances. It is a means to protect home equity through insurance protection against the predators of time and nature like accidents, ill health, or death.

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## The First Product Development Actuary Seminar

by Jay Jaffe

**T**he SOA's first Product Development Actuary Symposium was held May 14-15, 2001 in Chicago. The program was co-sponsored by three SOA sections: Product Development, Reinsurance, and Nontraditional Marketing.

There were about 115 program participants, making the meeting one of the most successful SOA new seminar programs. The seminar provided Professional Development (PD) credits and some participants also recorded Continuing Education (CE) credits.

The NTM Section was responsible for one of the symposium's concurrent sessions. The special program devoted to nontraditional marketing was entitled "Actuarial Aspects of Nontraditional Marketing."

The first half of the "Actuarial Aspects" session, presented an introduction to the pricing of direct response insurance programs. The second half of the program was a presentation by Doug Bennett which provided an introduction to pricing of worksite marketing life insurance programs.

Some of my major points included:

- Marketing costs are the most important risk factor in a direct marketed program rather than mortality or morbidity because marketing dollars are committed prior to any sales
  - Customers buy offers rather than products
  - Direct marketed programs have a customer rather than a product orientation
  - Programs often involve the direct sponsorship of another organization
  - Testing and retesting are essential to the success of direct marketed programs
- I concluded my presentation with

several observations about those factors which make programs successful:

- Market ownership rather than rental greatly helps to maintain control over all aspects of a program and ensures a long term relationship with the program
- Telemarketing is probably the most successful media currently being used
- Quality customer service is a vital component of a successful program
- Low cost operations make programs more profitable
- A constant flow of new offers and products is a key ingredient to sustaining a direct marketing operation
- Superior market knowledge is another necessary factor which leads to long-term success

Doug Bennett's presentation dovetailed nicely with my remarks. Doug repeatedly emphasized that there are opportunities to take conventional programs and make them better over time.

To make his point, he presented an example of a worksite marketing program which has been able to accomplish significant reductions in lapse rates by taking several simple and fundamental steps. As a result, the company has been able to increase agent compensation to reflect improved results and the company has also been able to achieve its profit objectives.

Several years ago, Doug's worksite marketing agent client was experiencing typical worksite marketing lapse rates. In policy year 1 the lapse rates were near 30% and declined to around 10% in the 6<sup>th</sup> year. Over a several year period, by making modifications to the program including improving customer service and personalized policyholder marketing, the agent's



lapse rates have declined to about 20% in the first policy year and under 10% starting in the second policy year.

Doug's client is dedicated to the concept that "a current customer is your best customer." The agent repeatedly resolicits existing customers for new life insurance. As a result, these insureds do not have the normal high lapse rates in the first policy years because they already are familiar with the program. The reduction in lapse rates which the agent has is remarkable!

In the future there will be repeat Product Development Actuary Symposiums. Members of the Nontraditional Marketing Section are encouraged to attend these sessions to obtain both general knowledge about product development and more detailed information about some of the products which are more typical of the NTM Section's markets.

If there is demand, one possibility would be to have an advanced NTM Section product development session either at the end or beginning of the Symposium. The session would probably last about half a day. If this advanced session would be of value to you, please contact me and I will pass along your request.

*Jay M. Jaffe, FSA, MAAA, FCIA, is president of Actuarial Enterprises LTD in Highland Park, IL, and a past chairperson of the Nontraditional Marketing Section. He can be reached at [jayjaffe@compuserve.com](mailto:jayjaffe@compuserve.com).*

## NTM-Sponsored Sessions at New Orleans SOA Meeting

October 21-24



***Here is an update on the New Orleans sessions sponsored by the NTM. We hope to see you there.***

### The Growing Senior Market (Session 11 PD)

Moderator: Steve P. Cooperstein  
 Panel: John Migliochio  
 Howard B. Passman

The senior market has been a niche target market for some years and will increase in importance with the aging of the baby boomer generation. More major marketing initiatives for this varied niche are on everyone's target list. Yet the market has unique qualities which have slowed development in certain quarters. This panel addresses the senior market in the context of life, health, and long-term-care insurance.

