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Session 10PD
Debt Protection Product Development In the Aftermath of Gramm-Leach-Bliley

Track: Nontraditional Marketing

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Summary: The passage of the Gramm-Leach-Bliley Act of 1999 changed the landscape for credit-related products offered through financial institutions. Credit insurance, long the mainstay in this venue, is being supplanted by a vast array of products designed to meet the particular needs of borrowers without the encumbrance of regulation. Attendees gain an appreciation of the activity in this long-neglected segment of the insurance industry as well as concepts that might transfer to other related instruments.

MR. JONATHAN PHILIP JANNARONE: I've been an actuary at Assurant Group, formerly American Bankers Insurance Group, for 13 years. My current responsibilities include debt-protection actuarial work for the company. The two presenters for this session are Scott Jentz and Chris Hause. Mr. Jentz is president of QSO, Inc., where he consults for credit-union service organizations. His role is to bring products and services from the insurance industry, and provide implementation and testing of these services. Prior to QSO, Mr. Jentz was a regional vice president for Minnesota Life Insurance Co., focusing on the financial-institution marketplace. Mr. Jentz will cover the history of debt protection, the current marketplace and a regulatory overview.

Our second presenter, Chris Hause, is president of Hause Actuarial Solutions, Inc. Chris develops actuarial software programs that assist actuaries in evaluating their

†Mr. R. Scott Jentz, not a member of the sponsoring organizations, is president of QSO, Inc. in Littleton, CO.

products. He recently acquired the consulting practice of William M. Buchanan & Associates, where he had been managing partner for five years. Mr. Hause has been very involved in credit insurance, including the current project of updating credit mortality tables.

Before our presenters begin, I will give a brief overview of debt protection for those of you that may be less familiar with it. Debt protection products are very important, especially to credit insurance actuaries and their companies, because these products have been replacing credit insurance. Our companies can either move into the debt protection world or, potentially, be forced out of credit insurance, if our clients switch to debt protection. Debt protection is not insurance, and no insurance company is even required. No claim payments are made. Instead, debt may be forgiven or deferred. Luckily for us, many lenders do not have the expertise in developing products or in handling the administration, which allows us to continue to operate in a consulting environment.

Debt protection involves an agreement between the lender and the debtor. The lender receives a fee, which is not premium, and the debtor receives protection from certain events. Mr. Jentz and Mr. Hause will explain some of these events later. There are three main types of programs. Debt cancellation will forgive the entire loan (for example, upon death) or the monthly payment or minimum monthly payment (for example, disability or unemployment). In either case, a portion of principal is cancelled or wiped out. Debt deferment waives the interest charges so that the loan doesn't increase while no payments are made, but the debt is also not reduced. The last type of program I'll call payment holiday, but be careful with this term. Payment holiday may be used for many different types of things. In this case, no late penalties are charged, but interest still accrues. Therefore, the loan gets larger. This type is not as common as debt cancellation or debt deferment.

One big problem with debt protection is the terminology. All the insurance terms that we're used to are no longer applicable. We're still trying to break old habits, so please forgive us if we use some of the insurance terms. Instead of insured, there's now an account holder. Since there's no insurance, there's no insurance certificate, but instead there's a loan addendum. Premium is not collected. Instead, a fee is collected. No claim payments are made, but there are activations, instead. Since the account collects a fee, it would not make sense for the account to pay itself a commission. So the account only keeps a percentage of the fee as retention. In the past, the insurance company would collect the premium and potentially reinsure this premium to a captive insurance company of the lender. Now the risk transfer is different, where the lender initially collects the premium and may transfer the risk to the insurance company through a contractual liability policy. Our first presenter is Scott Jentz.

MR. R. SCOTT JENTZ: I am from the sales and marketing side of the business, so I've spent a lot of time working with actuaries over my 30 years in the industry.

How many of you represent companies that are actively in the debt cancellation marketplace now? How many represent companies that are seriously considering it? And how many are just starting that process of determining whether or not debt cancellation makes any sense?

I'm going to go through the marketing part of this product and some of the roadblocks, the issues that have come up, as we start selling in the marketplace. Primarily, I work in is the credit union marketplace, but we also get involved with auto dealers and banks and other financial institutions. So my agenda's really going to cover what debt protection is.

Why would an entity, a financial institution, move to this product? The answer is a decline in credit insurance. I want to talk a little bit about history. Again, this is from a sales perspective, as to how this product is presented in the marketplace, and the evolution of debt protection, product considerations, and then give a brief regulatory overview, because there are a lot of regulatory issues that you get involved with in debt protection.

First of all, debt protection is something that can be offered by financial institutions as long as you charge a fee and you amend the lending agreement, because there has to be a contractual liability. Or there has to be an amendment to the loan agreement to offer the debt protection. And then it will cancel the debt or it will make payments, depending on life events. Why would a financial institution move to a debt-protection/debt-cancellation product? First of all, the idea is to improve the product offering to the customer base. It's going to be a better product than traditional credit life and disability products. We can tailor the product to the needs of the financial institution. And there's going to be, hopefully, a significant reduction in compliance risk. This is a product that is not regulated like credit life and disability, in most states. No insurance license is required at this point, and the selling process is going to be improved, because the reality is consumers have a pretty negative feeling toward credit insurance. And as long as we can get rid of that terminology, we can sell the product at a different level and consumers are more receptive to the product.

