CREDIT-RELATED PROPERTY AND CASUALTY INSURANCE

by

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Introduction and Use of the Book

Early insurers of credit-related insurance were life insurance companies. The first credit-related product was credit life insurance, and an insurance company had to be licensed as a life insurance company to issue credit life insurance. Credit disability insurance was introduced later and could be issued by a life insurance company or a property and casualty (P&C) insurance company. It was a logical step to use the existing credit life insurance company to issue credit disability insurance.

Over time, the need for property and casualty insurance products slowly emerged in the credit marketplace. An interesting variety of products has evolved to meet the specialized needs of the credit marketplace. Most products are borrowed from the broader insurance world, but they have been tailored to meet the needs or administrative systems of the credit marketplace. Single premium credit property insurance and some forms of collateral protection programs have been around for many years, but the other products in this book have emerged since 1980.

The credit-related insurance world consists of niche products that span the life insurance and P&C insurance worlds. These products protect against perils that are property insurance or casualty insurance in nature, but product design and marketing set them apart from their P&C counterparts. Actuarial pricing and reserving techniques are relatively simple as compared to other P&C products. The techniques are common to health insurance and disability income insurance that reside in the life insurance world. For this reason, a growing number of states are permitting a life insurance company to write one or more of these products.

The published literature about credit-related insurance primarily addresses credit life and disability insurance and gives only limited attention to P&C credit-related products. We have attempted to fill this void. In doing so, we faced several challenges. The primary challenge was organizing the products into a coherent structure. Each product shares many characteristics with the others, but the shared characteristics vary from product to product.

In the end, we chose to err on the side of redundancy. We have tried to make each chapter capable of standing on its own. As such, anyone reading the book straight through will find substantial redundancy. Read carefully, as many of the sections that appear to be repetitive contain subtle differences.

The lesser challenges involved finding the time to produce a quality document for a specialized (and small) audience. The span of products is growing. We could not include every product or every variation in the products covered. Terminology also presented some issues. The credit-related insurance industry tends to use life insurance terminology that a property and casualty professional may find confusing (anti-selection versus adverse selection, claim reserves versus loss reserves). We have used P&C terminology, except when describing life insurance products. We have used the word *producer* to refer to the organization that presents these products to the borrower. Producers include automobile dealers, banks, credit unions, finance companies, retailers, and other organizations.

Finally, we did not do it alone. The Acknowledgements section provides more detailed acknowledgements of the contributions of others, but many professionals in the industry provided valuable knowledge, commentary, and encouragement.

Gary Fagg
Joe Fairchild

December 29, 1997

Chapter One

Overview of Insurance on Open-End Credit

Definitions

Open-end credit is consumer credit under which the amount of credit extended may be increased at any time by additional borrowing up to the account's credit limit. The term of the credit is not fixed. The borrower makes monthly payments in any amount ranging from the creditor's required minimum payment up to the outstanding balance of the credit.

Credit life insurance on open-end credit is monthly premium, monthly renewable term life insurance purchased in conjunction with open-end credit that provides a benefit if death occurs during the month. The benefit is the outstanding balance of the credit on the date of death.

Credit disability insurance on open-end credit is monthly premium, monthly renewable loss of income insurance purchased in conjunction with open-end credit that provides a monthly benefit while the insured is totally disabled, up to the limits specified in the policy. The monthly benefit usually equals the minimum monthly payment due under the open-end credit obligation on the initial date of disability.

Credit involuntary unemployment insurance (IUI) on open-end credit is monthly premium, monthly renewable loss of income insurance purchased in conjunction with open-end credit that provides a monthly benefit while the insured is involuntarily unemployed, up to the limits specified in the policy. The monthly benefit usually equals the minimum monthly payment due under the open-end credit obligation on the initial date of involuntary unemployment.

Family leave insurance on open-end credit is monthly premium, monthly renewable loss of income insurance purchased in conjunction with open-end credit that provides a monthly benefit during an unpaid leave of absence from employment resulting from specified causes, up to the limits specified in the policy. The monthly benefit usually equals the minimum monthly payment due under the open-end credit obligation on the date that the leave begins.