Topics include:

- Forces driving market growth
- Recent innovations in the marketplace
- Product development opportunities
- Distribution difficulties

At the conclusion of this session, participants will have gained a better understanding of the dynamics of the senior market and will be better equipped to participate in its evolution.

*This session is designed for participants who have **moderate experience** with the subject.*  
 Session Coordinator: Steve P. Cooperstein

### Internet Marketing and Underwriting (Session 33 PD)

Moderator: W. Howell Pugh  
 Panel: David Ferguson  
 Harry Lyons

The proliferation of insurance sites on the Internet brings new challenges for marketing and underwriting. The variation in web site objectives range from educational, to illustrative, to full underwriting, to on-the-spot issuance. Underwriting the e-customer increases the demands for timeliness.

The panel discussion addresses the sources that drive the direction of growth for Internet marketing and underwriting.

Topics include:

- Distribution models on the Internet
- Underwriting innovations
- Product development opportunities

At the conclusion of the session, participants will understand the new models created by Internet marketing and the underwriting challenges those models create.

*This session is designed for participants who have **no experience** with the subject.*

Session Coordinator: W. Howell Pugh

### Distribution Channel Management (Session 61 PD)

This panel discusses ways to handle agency, direct marketing, Internet, and other distribution channels. How are companies managing multiple distribution channels and avoiding channel conflict? How do companies marshal their distribution channels to meet customer needs?

Learn how companies view channel conflict, including details about differing pricing philosophies and coordinating products and distribution.

*This session is designed for participants who have **moderate experience** with the subject.*

Session Coordinator: Steven E. Konnath

### Financial Services Modernization — 1 Year On (Session 78 PD)

Moderator: Tom Bakos

Panel: William Carroll  
John A. Hartnedy  
Elaine N. Pelletier

Companies are finding new opportunities and new challenges since the recent enactment of the Financial Services Modernization Act. The panel looks at this liberalized regulatory environment for insurance, banking and brokerage services from an insurance industry perspective.

Key topics include:

- The main issues faced by participants
- Reaction by players in the marketplace to the new opportunities
- The impact of privacy issues

Participants will gain better understanding of the act and how it's being played out in the marketplace.

*This session is designed for participants who have **none to moderate experience** with the subject.*

Session Coordinator: Tom Bakos

### Louisiana State University Molecular and Human Genetics Center Field Trip (Session 95 FT)

Over the past 10 years, amazing progress has been made in our knowledge of the human genome and many of the genes it contains. A draft of the sequence is completed, and the possibility of identifying genes that contribute to common diseases such as cancer, heart disease, diabetes, and Alzheimer's disease is becoming a reality. One child in 20 is born with a genetic disorder caused by a single

mutation, and DNA testing is now routine for diagnosing many of these serious disorders. Ongoing studies are developing gene-based therapies for both rare and common diseases.

The visit to the Louisiana State University (LSU) Molecular and Human Genetics Center consists of a presentation covering both the history and current developments in this fascinating field, focusing on some of the ongoing studies at the Center. Also included is a tour of some of the laboratories where this work is being done.

From this presentation, participants will learn about the current state of research in genetics and gene therapy and gain a better understanding of the ethical dilemmas which this work is spawning.

**Open to all meeting attendees. This field trip is limited to 100 participants. There is a non-refundable charge of \$10 per person for bus transportation to and from the LSU Molecular and Human Genetics Center. Please include the additional fee with your registration.**

*This session is designed for attendees who have **no experience** with this subject.*

Session Coordinator: W. Howell Pugh

### Nontraditional Marketing Section Reception (Session 114 SM)

Join your fellow section members in welcoming the new officers for the next year. An informal wine and cheese reception is the setting for

networking as well. Please join us and express your desires for section activities and programs. Tickets are collected at the door.

**Open to section members only.**

Session Coordinator: James B. Smith Jr.

### Experience Tables (Session 134 PD)

Moderator: Steven L. Ostlund  
Panel: Bob Butler  
Chris Hause

Do you ever wonder where tables come from? The need for current experience is ever present for product developers and financial analysts. Regulators are increasing the pressure on actuaries to incorporate recent data and company experience into their work.