I literally have been working in the credit-insurance industry for 30 years. I spent 28 years with Minnesota Life in their financial institution side, and our major products were credit life and disability insurance and mortgage life insurance for the bank and the mortgage industry. But what's happened is the short-term credit-type product has gotten some really bad press over the years. There have been a lot of articles written about how it's a rip-off and how it's overcharged. Banks and auto dealers have made a lot of money selling credit insurance. Consumers are not purchasing it like they used to. And then there are the regulatory issues. Every year, you hear about some regulator in some state who is now requiring a limited license to sell credit insurance, or is requiring a certain loss ratio, or is requiring this or that or the other thing, and so regulatory-wise, the product is becoming uncompetitive. So that's the nature of what credit insurance is doing today, and here's a little bit of a history on it.

The high watermark of credit life and disability was about $10 billion in 1979. In 1986, the debt cancellation marketplace originated and took some of the volume away from that, primarily in the credit card base for banks. In 2000, the credit insurance industry was about $6 billion. The projection is that by 2005, that industry will be $2 billion. The rest of it'll have gone to a debt-cancellation-type product. Those are fairly significant results.

How did debt cancellation evolve? It actually was a product that was approved by the Office of the Comptroller of the Currency (OCC) in 1966. So it's been around for a long, long time, and was used primarily by some banks for their credit card bases back then, but not very much. And for the industry that I work in primarily, in 1997, the National Credit Union Administration (NCUA)—which regulates credit unions, federally chartered credit unions—approved the use of debt cancellation coverage. So that was a fairly significant step in the direction of allowing credit unions to go into debt cancellation coverage. Most states treat it as not insurance at this point.

There are two problems with credit insurance right now—regulation and product. The product is old. It's tired. And those are the issues that insurance companies and salespeople like myself are facing. How do we get a product in the marketplace that will replace the consumer needs that credit life and disability is not fulfilling right now?

I just learned something the other day. Bank of America did a study, and they got a target group together, and these were consumers that were purchasing cars, intending to finance the loan through the bank. And they were asked a couple of questions. First of all, they asked them, what is your primary economic concern when you take out a new loan? Would it be death? The answer was no, they're not concerned about dying. Disability from sickness? Maybe. Disability from accident? Maybe. The most significant need consumers had from this focus group was unemployment. Consumers believe that they need to have unemployment insurance. They don't know how they're going to make their payments if they lose their job. And since September 11 and before, the marketplace has been losing jobs. Stability in the job market has not been there. Consumers need protection for job loss.

The other thing that I thought was very interesting was that most people felt that they would die accidentally. They're not going to die any other way. It's going to be an accident. They're also going to become disabled accidentally. So, when you think about what consumers are looking for, they're not looking for what traditional credit life and disability provides. They are looking for different coverage. We have a small test going. It's actually in a dealership. And the dealership is selling credit life and disability side-by-side with a debt-cancellation product that provides six months of death benefits, six months of disability benefits, and six months of unemployment benefits. The cost for all three of those types of coverage is about the same as full-credit life and disability. And on a participation level, 7.5 percent of the people are buying traditional credit life and disability and 15 percent are buying the debt cancellation coverage, because of the unemployment benefit. Again, this is a significant issue. This is what consumers want. And that's why this product's success is not only about regulation. It's also about the product itself. Credit insurance does not work.

The markets in which debt cancellation is popular will grow—for example, bank credit card, it's already there in a big way. Most large banks are self-insuring, doing debt cancellation. Fleet Bank, for example, is selling its own debt cancellation product to the industry. They're selling it to credit unions and small commercial banks, so the banking industry is going in, writing this product, taking a risk. Retail, anybody that has a credit card with Dillard's or Foley's—those are the two local ones in Colorado—any of the credit-card bases out there for department stores, they're selling debt cancellation coverage. Specialty finance, credit unions are starting to get into it. It's going to be a slower process, because they don't move quite as quickly as some of the other industries do. Auto, the dealership network will start getting into this product. And then mortgage clients, predatory lending for mortgage lending for that side of it, will force financial institutions to start doing an outstanding balance-type product. Single premium products won't be available. So, again, that is another open door for debt cancellation.

There are some product considerations that make it so exciting. You can have life. You can have accidental death. You can have accident and health, unemployment. I've seen products where they're talking about family leave benefits. I saw one product that would provide the waiver of one payment if you had a birth of a child. Other products will provide hospitalization-type things. A critical illness benefit allows for the loan to be paid off when you're diagnosed with a serious illness. And then terminal illness coverage offers about the same thing. The other things that you can build into this product include life events, such as marriage and divorce. I've seen some companies that want to start offering a divorce benefit that makes the loan payment for so many months if you go through a divorce. These life-event products offer benefits for the birth of a child, and later college.

Benefit periods that you see in this product are anywhere from full benefits, because it can mirror credit insurance, to a minimum of six months and a maximum of 24 months. And that's the other part that makes this very exciting. You can custom design it. Consumers, again, do not believe that they're going to die from natural causes. They believe that they're going to die from an accident, they're going to become disabled accidentally, or they're going to become unemployed. They need short-term fixes for those kinds of events, except for death, obviously. So a six-month or a 12-month benefit product is very appealing to consumers.