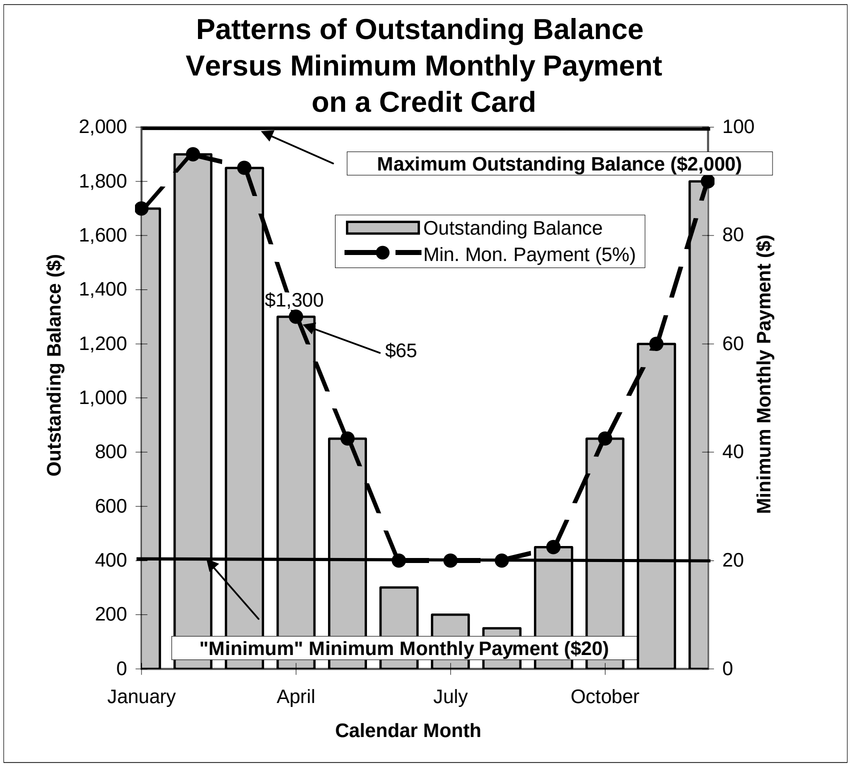
Credit property insurance on open-end credit is monthly premium, monthly renewable property insurance purchased in conjunction with open-end credit insuring consumer products that are bought via the credit (or pledged as collateral) against specified loss occurrences causing damage to, or disappearance of, the property. The benefit is repair or replacement of the property. It is also called MOB credit property insurance.

Open-End Credit

The use of open-end credit in the consumer marketplace continues to exhibit steady growth. Credit card borrowing is the primary example of this type of consumer credit. If the card is valid, consumers can borrow cash or charge purchases up to their credit limit. The amount of credit can be increased at any time up to the credit limit. Retailers' revolving charge cards operate on the same principles, but cash advances are not permitted and all purchases must be made from the retailer. Most credit union credit is structured as open-end credit. Some finance companies structure their credit as open-end credit.

In the 1970s, banks introduced the concept of a **personal line of credit**. This was comparable to a credit card with a higher limit. Once the line of credit was established, the borrower could use the credit at any time up to the approved limit. Early lines of credit were established based on the borrower's net worth. Lines of credit were not widely used until the mid-1980s when **home equity lines of credit** became popular. A homeowner applies for a line of credit based on the equity in the borrower's home. **Equity** is the value of the property in excess of any indebtedness (generally a first mortgage). The property is pledged as collateral. Once the line of credit is approved, the borrower may use the credit at any time for any purpose, up to the approved limit. Banks, credit unions, and finance companies now extend a significant portion of their consumer credit under home equity lines of credit.