Using the recently released Credit Disability Table as a case study, the panelists describe the process of having a table developed and adopted as a standard.

At the conclusion of the session, participants have a better understanding of the dynamic of turning data into a published table.

*This session is designed for participants who have **moderate experience** with the subject.*

Session Coordinator: Steven L. Ostlund

## Managing Non-Life Insured Products Sold Through Auto Dealers

### Part II — Gap

#### Introduction

**A**uto Dealers offer several insurance and insured products through their finance and insurance (F&I) departments other than credit life and credit A&H. Vehicle service contracts, gap and financing are three other products offered by the F&I department that are often insured by property & casualty insurers. We will examine each of these products separately in a three part series. This second installment covers GAP.

#### Product Basics

*Coverage:* Gap is similar to credit life and credit A&H because it pays the car loan in the event of certain contingencies. Gap covers the shortfall between the loan payoff and the book value of the vehicle or insurance recovery (depends on contract) in case the vehicle is declared a total loss from either physical damage or theft. Most contracts cover all or some of the property insurance deductible and may cover one or two delinquent payments. Some contracts even offer a new car purchase allowance if the insured returns to the selling dealer to buy a replacement. While the term for gap coverage matches the term of the loan, the possibility of a claim is zero once the book value of the vehicle exceeds the loan payoff.

Who is insured? Coverage may be offered as a waiver agreement (most states) or as an insurance contract to the purchaser, depending on the state. Waiver coverage is similar to VSCs where only a portion of the charge is considered premium and the total charge is not regulated. Insurance coverage is similar to credit life where the entire amount

is the premium and the total rate may be regulated.

*Rates:* GAP is generally sold for a single premium that is either paid or financed at the time the vehicle is purchased. In the case of waiver coverage, the price charged by the dealer is made up of 3 components - (1) insurance premium, (2) administrative fees and (3) dealer markup. It's important to note that the total price charged is unregulated in most states. It's also important to note that component (1) is the only portion that is paid to the insurer. Components (2) & (3) are not paid to the insurer, nor are they included in premium for purposes of calculating premium tax or risk-based capital.

The refund method varies by state, with most allowing a rule of 78s amortization due to the declining value of the coverage, but some (e.g., Texas) require pro-rata.

*Reserves:* Since Gap is sold for a single premium, the unearned premium reserve represents the bulk of required reserves. Claim reserves include both claims in course of settlement and IBNR because claim notification often occurs several days to months after actual loss. The same NAIC requirements that apply to VSC unearned premium also apply to Gap, namely that the aggregate reserve held must equal or exceed the larger of three quantities for each year of issue (3-year-old and older contracts can be aggregated): (1) the amount of insurance premium refundable to contract holders, (2) premium times future expected claims and expenses, divided by total expected claims and expenses, and (3) the present value of expected future claims and expenses.

#### Managing Gap

Why is there a gap? The gap, or positive difference between the loan payoff and the book value of the car, is a result of several factors, including:

- Previous gap from a trade-in that gets rolled into the new loan as a result of the dealer increasing both the value of the trade-in and the purchase price by an amount sufficient to pay off the previous loan
- Loan amortization which is slower than the depreciation of the vehicle's book value, especially with finance programs that don't fully amortize such as leases and balloon notes
- Dealer extras that don't increase the book value of the car by as much as they cost
- Other insurance coverages with refund values that amortize faster than the loan

Considering the above, it's clear that an insurer's exposure to a gap claim for a given vehicle can range from almost zero (e.g., used car purchased at book with no extras, 10% down and 36-month financing) to very high (e.g., new sports car with all the extras, credit insurance and VSC, payoff of loan on trade-in, nothing down and a 5-year balloon note). Also, the likelihood of a total loss varies considerably based on the type of vehicle and the driver's characteristics. However, most carriers currently offer the waiver version of this product at a single rate for all terms and vehicles, perhaps with a surcharge for long terms or leases. Simplistic pricing for non-homogeneous coverage only works when the coverage is automatic, but Gap coverage is voluntary. The F&I

specialist must sell the car buyer on this coverage and the sale is much easier when the gap is obvious as in the sports car example above. So long as the rate structure remains this simple, anti-selection is a real problem.