I'm going to speak about the regulatory issues generally from the credit-union side. In the credit-union marketplace there are state-chartered credit unions and there are federally chartered credit unions, and if you're a state-chartered credit union, you are regulated by the department of financial institutions in your state. If you are federally chartered, you are regulated by the NCUA, and what the NCUA has done is approve the offering of debt cancellation for federally chartered credit unions. That's a huge step. State-chartered credit unions must get approval from their departments of financial institutions. Thirteen states have approved this. There's a law out there called the parity law. I'm not an attorney, but the parity law implies that if the federal government or the federal regulators have approved this product in a lot of the states, and I think it's at 28 right now, they will go along with the federal approval for their state regulatory issues.

That's just a brief update, from a marketing perspective, on what's going on with debt cancellation and the regulatory issues there. Chris is going to talk about the products themselves and the actuarial pricing of those products.

MR. CHRISTOPHER H. HAUSE: The new areas that Mr. Jentz has talked about in terms of actuarial work provide a lot of challenges. The newness of the client—we're not working for insurance companies anymore. Most of the time, our clients are financial institutions and, occasionally, third party administrators or marketers of debt cancellation products. There no longer needs to be an insurance company involved. And that is difficult for some people to accept. It seems that there's certainly a risk involved. There's a risk that involves a contingency that's on the books to the banks. And I believe that's probably why the OCC has been somewhat slow in coming out with their regulations. They realize that there are contingent liabilities on the books of banks that hadn't been there before. And I think they want to be very careful to make sure that those are properly provided for and the public is protected. They've certainly seen enough financial institutions in trouble to last them for a while. So the OCC had, I believe, scheduled February to declare its regulations with regard to debt cancellation. And it's almost June. I think that's indicative of some pretty complex issues.

We really think that the market, which has been a little tentative, is going to mushroom and expand significantly and quickly, when the OCC declares these regulations. There will still be a lot of issues, no doubt. Simply issuing a regulation rarely answers all the questions involved, but I think it's going to give people some comfort in how these products are offered.

So, we talked about the products—traditional life and disability. Involuntary unemployment is not a new credit insurance product. Many people have been offering that. It's been not very well accepted on the bank installment side. Single premium unemployment has appeared from time to time, but on the credit card side, certainly unemployment is very popular, and this is where debt cancellation started primarily, in the credit card area. So that was a natural fit. But from there, we get to some different sorts of things—marriage, divorce, hospitalization, long term care confinement, college enrollment, birth or adoption, leave of absence, especially with the Family Medical Leave Act. One thing that we haven't touched on so far is gap coverage, which is a property and casualty coverage, by and large. Several states have successfully argued that that is in fact insurance, and we see a lot of caution for that reason.

It's not going to be a universal move to gap. Gap for auto loans covers the difference between the loan and the value of the automobile, and it has been asserted by state insurance departments that, that is in fact insurance coverage. And so, we'll see limited entrance into the Gap market. But there are new products to cover just about anything. I even heard some people talking about death of a pet as a possible insurable event. Obviously, for pending divorce, this coverage would be active between the time of the filing of the divorce and the time the divorce is final, as opposed to the divorce decree itself, which is between the filing and the decree. Some people are getting very creative with some of these things, and I think it's more market-oriented. It's a way to differentiate your product offering, to make it more appealing and friendly. Some people have suggested that it's like a snake-bite benefit that offers very little, but allows you to add things to your list of product offerings. Whatever the case, we have to assess the probability and the cost of providing that benefit and incorporate it in our pricing.

Now if you look at this list, it's clear that some of these are single events—marriage, divorce, birth or the adoption of a child. Others are dependent on the continuing status—being disabled, being unemployed. So the claim costs have developed in different ways, and we'll address that a little more later. The second thing is that some of these are—I wouldn't say elective—but the timing of them can certainly be controlled to some degree by the individual, and for that reason, they have not been considered traditionally insurable events. This presents two issues. The first is in the waiting period, eligibility periods, those sorts of things. We see a lot of expanded waiting periods. There's no benefit during the first six months of an installment loan or within six months after an advance on a revolving line of credit. Those of us familiar with anti-selection as it exists in credit insurance certainly recognize that someone can time in advance a loan activity that would benefit him or herself—with a pending adoption, for instance. So, waiting periods are very important. And the other thing that occurs to us is that, since some of these are not traditionally insurable events, we have to get creative as far as where we get the data to assess the claim costs associated with them.

So what is the benefit that we're providing? Life insurance benefits, which also include accidental death, may cancel a loan or waive finance charges, or they'll pay the finance charges only this is popular on the revolving lines of credit. Or they'll waive the monthly payment or minimum monthly payment in the case of a revolving line of credit. So that's the benefit that you're providing.