Open-end credit requires a minimum monthly payment based on the balance of the account and other terms of the credit obligation. Each month, the borrower makes a payment ranging from the minimum payment up to the outstanding balance of the account. The minimum monthly payment is a specified percentage of the balance on the billing date, such as 5%. If the balance is $1,300, the minimum monthly payment is $65. Most agreements specify a minimum dollar amount also, such as $20. Using 5%, the calculated minimum monthly payment on a $300 balance is $15, but a $20 payment would be required. Revolving charge cards often vary the percentage based on the level of the balance, such as 10% of the first $200, then 8% of the next $300, then 5% on the remainder of the balance, with the total amount subject to a $15 minimum.



Sample Credit Card Monthly Balances and Minimum Monthly Payments over a Year. For example, in April the balance was $1,300 and the minimum monthly payment was $65 [= 5% x $1,300].

The typical insurance benefit is defined in this book *as the minimum monthly payment due on the date of loss*. Technically, it is unlikely that a payment is due on this date. A more complete description of the benefit is *the minimum monthly payment calculated based on 1) the balance on the date of loss, and 2) the terms of the open-end credit obligation.*

Insurance on Open-End Credit

In most states, the typical credit card or revolving charge card insurance program is a package of life, disability, and involuntary unemployment insurance. Family leave insurance is a common addition to the package. Cardholders are offered the opportunity to enroll during the credit application process, by card carrier in the letter containing the newly issued card, by subsequent mail solicitation, by billing inserts, or by telemarketing. After enrollment, insurance is automatically renewed each month, unless the card privilege or the insurance is terminated. The grid below displays typical packages.

Producer	Type of Credit	Typical Insurance Offered
Bank	Credit Card	Life, Disability, IUI, Family Leave
	Personal Line of Credit or Overdraft Checking Protection	Life
	Home Equity Line of Credit	Life
Retailer	Revolving Charge Card	Life, Disability, IUI, Property, Family Leave
Credit Union	Member Loan Accounts	Non-Contributory Life or Member-Pay Life; Member-Pay Disability

All types of open-end credit share the characteristic of variability. An upper limit is established, and the outstanding credit can vary daily from zero to the full credit limit. Credit-related insurance regulations were designed for installment credit and limit the amount of insurance that can be sold to the amount of indebtedness at any point in time.

Given the variability of the conditions of open-end credit, a single premium is not appropriate, so an alternative premium method is used—**monthly outstanding balance (MOB)**. The premium is levied monthly on each monthly billing date. MOB premium rates are expressed per $1,000 of insurance in force in most regulations, per $100 of outstanding balance in most literature, and per $1 of balance for actual premium calculations.

Each month, the MOB rate per $1 is multiplied times the "balance"—either the outstanding balance of the account on the account's billing date, or the average of the daily credit balances during the previous month. The resulting premium is included in the charges for the month on the borrower's monthly bill. The creditor totals the premiums of all insured borrowers and remits the premium to the insurance company.

For example, if the MOB premium rate is 60¢ per $100 per month (60¢/$100/month) for the package of life, disability, and IUI, and the borrower's balance is $1,250, the monthly premium is:

(60¢ per $100) x ($1,250 / 100) = $7.50

Credit Life Insurance

The life insurance product is monthly renewable term life insurance. When the credit limit is under $10,000, the death benefit is usually the outstanding balance of the account on the date of death.

For accounts with credit limits in excess of $10,000, the definition of the death benefit has been modified in recent years because of **anti-selection**. Anti-selection is the tendency of people to buy insurance products when they believe that they have a higher-than-average probability of a loss. For example, a borrower could learn of a serious or terminal health condition and immediately exercise the full credit line. To protect themselves from anti-selection, insurers may impose conditions on the determination of the death benefit on open-end credit. For example, some policies impose a life pre-existing condition exclusion. A charge (or cash advance) is not covered if the insured dies within six months following the charge for a condition that the insured was treated for during the six months preceding the charge.

An alternative is a setback provision. The death benefit at all times is the balance of the account a certain number of days prior to the date of death. Ninety days is a common setback period.