Is there an alternative? The most accurate rate structure for Gap would include provision for both the amount of real coverage and the probability of claim. This structure would require a rate that varied by vehicle and/or driver characteristics which is applied to the estimated amount of coverage. Since future book values are only an estimate, the projected coverage based on them is also an estimate. This approach may be reasonable for an auto insurer that chooses to enhance its policies to include Gap coverage, but it certainly complicates the sale of stand-alone Gap in an auto dealership.

Exposure to claim under Gap coverage is similar to that under credit life because both have the same end result—that the debt is fully paid if the covered event (total loss of vehicle/death) occurs. The primary difference is that credit life pays off the entire loan while Gap pays the excess of the loan above the value of the vehicle at the time of loss. Therefore, a rating approach similar to credit life using a single rate multiplied by exposure may be a reasonable compromise between the anti-selective one-rate-fits-all and a comprehensive structure that includes both amount of exposure and risk classification.

### Estimating Exposure

If a deductible and delinquent payments are covered, the estimated exposure at the end of month  $t$  is shown at the bottom of the page.

The total exposure under the contract is the sum of each monthly exposure. Using the estimated vehicle book value as of the loan

maturity date from an industry source such as the Auto Lease Guide (ALG) and the book value at the purchase date, estimate the book value at each month-end using linear interpolation. Since new car book values often have a steep drop in the first year, include the estimated book value in 12 months from the same industry source as a third point to refine this interpolation. If there are other insurance coverages that have a refund value, the refund values can be estimated using the refund formula for each coverage as of the end of each month.

The formula at the bottom should be relatively easy to add to an F&I system because all of the input values are available or readily derived from values used in preparing financing documents. The only additional piece of information needed is the rate per exposure unit.

### Estimating Claim Frequency

If an insurer has been writing Gap coverage for a few years and has had a sufficient number of claims, it is possible to derive a claim frequency per covered month. Covered months include all months during which the exposure is greater than zero; therefore, it is necessary to estimate the exposure for fully amortizing loans to determine if it is positive in each month. Since the final payment for a lease or balloon note is based on the vehicle's book value at the end of the term, it's reasonable to assume that all leases and balloon notes have a gap (positive exposure) in each month. An alternate approach, and a good check on the previous procedure, is to use the average frequency of total loss on insured and financed vehicles from company data or a service bureau.

### Administration

Gap is relatively easy to administer because there's only one premium, there can only be one claim and claim frequency is low. However, the insurer should gather enough information at application, during policy issue and for claims and refunds to facilitate exposure and claim studies. This information should include:

- Vehicle information: selling dealer; make, model & year; book value of the vehicle at purchase and at loan maturity
- Loan characteristics: Type—fully amortizing, balloon, lease; effective date; initial amount; term; payment; balloon amount, if any; interest rate
- Coverage characteristics: coverage limit; deductible covered; delinquent payments covered
- Claim information: date of loss; cause of loss (theft, accident); net claim; loan payoff; insurance recovery; book value as of loss date; deductible/payments covered
- Refund information: refund date; amount of refund

### Summary

Gap is easy for consumers to understand and insurers to administer, but is a relatively immature and highly competitive product. The relative immaturity shows in the "one or two rates fit all" rate charts of most carriers. Gap should be a good product for insurers in the auto dealer market, but it needs a market leader to redefine the rating scheme so that the underlying risk is better reflected in the rate charged before it becomes an attractive product to underwrite.

*Next installment: Finance Reserve*

$$Exposure_t = \text{Max}(0, \text{LoanPayoff}_t - \text{VehicleBookValue}_t - \text{refunds}_t + \text{deductible} + \text{payments})$$

## *Activities of the Small Face Amount Working Group*

*by Rick Campbell*

### I. Introduction

The purpose of this article to provide interested parties with a summary of the activities of the Small Policy Consortium (the "Consortium"), a group of life insurance companies, each of which writes small face amount life insurance policies. The Consortium was formed in response to the actions of some insurance regulators who questioned the benefits of small face amount products. Initially, the concerns of regulators were expressed in an NAIC resolution (the "Small Policy Resolution") signed by representatives of over 40 state insurance departments in June of 2000. Unfortunately, the resolution tied small face amount policies to products that are underwritten using race-based guidelines.