For non-life benefits, it gets a little more complex. You have, once again, incidents of continuous types of claims, waiver of finance charges, waiver of the minimum monthly payment (or the actual monthly payment in the case of an installment loan), cancellation after a specified duration. For instance, if you are confined to a hospital for more than 15 days, the debt will be cancelled. If you are unemployed for 90 days or more, the debt will be cancelled. Or total and permanent disability cancellation upon declaration of a total and permanent disability status. When one approaches the waiver of debt protection premiums during a period of disability or unemployment, normally other coverage is carried, so one must build into the claim costs the fact that you're waiving the debt-protection premiums themselves.

We talked about limitations in increased waiting periods and eligibility periods, but let's talk about the pervasive use of a specified benefit period, the six months to 24 months. Traditionally, credit insurance has been—on the disability side at least—offered for the entire term of the loan. The unemployment insurance that we've seen offered has always been of limited duration, six to nine to 12 months. Occasionally, depending on the term of the underlying loan itself, if there's a five-year loan or more, you may have an 18-month benefit; if it's a 10-year loan, perhaps a 36-month benefit. But involuntary unemployment insurance (IUI) has always been offered on a specified benefit period. Those of you involved in credit insurance know that it's important to cap the maximum monthly benefit. You don't want to expose yourself to thousands of dollars of monthly benefits in disability income, even if you do have a short monthly benefit period.

Next one, total benefit, for instance, if your maximum disability benefit is 12 months, your contract may frequently have written into it that the total number of monthly payments during the term of this installment loan can only be two maximum-benefit periods or 24 months total. So recurrent disabilities are kept to a minimum.

Accident only is very popular. No one really anticipates a health status, but everyone wants the unforeseen to be taken care of. With pre-existing exclusions, we've seen differing opinions on the use of those, but we are going forward in our programs with a standard "six and six" pre-existing exclusion on the disability. And the eligibility waiting periods have ranged from three months to 12 months, where there is no eligibility for benefits if a loss occurs within a certain amount of time after the advance or after the inception of the loan.

And then with the benefit limitations, there is a lot of discussion about age limitations, whether age limitation on a benefit is discriminatory, and whether that will be allowed under the final OCC regulations. From a risk standpoint, obviously, we would like to see reasonable age limitations allowed, but that remains to be seen. We've seen encouraging signs from some regulators and hints that we'll be able to use underwriting, as well as age limitations. We're just going to have to see how much underwriting is allowed, how much will be allowed, how much will be tolerated by the public. That's one of the things that have always made our lenders just a little bit nervous, asking health questions at the time of a loan application, and this is fueling some of the argument toward accident-only benefits.

We have seen accident-only above a certain age. For instance, full life benefits up through age 65, and accident-only benefits above age 65. Even the accident only has a problem once you get to advanced ages. Obviously, at 80 to 85, small accidents can more readily lead to death. And once again, the use of waiting periods is much more important, depending on how little or how much underwriting you do. The less you do, the more that we're encouraging people to use the waiting and eligibility periods.

Now we're going to get to benefit cost calculations, claim cost calculations, if we can call them that. Most banks, most credit unions, most auto dealers have some experience under credit insurance currently, mostly credit life and disability. Not a lot of them have experience with some of the life event types of coverage, but credit life and disability and, to some degree, involuntary unemployment, are going to be where more of the claim dollars come from. So you want to first look at any available experience with regard to that particular account—geographical distributions, in the credit unions certainly, the occupation class, a dominant industry within a particular town, for instance, can have a very significant effect on the claim expectation. So if you have information about that account, whether it is a credit union or a bank in a small town, or whatever it is that you're working with, first get the account experience.

Secondarily, you want to look at credit-insurance experience. Two years ago, we finished a morbidity study on credit insurance that involved nationwide contributions, and we are in the process of updating Jay Jaffe's good work in 1992, I believe it was, on the mortality side. We've gotten a very good response and very good participation of the accredited insurance mortality study. Again, these are nationwide and should be considered as nationwide. Once again, go to the account level, if you can, to modify that. Credit insurers all know that there's much geographic, even state-by-state variation in the life-claim costs, as well as the disability-claim costs.

Other insurance experience should be your third area of data. For instance, on the hospitalization benefit, on a long-term care confinement benefit, there's certainly enough data in SOA's *Transactions* and other publications at least to help you devise a framework for those benefits. The timeliness, obviously, there's always some concern when you talk about society. It takes a while to amass the data. So in areas where there's a lot of cyclical nature—unemployment is certainly one, disability is another—you're going to definitely want to see what side of the economic cycle you're on. So other insurance data should be your next area, and then general population statistics, you can use the Bureau of Labor Statistics and the *Statistical Abstract of the United States*. There are state variations and there are geographical variations. You can find unemployment data, for instance, by major metropolitan area, by state. These things are available. I'd highly suggest that you use them. If you intend to go to a certain state that has a history of loss experience on the disability side, chances are you would have higher anticipated-claim costs on the unemployment side as well.

And, of course, with insured life studies, whether it's credit insurance, other insurance, the applicability of the data to the underwriting that has been applied to that segment of business that is being reported in that study, versus the underwriting that you're applying, the general population data, applying that to the socioeconomic class that you are going to be insuring, may have a significant effect on your claim costs. Obviously, your age mix is significant as well. Any data that you get that is not age-specific, you ought to carefully consider whether you need to break that down by age. Much of the work that we've seen done has not been broken down by age, and I think that everyone undertaking a claim cost study should look at geographical, occupational and age and gender data. They should recognize that to the greatest degree possible, or choose to recognize that once experience starts to emerge.