Virtually all credit life insurance is offered at the same premium rate throughout a particular state. One rate is charged for all ages and both sexes. Ordinary life rating distinctions—age, sex, smoker/non-smoker, and occupation class—are not reflected in the premium rate charged for the product. In recent years, a few age-banded products have been introduced for home equity lines of credit.

Premium rates vary by state reflecting the differences in state prima facie rates. A typical rate is 8¢/$100/month for single life coverage and 13¢/$100/month for joint life coverage. Some programs insure both the cardholder and a co-cardholder (if any) or both cardholder and spouse (if any). The premium rate may be the joint rate or a blended rate reflecting the expected percentage of cards with two insureds.

Credit Disability Insurance

This insurance is monthly indemnity, monthly renewable loss of income insurance. Thirty-day retroactive coverage is the most common plan. A benefit begins after 30 days of disability, and benefits are retroactive to the first day of disability. Fourteen-day retroactive coverage and lump sum benefits are also offered.

The disability benefit typically equals the minimum monthly payment as defined in the credit obligation. In recent years, some creditors have reduced the minimum monthly payment percentage to a level just sufficient to cover the required interest and insurance charges. To provide a more substantial benefit, some insurers provide a monthly benefit that is the greater of: 1) the minimum monthly payment, or 2) the balance times a stated percentage, such as 5%. However determined, this dollar amount becomes the benefit that is paid each month for this disability.

This level monthly benefit continues until a maximum benefit is reached, generally defined as the outstanding balance on the date of disability or a stated number of monthly benefits. For example, consider a credit obligation that has a minimum monthly payment of 5% and a claimant that has a balance of $1,000 on the date of disability. The disability benefit is $50.00 per month. A claimant may receive up to 20 benefits [= $1,000 / $50] before the maximum [= $1,000] is reached. Benefits also terminate anytime the balance is paid off.

In most cases, the definition of disability and the claim adjudication process are comparable to the standards used for installment credit. Benefits are paid as a direct credit (or reduction) on the card billing statement. The cardholder may continue to use the card, but purchases after the date of disability are not usually covered.

Premium rates vary by state reflecting the differences in state prima facie rates. A typical rate is 20¢/$100/month.

An alternative seen in the retail market is 90-day coverage. If the insured remains disabled for 90 days (the “qualifying period”), the outstanding balance on the date of disability is paid as the benefit. The coverage is more expensive than monthly indemnity, about 50¢/$100/month.

Involuntary Unemployment Insurance

Involuntary unemployment insurance (IUI) pays a monthly benefit if the insured becomes *involuntarily* unemployed. The cause of unemployment must be involuntary, such as layoff, strike, termination for cause, or business closing.

The coverage often matches the credit disability coverage. Thirty-day retroactive coverage is the most common plan. A benefit begins after 30 days of involuntary unemployment, and benefits are retroactive to the first day of involuntary unemployment. Fourteen-day retroactive coverage and lump sum benefits are also offered.

The involuntary unemployment benefit typically equals the minimum monthly payment as defined in the credit obligation. In recent years, some creditors have reduced the minimum monthly payment percentage to a level just sufficient to cover the required interest and insurance charges. To provide a more substantial benefit, some insurers provide a monthly benefit that is the greater of: 1) the minimum monthly payment, or 2) the balance times a stated percentage, such as 5%. However determined, this dollar amount becomes the benefit that is paid each month for this occurrence of unemployment.

This level monthly benefit continues until a maximum benefit is reached, generally defined as a stated number of monthly benefits or the outstanding balance on the date of involuntary unemployment. IUI plans are more likely than disability insurance to have a stated maximum number of benefits, such as twelve. Benefits also terminate anytime the balance is paid off.

In most cases, qualification for benefits only requires proof that the insured qualifies for state unemployment benefits. Proof of continued unemployment must be submitted monthly. Benefits are paid as a direct credit (or reduction) on the credit card billing statement. The cardholder may continue to use the card, but purchases after the date of involuntary unemployment are not usually covered.

Only a few states have promulgated prima facie rates for IUI. In most states, the insurer must file a rate and provide actuarial justification that the rate is reasonable. A premium rate of 39¢/$100/month is common.