In a meeting of the NAIC Home Service Working Group held on June 11, 2000, then Kentucky Insurance Commissioner George Nichols, who at that time was also serving as NAIC President, announced the formation of a new NAIC committee to study the economic value of small face amount life insurance policies (the "Small Face Amount Working Group" or the "Working Group"). He explained that the officers of the NAIC had drafted the Small Policy Resolution to ensure that small face amount policies would be examined on a national level. He added that the NAIC was not looking to shut down companies that write the products. Rather, he noted that the NAIC had a priority to protect policyholders who may have purchased "upside down policies," i.e., those policies where premiums paid over a number of years exceed face amount.

On the issue of whether small face amount policies were linked with race-based underwritten policies, Commissioner Nichols stated that he had seen several race-based products and that all of them had a small face amount. The Consortium made the point with Commissioner Nichols (and with others) that while some race-based policies may have small face amounts, not every small face amount policy has a race-based premium. The Consortium spent a great deal of time and effort over several months separating these two issues.

In early July of 2000, the Consortium decided to formally organize using the National Alliance of Life Companies (the "NALC") as its primary resource for sharing of information and coordination of activities. The NALC members realized that the Consortium's efforts need to span across association lines. Therefore, Consortium members were sought from the LIC and the ACLI and support was requested from each of the Associations.

During the remainder of the Summer, representatives of the Consortium visited with regulators and worked to ensure that its views would be represented at the first meeting of the Small Face Amount Working Group to be held during the September meeting of the NAIC.

### II. The First Meeting of The Working Group

On September 12, 2000, the Small Face Amount Working Group held its organizational meeting. Pennsylvania Insurance Commissioner Diane Koken chaired the meeting, and asked commis-

sioner George Nichols to make an opening statement. In his remarks, Commissioner Nichols observed that the NAIC decided to take up the study of small face amount policies where the Home Service Committee left off. He acknowledged that not all small face amount policies have race-based premiums (this was the Consortium's first victory), and announced that the two issues were independent of one another and would be addressed in different forums. He suggested that the Small Face Amount Working Group should complete its work by June, 2001.

The Working Group then discussed the charge given to it by the NAIC. That charge is as follows:

[The Working Group should] complete a regulatory analysis of the small face amount (less than \$15,000 face value) life insurance business, in all its various distribution forms, with an emphasis in this analysis on the overriding goal of fair policyholder treatment, not only in terms of market conduct, such as appropriate disclosures, but also addressing the issue of fair value for the premiums paid, and any other related issues. The analysis shall result in detailed proposals for reform by the Summer National Meeting.

Following the comments of Commissioner Nichols, the Working Group agreed that it would not include in its analysis credit insurance, escheat issues, the sale of multiple policies, and suitability. The Working Group then planned

an interim meeting for the month of October. The purpose of the interim meeting was to hear a report from the industry about small face amount policies and the market-place in which they are sold.

For the next several weeks, members of the Consortium prepared for the interim meeting. Topics were assigned and speakers were recruited to address various aspects of the industry and its different distribution systems.

### III. The October 2000 Interim Meeting

On October 26, 2000, the Working Group held its first interim meeting. The industry provided 11 speakers for the event. Presentations were made on actuarial issues, final expense policies, fraternal organizations, preneed insurance, and the home service industry. The meeting lasted an entire day and there were numerous questions asked of the industry by regulators.

Subsequently, the industry and the Working Group agreed upon the language of 28 questions that had been asked by regulators during the interim meeting. The industry responded to a number of the questions in a letter, dated November 22, 2000, to Commissioners Koken and Nichols, who co-chaired the interim meeting. The letter contained a general overview of small face amount products, and included correspondence from Alex Zeid (the Consortium's Independent Actuary) explaining how cumulative premiums can exceed the face amount of some life insurance policies. The Consortium spent considerable time working on the November 22nd letter and providing information to regulators in a manner that was responsive to their inquiries.