So, back to basics. When you do undertake to calculate claim costs, and you do have some usable data, especially when it comes to life-event-type coverage or something that may not be a traditional insurable event, remember incidence, severity, and most of all, variance. The mean is not always where you want to be. You'd like to look at the variance as it occurs among geographical areas, among the economic cycles, and just the overall variance of claim costs, to make sure that you're not pricing at a mean that is very polarized in terms of its distribution.

Is the data you gather to develop tables something you can use? We have developed some unemployment incidence and continuance tables by age. Yes, they're a little rough, and we'll be refining those as we get more and more data, but we have devised things like that. Remember the nature of the benefit. If you look at some claim cost studies, and you say, "Okay, well, the benefit for a 30-day retro, six-month, involuntary unemployment benefit is 'X'," you may walk away and think you're done. But somebody is going to come up and say, "Well, hold it. That's a little too expensive. What if we put a three-month benefit on it?" And you go, "Oh, uh, I really don't know how that affects the claim cost." So if you take the time to develop some appropriate unemployment incidence and continuance rates and fit the claim costs and the data that's available, you can answer those questions very easily. And they will come up.

Adjusting the results, certainly smoothing out the bumps, any data that you get is probably going to have age groupings; we'd like to see people smooth those out. No doubt, even large-scale mortality studies will have anomalies in them. You need to smooth those out, because otherwise you may risk unreasonable results. We find that a lot of times the data is too sparse by individual age. We recommend, in most cases, combining the central ages, and if it's usable in those central ages, that's fine. If you need to spread that out to individual ages, there are certainly traditional actuarial methods to do that. We were asked to develop a specific set of benefit periods and elimination periods, and that was the approach that we took initially. And because of all the variations that we're seeing, we're going back to basic principles and building those incidence and continuance tables for all of our benefits. So if somebody asks for a 60-day elimination period on a disability benefit, we can reasonably produce that. That's not something that just falls out of the tables. Those are currently constructed.

And I was asked to comment on what we've seen as far as the effects of September 11. In the claim cost area, we find there is a renewed interest in debt protection products. That's just a general statement, of course, but certainly the unemployment incidence rates have been growing; the number of new claims on unemployment had been in the 400,000 range weekly, and now has hit a high of over 700,000. With the extension of unemployment benefits, which I believe was passed a month ago, does that lead to increased severity? Those people that had no limitation on their unemployment benefits may be rethinking that and limiting their unemployment benefits. And certainly there's been a demonstrated relationship between disability and unemployment. We anticipated that the claim costs for disability are going to be approximately 10 percent higher over the next three years than they were over the three years before September 11, and that could well prove to be too low.

So now you've developed your claim costs, and you have to package your fees or rates. By far, the most popular rate schedules start with outstanding balance, because, as we discussed, this comes from the credit card side. This was the first thing that everybody generated, and because the need was to have one rate for all ages and both genders, that was the start of all this claim cost development. Obviously, as we've said before, you have to pay attention. If you have a credit card that's targeted to the graying market, the Silver Fox Club or something like that, obviously you want to be very careful of the benefits that are being provided. We see some interest in the issue of age-based outstanding balance. This is an entry-age-based outstanding balance. We see this on installment loans particularly, but we have heard of it on home equity lines of credit. For those, we're looking at age-bracketed rates, as well.

A lot of people are looking at levelized premium outstanding balance. One insurer that we know developed an outstanding balance program, took it to their banks to combat the stigma associated with single premium credit insurance, only to find out that the bank in this case could not administer an outstanding balance based on the principal outstanding balance. The bank needed to introduce a level premium outstanding balance plan, instead.

We have seen some interest in single premium, and most of this is in the short-term installment area. We think we're going to see a little more of those people that sell—finance companies, perhaps, small-goods dealers have asked for the single premium, those that are not in the real-estate-secured market. Traditional credit insurance rate schedule, we think that a number of the smaller banks, particularly those that that are entering on the installment loan side, will require that you walk into their current administration system with a traditional credit insurance-type rate schedule. And we've seen separations, interest in separations at least, by age and gender, or one rate for all ages and genders. We haven't seen any desire to split rate based by occupation class.

So, now you've got your claim costs, but everybody knows that claim costs are only a part of the puzzle. Cost-plus pricing, we don't see a lot of interest in that because of the structure of the rate. There's no asset share testing. It's priced on a more traditional cost-plus basis, perhaps a component base rating method, like the credit insurance companies are advocating as being the claim cost plus the expense cost, divided by one plus investment income less taxes less profit less commissions. There are no taxes on this, except for the profit margins and the commission margins. And that's the approach that we've seen taken on this. There's not a lot of science. There's no risk-based capital. There are no reserve requirements, although almost certainly there will be when the OCC promulgates their regulation on single premium, and perhaps on disabled lives as well. Claims in process will probably need to be reserved, but we don't know where that's headed—at least I don't, as of right now.