An alternative seen in the retail market is 90-day lump sum coverage. If the insured remains involuntarily unemployed for 90 days (the “qualifying period”), the outstanding balance on the date of unemployment is paid as the benefit. The coverage is more expensive than monthly indemnity, about $1.00/$100/month.

Family Leave Insurance

In 1993, the Family and Medical Leave Act was enacted requiring large employers to offer an unpaid leave of absence for up to 90 days in the event of certain family situations—sickness of a family member, birth, and adoption. Insurers began to file policies, riders, and endorsements that provided benefits for events closely resembling the situations covered under the act. It is not necessary for an insured to be covered under the Family and Medical Leave Act to qualify for the insurance benefit.

To qualify for the benefit, the insured must take an unpaid leave of absence from work. The employer must provide a written statement that the unpaid leave has been taken. The leave must be associated with one of the following events:

- Birth or adoption of a child
- Accident or sickness of an immediate family member (spouse, natural or adopted child, or parent) that requires the insured to attend to the family member's needs

Some insurers include leave associated with living in a federal disaster area, being recalled to active military duty, or being called to jury duty.

The insurance is monthly indemnity, monthly renewable loss of income insurance. Thirty-day retroactive coverage is the most common plan. A benefit begins after 30 days of unpaid leave, and benefits are retroactive to the first day of leave. Insurers have offered plans with maximums of three monthly benefits and six monthly benefits.

The monthly benefit typically equals the minimum monthly payment as defined in the credit obligation. In recent years, some creditors have reduced the minimum monthly payment percentage to a level just sufficient to cover the required interest and insurance charges. To provide a more substantial benefit, some insurers provide a monthly benefit that is the greater of: 1) the minimum monthly payment, or 2) the balance times a stated percentage, such as 5%. However determined, this dollar amount becomes the benefit that is paid each month for this leave of absence.

Adverse selection appears to be a concern, but several cost containment measures are in place. The provision that the leave must be unpaid acts as a severe deterrent to taking a leave just for insurance benefits of $20-$50 per month. In addition, benefits are limited to three or six months, greatly reducing the exposure.

Credible loss experience has not emerged, so pricing has been based on a high degree of judgment. Current rates are about 12¢/$100/month for the three-month benefit and about 16¢/$100/month for the six-month benefit.

Credit Property Insurance

Revolving charge cards offered by retailers, such as furniture or department stores, are the primary vehicles for this insurance. Credit cards and open-end credit obligations used exclusively for the purchase of consumer products are also possible candidates for the sale of monthly premium credit property insurance. In a typical program, credit property insurance is offered as a part of a package of life, disability, and involuntary unemployment insurance.

If a consumer product is purchased from a retailer using a revolving charge card, insurance protection is usually provided for a stated period, such as 36 months from the date of purchase. A claim will be paid if any of 19 standard perils occur, including burglary and damage by fire. At the insurer's option, the damaged consumer product is repaired or replaced. Insurance protection is from the first dollar, or is subject to a small deductible for burglary, such as $25.

Another market application of monthly premium credit property insurance is open-end credit that is secured by property. A consumer finance company offering open-end, general-purpose credit that is secured with a collateral asset is one example.

Only a few states have promulgated prima facie rates for monthly premium credit property insurance. In most states, the insurer must file a rate and provide actuarial justification that the rate is reasonable. A premium rate of 29¢/$100/month is common.

Other Applications

Any industry having a monthly payment obligation collected via a billing system that can serve as a product delivery system is a potential market for monthly premium disability insurance, IUI, or family leave insurance. Examples of industries and the monthly payment obligation include: oil companies and gasoline credit cards; monthly bills for cable TV and satellite dish services; and monthly-billed utilities, such as electricity, telephone, gas, and water.

Since no credit obligation exists, these products fall outside the scope of credit-related insurance regulations. Products for these markets may be subject to different rules concerning rates, forms, licensing requirements, and other product parameters. Some of these industries also have their own rules and regulations governing the sale of ancillary products.