Following the October interim meeting, the Consortium turned its

attention to preparation for the next meeting of the Working Group, which was to be held in conjunction with the Winter National Meeting of the NAIC.

### IV. The December 2000 Meeting of The Working Group

On December 5, 2000, the Working Group held its second meeting. The gathering was chaired by Commissioner Nichols, who announced his appointment of South Carolina Insurance Director Ernst Csiszar and Arkansas Insurance Commissioner Mike Pickens as co-chairs of the Working Group. Commissioner Nichols also announced that he had written a letter to the American Academy of Actuaries (the "Academy") asking for:

assistance in addressing the issue of fair value for the premiums paid and any other related issues. The working group members are trying to gain an understanding of how, in some instances, cumulative premiums can total several times the amount of insurance provided by small face amount products.

Ms. Barbara Lautzenheiser, Vice President of the Academy, appeared before the Working Group and agreed to assist in the study of small face amount products. She opined that the matter before the Working Group was not an actuarial problem. Rather, she said that small face amount policies have a higher unit price than large face amount policies. She went on to state that while the Academy was willing to help the Working Group, she was not optimistic that the answers sought by the Working Group would be found in any actuarial analysis.

Commissioner Nichols expressed

his appreciation to the Academy and outlined an agenda for consideration by the Working Group. In addition, he reaffirmed his goal that the Working Group complete its study by June, 2001. With regard to the future, he stated that he would like the Working Group to address the following issues:

1. The discounting of premiums when the policyowner changes the mode of payment from weekly or monthly debit to bank draft;
2. Whether an insurer should be required to present all of its products to a prospective client at the time of sale (the "Portfolio Issue"); and
3. Whether a policyowner should receive a disclosure advising as to the fact that premiums paid may exceed the face amount of the policy.

Subsequently, on December 8, 2000, representatives of the Consortium held a conference call to discuss issues relating to the Working Group. The Consortium agreed to: (a) assist the Academy in its efforts to provide information to the Working Group, (b) respond to the Working Group on the agenda items above, and (c) prepare follow-up materials requested by the regulators during the October interim meeting.

### V. Other Activities

On February 7, 2001, the Consortium wrote Director Csiszar and Commissioner Pickens for the purpose of reaffirming the commitment of the industry to provide information and assistance to the Working Group in its analysis of the small face amount life insurance business. The Consortium also asked for direction from Director Csiszar and Commissioner

## Activities of the Small Face Amount Working Group

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Pickens on how it should best use its resources. Specifically, it requested whether the industry should focus its immediate attention on assisting the Academy, or whether it should begin the time consuming and expensive process of completing survey questions asked by the regulators in October. (Representatives of the Consortium met with Director Csiszar and Commissioner Pickens to stress the importance of an answer to this question.) The letter dated February 7 also contained information supplementing responses to questions previously asked by the Working Group at the October interim meeting.

After February 7, the Consortium worked to prepare an agenda and materials for presentation to the Working Group at an interim meeting scheduled for February 22, 2001. The Consortium was also involved in discussions with the Academy on the scope of its proposed study. In addition, several actuaries of Consortium members were invited to participate in the Academy committee's activities.

### VI. The February 2001 Interim Meeting

On February 22, 2001, the Working Group held its second interim meeting. The meeting was co-chaired by Director Csiszar and Commissioner Pickens. Director Csiszar outlined the many different issues the Working Group had discussed over the last eight months, and distilled them into the following three questions:

1. Is the small face amount industry making excessive profits on the backs of the poor?

2. Are small amount products properly priced, and are they actuarially sound?

3. What types of disclosures should be offered to purchasers of small face amount products?

Commissioner Pickens opined that the Working Group should develop a meaningful disclosure, and added that the Working Group should set specific objectives and establish timelines for its work.