So the commission level, remember we call that retention now, and then the margin for adverse deviation and profit, you lump those together and come up with a cost-plus sort of rating formula. If you're using a contractual liability policy—for which we see a lot of interest in the smaller banks; smaller meaning non-humongous, and the credit unions have a keen interest in not having that risk on their books—if they're using a contractual liability policy to place the risk in the hands of an insurance company, their margins are guaranteed in advance, or once the contract is written. Certainly, the cost of the contractual liability policy may change from time to time, but they will have a chance to change their rate schedule to properly adjust for that without going through a regulatory process, which makes it a lot more responsive.

The loss ratio pricing, we've all done it on health insurance that required loss ratios. Loss ratio pricing has been used in the United States, certainly, to set credit insurance rates. It can be used. We've seen this, where costs are all developed as a percentage of anticipated premium, especially for packaged type products, and you just say, "Well, here's what we want as a claim ratio," and you divide the claim cost by that intended ratio, and there it is. The other is the competitive analysis, and one thing that we need to caution ourselves in is that all of these have different benefit variations, especially on the life event side—maximum benefit period, involuntary unemployment. We see a lot of people "spreadsheeting" their debt-cancellation program. So, what does this group offer? What does that group offer? And the competitive analysis is definitely done, especially by those that are looking to sell their services directly to the banks and other financial institutions in exchange for, say, administrative fees.

You have to manipulate it. You have to have it available. There are spreadsheets. Certainly, companies have put together their own spreadsheets. We're aware of some other consultants that have put together spreadsheet-oriented programs, customized programs, with a claim cost database behind an interface that could be written in, say, Visual Basic, or something like that. And you design your debt cancellation program, and it works with those claim costs, and, if it's put together properly, a final gross rate that's charged to the insured that also includes the waiver of charges cost is produced. Once again, with regard to competitive position, I'm sure there are people out there just targeting the competition, saying that if they're charging that, then we must be able to, too, because of lack of data or just because of lack of first-hand information.

Special market considerations—we talked about the over-age market—certainly home equity lines of credit versus installment. You have to be careful who you're selling this to, a Cadillac dealer versus a Chevy dealer. Particularly in the over-age market, you want to be careful to offer appropriate benefits. Birth and adoption to the Silver Fox Club is not going to have a lot of appeal, most likely. Involuntary unemployment may not have a lot of appeal to some of the older age groups, as well. Usually at that point, and we've observed this in the involuntary unemployment claim costs as well as the nationwide statistics, unemployment is low in those groups. Bank clubs, credit unions, obviously credit unions can serve a particular community or a particular industry, and you need to be careful of those. 'In a small market dominated by a given industry, involuntary unemployment and disability may be very much affected by these factors.

And in implementing the results, like I say, it pays to look ahead to see what the financial institution that you're going to be offering this through wants and needs as a rate structure. You must balance equity with simplicity. I don't think any of us would argue that claim costs are the same throughout all ages, but that's what credit insurance has done in the past, and some financial institutions will still require it. There are limitations to the existing computer systems, where perhaps they should be offering age-rated outstanding balance on their home equity lines of credit. Their existing computer systems just can't do it right now, and that's what we're going to have to live with. We're just going to have to be able to record and react.

There are some third party administrators out there that are looking at taking over the traditional role of the insurance company as administering. I believe they will control some of the market, and they will have some services for claim development. Obviously, if you can lay off the risk at a cost that you feel is lower than what you can absorb internally, that may well be a wise course and something to suggest to a financial institution that may be a little squeamish about the risk it's putting on its books.

So I'm going to leave you with a few final thoughts. It is a new world. There are a lot of things opening up in terms of benefits. They're consumer-friendly benefits. They're things that people see as happening to them. I may have a birth, I may have a divorce. I may want to take a leave of absence from work...those sorts of things. I think we have an opportunity to be very consumer-friendly in the way that we design these things. And to the extent that we can stay away from the very silly things, I think that we should probably do that, too. But the financial institutions are the retailers, and they buy from the best wholesalers. And they've always done that in a way, especially on the large bank market, if they have a captive insurance, they're shopping for the insurance company that will give them the lowest administrative or net cost. If there are people who go out to the general bank market who are selling administrative services and contractual-liability policies to take the risk off their books, they're going to look at the total cost of taking that risk off their books, and they're going to add their own margins on top of that and set their price. That's how they're going to become retailers. No longer is the state setting the rate, and everything has to fit within that. The financial institutions, no doubt, are going to be looking at their net-cost claims plus administrative costs and adding their own margins onto that.

Get used to saying, "Yes, we can insure that." I think we've talked about that before. Any new market is going to call for discipline in pricing, compensation competition. Every time there's a new market, I think we have another chance to do it right, to make sure that the financial security of our programs is there, and I think this is especially true in the debt cancellation area. Like I mentioned, third party administrators may not be as savvy as we are in establishing these rate levels. They may be jumping in, based only on where the competitive levels are. And I think we have to be aware of that, and as educated and conservative people, advise our financial institutions accordingly.