Chapter Two

Credit Disability Insurance on Open-End Credit

Definition

Credit disability insurance on open-end credit is monthly premium, monthly renewable loss of income insurance purchased in conjunction with open-end credit that provides a monthly benefit while the insured is disabled, up to the limits specified in the policy. The monthly benefit usually equals the minimum monthly payment due under the open-end credit obligation on the initial date of disability.

Policy Structure

This insurance is generally written under a master insurance policy or a group insurance policy. The creditor is the policyholder (master policyholder or group policyholder). A borrower of the creditor who elects insurance becomes an insured borrower or a certificateholder and receives a certificate of insurance.

Many policies have a “30-day free look” provision. This provision allows the borrower to purchase the insurance, think about it for 30 days, and, if not satisfied for any reason, cancel the policy during the 30-day period without any obligation.

Eligibility for Insurance

Only the primary borrower is eligible for disability insurance in most policies, but joint disability insurance protection is being offered. An “actively-at-work” requirement is common. The borrower must be working for wages a minimum number of hours per week in accordance with the terms of the policy, such as 30 hours per week. Some insurers have more liberal policies that do not have an actively-at-work requirement.

The Insured Event

Benefit payments are made to the creditor when the insured borrower loses employment income as the result of total disability caused by accident or sickness.

The Underlying Credit

Disability insurance can be offered with most open-end credit obligations, but it is usually offered in conjunction with credit limits of $10,000 or less and maximum monthly payments of $500 or less. Credit obligations that fit into this category are:

- Credit cards (banks)
- Revolving charge cards (retailers)
- Unsecured personal lines of credit or overdraft checking protection (banks, credit unions, finance companies)
- Home equity lines of credit (banks, credit unions, finance companies)

Credit limits continue to increase, and a number of credit card programs have reached the $10,000 level. Gold and platinum cards have limits from $10,000 to $25,000. Personal lines of credit and real estate secured programs have much higher credit limits, but few insurers have been willing to offer a disability product for these programs. Disability insurance generally insures the full minimum monthly payment, but some policies have internal limits that define a maximum monthly benefit.

Markets and Marketing

The market for credit disability insurance has grown dramatically in recent years. All financial institutions making open-end credit obligations can potentially offer disability insurance, including banks, credit unions, and finance companies. Most financial institutions offer this product in one form or another. Retailers market the product extensively.

The Insurers

Independent insurers offer the product through a variety of creditors and retailers. To participate in this marketplace, an insurer needs approved forms in almost every state, since a producer's cardholders may be spread over a large number of states.

The direct writing insurance company may be licensed as a life insurer or as a property and casualty insurer. A number of insurers issuing disability insurance are owned by or affiliated with a retailer or a creditor, such as a bank or a finance company. By federal law, a bank holding company or a subsidiary is specifically authorized to offer this product, and an affiliated insurance company can underwrite the product.

Underwriting Criteria

For Borrowers. As with most credit-related insurance, the disability insurance underwriting process piggybacks on the credit underwriting process. If the cardholder's financial condition passes the creditor's normal credit risk analysis, the creditor approves the credit limit. Typically, specific underwriting for disability insurance is not done, except for a maximum age. Applications from all eligible insureds with open-end credit accounts in good standing are approved.

This underwriting process succeeds because the creditor's credit risk analysis adequately serves as a disability risk analysis. Consequently, it is important that the creditor maintain the quality of its credit risk analysis on insured credit.

For Creditors. Insurers underwrite at the group level for this product by considering the financial condition of the policyholder, the nature of the underlying credit obligations, and the financial profile of the policyholder's customers. Since the product is tied to the quality of credit extended by the financial institution or the retailer, the insurer's interest is reasonably well protected.

Term of Insurance

For Borrowers. The inception dates of the credit and the disability insurance do not need to coincide. Insurance can be offered at the time the credit application is taken, at the credit closing (if applicable), or via direct response marketing techniques, such as direct mail, card carriers, billing inserts, or telemarketing.