A representative of a consumer group was present and spoke about the content of any possible disclosure. She also indicated that there are several other consumer groups that would want to be heard before any final result was reached. (The Consortium expects the other groups to be present at future meetings of the NAIC. As consumer groups become more active, the industry will need to respond with an independent analysis of the small policy market in order to contradict the perceptions of the consumer groups and some regulators.)

Following a lengthy discussion, with many contrasting views, including an offer from the Consortium to initiate its own actuarial analysis and economic study of small face amount products (and report to the NAIC), the Working Group agreed to focus its effort on a disclosure statement. Two actuaries, one from the South Carolina Insurance Department and one from the Arkansas Insurance Department, agreed to examine the disclosure issue in more detail and to report back to the Working Group. As a part of their review, the actuaries agreed to address the following questions:

1. Is the sum of the premiums paid on small face amount policies greater than death benefits?

2. Will premiums paid exceed death benefits within 10 years from the date of policy issue?

3. Whether a disclosure statement should include a "free-look" period for the policy, i.e., all policyowners are entitled to a full refund of premiums paid within 30 days of the receipt of the policy and disclosure.

4. Whether a disclosure statement should contain a list of options available to a policyowner when the premium paid equals or exceeds the face amount.

Director Csiszar stated that the Working Group would review its progress on a disclosure statement at the Spring Meeting of the NAIC scheduled for March, 2001. He mentioned the likelihood of an interim meeting of the Working Group in late Spring, and reminded the Working Group that its final report is due in June, 2001.

Due to the stated interest of the Working Group, the Consortium determined to assist the Academy in an actuarial study and commission an economic study to answer the following questions: (1) whether premiums charged for small face amount products are reasonable in relationship to other products in the market which insure similar risks; and (2) whether the profits of the companies issuing small face amount products are reasonable when compared to the rest of the life insurance market?

Other issues that will undoubtedly arise during future discussions are: (1) at what point in the sale process will the disclosure be required; (2) where will the disclosure be located; and (3) will there be an event (such as a premium-to-benefit ratio) that triggers a more severe disclosure?

## VII. The March 2001 Meeting

On March 27, 2001, the Working Group held its third regular meeting. The participants focused their attention on the two industry studies and the development of the disclosure statement. The industry informed the Working Group that the Academy has agreed to prepare a report to educate regulators about the pricing of small face amount products. Mike Pressley, the Chairman of the Academy's Small Policy Task Force, gave a detailed presentation on this matter. On a related topic, the industry described its efforts to retain the services of Professor Michael Porter, of the Harvard Business School, to review the profitability of companies that write small face amount products. While the scope of this project remains to be defined, the issue is of interest to several regulators who are concerned that some companies are making "excessive profits on the back of the poor."

On a going forward basis, the Working Group agreed to give its immediate attention to the preparation of a disclosure statement. It will then turn its attention to the industry studies, which will be completed this year. The Working Group left open the possibility that it may subsequently address problems that are raised in the industry studies, if any.

## VIII. The May 2001 Interim Meeting

On May 2, 2001, the Working Group held its third interim meeting. Discussion focused on the disclosure statement, multiple policies, the actuarial study to be performed by the Academy, and the public policy issue of providing enhanced benefits to insureds whose policy premiums exceed the death benefit over a certain amount.

With regard to the disclosure

issue, it was determined that a special subcommittee of the Working Group would hold a telephone conference call within the next two weeks to develop the final draft of a proposed disclosure statement for consideration by the Working Group.

The subcommittee was instructed to begin its work by using the generic disclosure statement submitted by the industry. The Working Group agreed that no disclosure will be required if premiums will never exceed the face amount of the policy (for example, single premium products) and that an exemption will be given to policies where age, sex, or other demographics would make it impossible for premiums to exceed the death benefit during the term of the policy. If it will not be possible for a company to calculate whether premiums will exceed the death benefit for a particular policy, the Working Group agreed that a company can provide the disclosure statement to all policyholders. The Consortium provided the Working Group with feedback on a number of related issues in a letter dated April 20, 2001, and a follow-up memorandum dated April 24, 2001. The Consortium was successful in its efforts to avoid a date specific disclosure and to keep the disclosure statement as generic as possible. In addition, the Consortium achieved its goal of ensuring that the disclosure statement would be provided to consumers no later than the date of policy delivery.