When we say it's a new world, I do want to stress that people like Mr. Jannarone at Assurant Group are not out of business. As a matter of fact, there are quite a few similarities in, say, a large bank group, between what's happening now in debt cancellation versus what happened before. A bank might have a captive insurance, either offshore or an Arizona-based one. They contract with an insurer. The only thing that we've done is remove the two insurance companies; we're funneling the risk back to the bank, whether they dispose of it through a contractual-liability policy, or not. The insurance company is still the keeper of the data, the administrator, the claims adjudicator, and they're taking a lot of the same types of responsibility that we were. So the insurance industry can preserve its place, and I think, in order for us to maintain that place, we have to add value. Adding value, in this case, means being flexible, having the data, using the data properly, and advising our client banks and financial institutions into having sound programs that do what credit insurance used to do.

MR. JANNARONE: We will now open the floor to questions.

MS. LISA HENRY: On coverage like marriage, would being engaged be a preexisting condition, if you've got a year-and-a-half engagement and you've got a six-month eligibility period? It seems like that's way too open to anti-selection.

MR. HAUSE: Right, and that's where we see the eligibility waiting period. For instance, on a life-event coverage, such as marriage, there may be a nine- or 12-month eligibility waiting period, and that's how that's controlled right now. You're absolutely right. If I'm planning to adopt, and if I know my child is going to be enrolled in college, there's definitely a real risk there. To the extent that these types of coverage are bundled, that helps smooth that out a little bit. If, in order to get the marriage benefit, you have to buy life and disability and IUI as a package, that helps you smooth out that anti-selection, but that's where the eligibility waiting period comes in, both on advances on revolving lines, as well as installment, from inception of the loan.

MR. JANNARONE: And also, when you talked about a marriage benefit it's probably not to cancel the full loan. Let's say it's on a credit card with a $2,000 balance. The marriage might provide a three- or six-month benefit of the minimum payment, which might be 2 percent. So you're talking about $40 a month, not a $2,000 benefit.

FROM THE FLOOR: As you're aware, the auto-dealer industry is a major component of credit retailing. Do you foresee the auto dealers using debt cancellation or debt protection, given that they're neither a bank nor a credit union or even a finance company?

MR. JENTZ: The place that we see it most, and again coming from the credit-union side, credit unions do what's called indirect lending, which means that they have the dealerships in their city act as an agent to write loans for their members. So then we have a contractual liability policy set up. We have debt cancellation set up with that particular credit union. And the dealerships can then sell debt cancellation to those members who have purchased a car and then financed it through the credit union.

FROM THE FLOOR: But don't you have situations where most of your dealers are not financing through one organization? They may have five or six lending institutions they're funneling it through, so they're going to lose consistency where this one will do debt protection, but this one won't, and so forth. It's going to get ugly, isn't it?

MR. JENTZ: Well, we see it as an advantage, as least for credit unions, because the dealerships can then offer it just on those loans that are underwritten and are for the members of that credit union. They can't offer it on their other loans. And on the indirect lending side, again, the dealer's just acting as an agent for the credit union. So they can go ahead and offer this product. They know up front that that member is going to purchase the car and that they're going to finance it to the credit union. They're eligible to buy debt cancellation.

MR. JANNARONE: It's also with any lender, whatever the dealers are using to offer the loans is really where that's going to go through. This starts to get messy legally, and we really didn't touch a lot on the legal issue, partly because we're not experts and, second, because it is very uncertain. We're looking at moving a company in between the dealer and the lender so that the dealer would actually issue the loan through one source and then have that filter through the lenders. That's another possibility but, again, very, very uncertain legally.

MR. HAUSE: I have seen an opinion written by a lawyer—and I'm in no way qualified to determine how valid it was—that insisted that the auto dealers are, in fact, empowered to offer debt cancellation. It appeared to be the first proclamation of this sort that I've seen. I was rather surprised to see it, and I have no idea how valid it is, but there has been an opinion expressed to that effect.

MR. JANNARONE: Also, as the regulatory environment continues—right now it's clear on national banks, it's clear on credit unions, what about the other banks? Is it really fair that national banks are treated differently? I think, as this evolves, there's going to be more federal regulation to say who is and who is not allowed to move into debt protection.

MS. HENRY: Is there a consumer education rollout of any kind where we say this is an alternative credit insurance, because it's had such bad press? How do we convince a person that's buying into this that it's not the credit insurance they've heard so much about?

MR. JENTZ: Our rollouts have been limited. Obviously, it is a training issue. The other part of this thing is that the products, when we have sold debt cancellation, the financial institution has continued to sell credit insurance side-by-side, and I think that that's where the consumer can truly see the difference. You can have credit insurance. Here's what that looks like. It's a death benefit. It's a disability benefit. The beauty of debt cancellation is that they can call it their own product. Credit unions call it their loan-protection product. You can trademark the name of the product. You can call it something different. You don't have to use the word insurance. And it looks totally different. It has an unemployment benefit. The products we've been selling are usually six months of benefits maximum. The pricing is much less than full-credit life and disability. So, that's what distinguishes the product.

MR. HAUSE: And as far as bad press goes, and consumer groups, the debt cancellation industry is not going to escape the same types of criticism that credit insurers have been enduring for quite some time. Any of a number of consumer groups that we've heard from have already made proclamations about debt cancellation insurance and how, because of the lower level of regulation, it could be a more dangerous abuse of consumer rights.

MR. CHRISTIAN LEE: Along that same line of thought, as debt cancellation grows, do you think it will gain more scrutiny from regulators and become just a new credit insurance?