Most applications for open-end credit are simple brochures. They are available to customers at "take away" displays or sent by mail. The insurance is mentioned, and the applicant has the opportunity to elect the insurance. A portion of the brochure contains a surprising quantity of disclosures and information about the insurance products. If elected, the insurance becomes effective as soon as the credit is approved.

Existing accounts are solicited for the insurance by mail and telemarketing. If the cardholder elects insurance, some insurers make the insurance effective immediately. They generally provide free insurance for the partial month and do not levy a premium until the end of the first full month of insurance. Alternatively, the initial date of insurance is the monthly billing date following election of the insurance by the borrower.

Each month, the insurance is renewed when the monthly premium is paid. Since the premium amount is calculated on the basis of the balance, the insurance can be renewed and remains in force as long as there is a balance. The term of the insurance is not limited if the open-end credit is active, has a balance, and monthly premiums are current. Insurance is suspended when the open-end credit balance is zero, but it is automatically reactivated when additional charges are made.

If the borrower cancels the insurance, the insurance ceases; however, the open-end credit remains available. If the credit is canceled, all insurance ceases. Insurance is structured 1) to cease immediately without a charge for the final partial month of insurance, or 2) to cease at the end of the billing month in which the cancellation occurs.

Most policies have a maximum age limit for insurance. All insurance generally ceases on the first billing date after the borrower attains age 66, unless a state requires a higher maximum age.

The premium is charged at the end of the month of insurance, i.e., "monthly in arrears" premiums. The premium rate is multiplied times either the outstanding balance on the billing date or the average daily balance during the preceding month.

Benefit Conditions

Benefits vary significantly based upon the particular disability insurance policy. The general structure of the benefits provided, eligibility to receive benefits, elimination periods, and policy maximums are described below. Alternatives are shown in *italics*.

Benefit Provided. The policy benefit is paid for any billing date that occurs during the period of disability. Only whole monthly benefits are paid.

- *Alternatively, a daily benefit may be provided for partial months of disablement.*

The monthly benefit is a <u>level</u> dollar amount that is determined as of the date of disability. It equals the minimum monthly payment, as defined in the credit obligation, on the date of disability. A credit card might define the minimum monthly payment as 3% of the balance, subject to a $20 minimum. Subsequent charges to the card do not affect the monthly benefit.

- *Alternatively, the benefit may include the insurance premiums falling due during the period of disability.*
- *Alternatively, subsequent charges are included in the calculation—a "keep charging benefit." (This benefit is only granted in conjunction with a maximum benefit equal to a stated number of monthly payments, usually 12 or less.)*
- *Alternatively, the monthly benefit is a stated percentage of the outstanding balance on the date of loss for all cards under one group policy, where the stated percentage is unrelated to the percentage in the credit obligation for a particular card. For example, the benefit percentage might be 5% or $25, whichever is higher; but not less than the particular card's minimum monthly payment. Using one percentage rate for all card programs simplifies the administration and provides a more substantial benefit when the percentage specified in a particular credit obligation is low.*
- *Alternatively in the retail market, the monthly benefit is the minimum monthly payment, as defined in the credit obligation, on each successive billing date based on the balance on the initial date of disablement.*

Eligibility for Benefits. To qualify for benefits, the borrower must be totally disabled for the number of continuous days specified in the policy's elimination period, such as 14, 30, or 31 days. For benefits to continue at monthly intervals, the insured must prove continued disablement at monthly intervals. Otherwise, the insured must make timely monthly payments to keep from incurring late charges under the credit obligation. Insurers will accept claims covering periods longer than one month, but they will not pay a claim until proof of the continuance of the claim has been received. Insurers may have less stringent requirements for severe disabilities.

Elimination or Waiting Period. A 30-day elimination period is prevalent, but a 14-day period is occasionally used.

Retroactive Clause. Most policies have retroactive benefits after 30 days of disability; benefits are paid from the first day of disability. Non-retroactive benefits are an alternative; benefits begin on the first day of disability following the elimination period.