The multiple policy issue was discussed at the request of Illinois Director of Insurance Nap Shapo, who asked that companies exercise due diligence in locating all policies when a claim is filed for a named insured. Apparently, this matter surfaced in Illinois during a market conduct examination. Members of

the Working Group and representatives of the industry agreed that reasonable due diligence is appropriate, and indicated some agreement can be reached as long as a specific process for searching for a named insured is not mandated by the NAIC.

Mike Pressley, a representative of the Academy, discussed the status of the pending actuarial study. The Working Group expressed its concern that the data utilized by the Academy may not be sufficiently independent to satisfy regulators and other third parties who will review the final product. The Working Group agreed to appoint a subcommittee to develop a set of questions from regulators that should be addressed in an actuarial study. In addition, the subcommittee will recommend a method for collecting data and a process for conducting the study. The efforts of the Academy were put on hold pending the submission of this information.

The issue of whether enhanced benefits should be provided to policyholders whose premiums exceed the death benefit was discussed by the Working Group. While no consensus was reached, it is clear that several members of the Working Group wanted to talk about the matter in the context of legislation recently considered in the state of Florida. That proposal includes an annual notice to all policyholders with death benefits of \$15,000 or less and benefit enhancements to all policies where cumulative premiums exceed 250% of death benefit. The industry anticipated a full discussion of the Florida bill by a representative of the Florida Department of Insurance at the June meeting of the Working Group.

## Activities of the Small Face Amount Working Group

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### IX. June NAIC Meeting

The Consortium continued to assist the Working Group in developing a disclosure statement. The Working Group voted to expose a draft disclosure statement during the June meeting of the NAIC. That happened with little incident, primarily due to the closeness with which the Working Group worked with consumer representatives. Public comments to the draft disclosure will be addressed at the September NAIC meeting. We expect adoption of the final measure will take place in September.

The study sub-group will receive comments and information to

assess: 1) the magnitude of the "problem" with premiums exceeding face amount; 2) if the problem exists, find out how and why it happens; 3) the role for regulatory intervention. It will assess the effect of a regulatory "solution" to the problem. It will study what information needs to be collected, who will collect it, and will use services of AAA if at all possible, with consumer group input. Industry is quite concerned with confidentiality due to the continued threat of legal action.

There was a brief report on the proposed Florida legislation. Similar action was considered, but not passed.

### X. Future Developments

With regard to the actuarial study, the Consortium will stay in contact with the Academy and will cooper-

ate with the Working Group in developing an appropriate report. The economic study, which was of significant interest to the Working Group several months ago, has been temporarily set aside in order to focus on the disclosure statement and the actuarial study. Because regulators may want to increase the scope and costs of the economic study, the Consortium has informed the Working Group that it reserves the right to discuss the matter in detail before agreeing to underwrite the project.

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## Your ideas for NTM programs for 2002

We recently sent the following blast e-mail to NTM Section members, but in case you aren't on e-mail, passed it by for one reason or another, or have since come upon an idea or two, we are repeating the request here because we really do want your input.

Planning has begun for programs the Nontraditional Marketing Section might sponsor in 2002.

We welcome your ideas for sessions or speakers for the Spring or Annual Meeting programs, or for seminars, in 2002. Don't hesitate to suggest your own desire and qualifications for participation, though this is clearly not necessary.

For the Spring meetings we are considering a group of sessions related to Internet marketing, e.g., 101; Regulation; Strategies; Integration with Brick and Mortar; Long term perspectives; and Actuaries and the Net. Individual sessions on Credit, Worksite, Direct, and Bancassurance marketing are also possibilities. Any thoughts on such sessions and/or speakers for them would be most appreciated.

Annual meeting topics are wide open.

Please direct your suggestions to Steve Cooperstein, who is handling the Spring Meetings, at SC@IS4Life.com or 831 655-8670, or Tom Bakos, who is handling the Annual meeting, at tbakos@blazenet.net or 717/671-6672.