MR. JANNARONE: Currently, there is a battle going on between the federal agencies and state insurance departments. Some states say debt protection should be regulated; the states have the power to regulate debt protection. The OCC and other federal groups have basically said, "Don't even try." This may develop later into some sort of a legal fight between the two. The consumer-advocate groups will continue to make noise. They may push for more federal regulation. The OCC is looking at additional regulation. I think that, definitely, in the future there will be a lot more regulation. Do you want the federal government to really regulate—because it can get even more burdensome than the states? So, we'll have to see on this. It probably will be a couple of years before it gets interesting.

MR. HAUSE: One of the things that we've heard is that the OCC is most concerned about banks offering adequate rates, that they rate it properly and reserve it properly. They do not want this to be a loss leader or loss source for a bank, which is a rather marked departure from the direction that the state insurance departments have taken, that it is their duty to push the rates as low as possible. I think the OCC actually will be pushing in a different direction, making sure that the rates, as well as any reserves that are set up, are adequate for the benefits provided.

MR. AHMAD KAMIL: These financial institutions and credit unions that write this debt cancellation business, do they typically take the risks themselves or do they insure it with an insurance company? Do they pass on the risk? And for the ones that take on the risk themselves, are there some guidelines on how they manage this contingent risk, on things like reserving and so on? Are there any guidelines?

MR. JANNARONE: The accounts that we've been involved with have been the largest accounts that we have, typically. Those accounts on the credit side had the business reinsured where they were taking the risk. When they moved to debt protection, typically they do not have contractual-liability policies where they transfer the risk to insurance companies. They have a pretty good idea of the profitability of the product and are willing to take that risk. In most of the examples, it's a monthly fee product, which would not have the large mortality reserves or unearned premium reserves, statutory reserves. So the only reserves would be claim reserves, and they've really handled that on their own. I don't think solvency is really a concern at this point with these products.

MR. HAUSE: However, we see a lot of interest in the credit unions, especially the smaller ones, and the smaller banks, of using contractual-liability policies to keep those liabilities off their books, and those are contractual-liability policies that are written through property and casualty insurers by and large. And we're presuming that those property and casualty carriers will know how to handle the risk and will be properly regulated.

MR. JANNARONE: There was an issue with securitization of the loans. Could the banks securitize the loans if there was residual risk? Several companies have looked at contractual-liability policies merely to get rid of that residual risk, so they can securitize the loans. Others felt that that was not a problem.

FROM THE FLOOR: I used to regulate credit insurance for the Virginia Insurance Department 20 years ago, so this is interesting. One question I have is on accidental death. Are we seeing companies offering this kind of coverage on mortgage insurance for accidental death? And, if so, are they limiting the face amounts?

MR. HAUSE: I have not worked with but one or two mortgage lenders on an experimental nature. There certainly is a lot of interest in limiting the face amounts, across the board. And with regard to mortgage insurance, $100,000 has been suggested. Obviously, with accidental death, we would strongly advise them to seek contractual liability coverage. That's just too erratic a risk, we believe. But I don't have a lot of experience in actually implementing mortgage plans as yet, but we'll see what comes out of that.

FROM THE FLOOR: And a follow-up question. Have you heard anything from the New York or Pennsylvania insurance departments as to how they feel about this type of coverage?

MR. HAUSE: Well, we certainly heard from Texas. They aren't as taken with it as we are, but there are certainly some folks who are insisting that this is insurance, and the regulators feel that their hands are being tied in not being able to regulate this as insurance.

MR. JANNARONE: I've heard of no state insurance department that is directly challenging the federal government's authority on this, but several are keeping the right to do so in the future.

FROM THE FLOOR: With the different premium schedules, you mentioned the periodic and then the single premium—with the single premium, what kinds of refund features do you have? And, secondly, since this isn't a separate insurance contract, it's an addendum to the loan, when somebody wants to terminate, how do they handle that administratively? Just stop paying premiums, and the addendum goes away?

MR. JANNARONE: Regarding the first part on single premium, it's really up to the lender. Some have even talked about not having a refund feature, that that would just be agreed upon. I saw one paper that said that if you do have a no-refund feature, you must also offer a separately priced product with a refund feature. But on the method for paying refunds, that's really open to the lender. I have not seen as much on the single-premium side as on the monthly side, and I think that the single-premium side will become larger in the future, definitely. But it's not really clear whether or not there will be regulations on how the refunds are handled.

MR. HAUSE: So far we have seen pro rata refunds suggested, with the exception of the life-insurance risk. Because of the critical-period nature of most of the benefits, it really is almost a level benefit, and pro rata is what we've discussed, more often than not.

MR. JANNARONE: And with a lot of the programs eliminating the life benefit, then you're only looking at the disability/unemployment-type critical-period benefits. So that would tend to make it more level. A life benefit, which over, let's say, a five-year closed-end loan would have a significant decrease in the amount from the beginning to the end, may need a different type of refund method.

The second question, there's wording in the addendum to almost separate the two items to say that if you no longer pay the fee for the debt protection, then you no longer get the benefits associated with that. But the loan can continue even though you cancelled the debt-protection portion.