Maximum Benefit. All disability insurance policies have provisions defining the maximum amount of benefits that are payable. Most commonly, total benefits are limited to the outstanding indebtedness on the date of disability, subject to a stated dollar maximum.

- *Alternatively, benefits will not exceed the gross indebtedness of the credit balance on the date of disability, subject to a flat dollar maximum. In other words, the maximum includes the interest accruing on the credit from the date of loss.*
- *Alternatively, benefits may be limited to a stated number of benefits for each occurrence of disability, such as 12 monthly payments.*

Exclusions. Disability insurance benefits are not usually payable if the disability is a result of:

- Normal pregnancy, except for complications of pregnancy
- Intentionally self-inflicted injury
- Declared or undeclared war or military service
- Operating, riding in, or descending from a non-scheduled aircraft
- Travel or residence outside the United States and Canada

A **pre-existing condition** is an impairment for which the insured has been treated prior to the effective date of the insurance. Insurers have the option of covering pre-existing conditions or excluding them. Unlike credit disability insurance on installment credit, most credit disability policies on open-end credit do not exclude them.

If pre-existing conditions are excluded, the standard exclusion is a **six-and-six pre-existing condition exclusion**. Under this exclusion, a disability is <u>not covered</u> if:

- The insured receives treatment within the six months prior to the effective date of the insurance, **and**
- The insured is disabled due to the pre-existing condition within six months after the effective date of the insurance.

In addition, the policy may contain a **rolling six-and-six pre-existing condition exclusion**. Under this exclusion, the date of each charge to the card or cash advance is examined and compared to the initial date of disability. The portion of the monthly benefit that relates to a particular charge or advance is <u>not covered</u> if:

- The insured receives treatment within the six months prior to the charge or the advance, **and**
- The insured is disabled due to the pre-existing condition within six months after the charge or the advance.

Rolling six-and-six preexisting condition exclusions are commonly used when the credit limit exceeds $10,000.

Lump Sum Benefit Riders. Depending on the minimum monthly payment percentage and the maximum benefit, monthly benefits may be payable for a long period of time. The trend in the underlying credit obligations is to reduce the minimum monthly payment percentage. If the minimum monthly payment is 1/48 of the balance, it takes 48 months of disability for benefits to reach the outstanding balance on the date of loss. Since there are fewer recoveries from disability as time progresses, some insurers provide a lump sum benefit at the end of certain periods of continuous disability.

For example, a lump sum benefit may be paid at the end of 12 months under a plan where the maximum benefit equals the outstanding balance on the date of loss. Up to 12 monthly benefits are paid. If a claimant remains disabled for 12 complete months, a benefit is also paid at the end of the twelfth month that is equal to the outstanding balance on the date of loss, less all monthly benefits that have been paid relative to that particular loss. If the monthly benefit is $5 and the outstanding balance on the date of loss is $100, the lump sum benefit is $40 [= $100 – (12 x $5)].

Lump Sum Coverage Policies. From the early days of credit-related insurance, a few credit disability insurance policies have provided only a lump sum benefit that is equal to the outstanding balance on the date of loss in the event of total and permanent disability. This concept is now being applied in the retail market. The *qualifying period* is long, generally 90 or 180 days. If an insured remains disabled for the qualifying period, the benefit is the outstanding balance on the date of disability. Accrued interest until the end of the qualifying period may be included.

Premium Rates

When disability insurance is purchased in conjunction with open-end credit, the premium rate is commonly expressed as a monthly rate per $100 of balance, such as 20¢ per $100 of balance per month.

The insurer must file the premium rate that will be used in a state at the time the policy is initially submitted to the state insurance department. Only a few states have promulgated prima facie rates specifically for monthly premium open-end credit disability insurance. All states have adopted prima facie rates for single premium credit disability insurance. In most states, a formula must be used to calculate the monthly premium rate from the table of single premium rates. The state laws and regulations are usually silent as to the specific conversion formula to be used.

There is no mathematical relationship between monthly premium credit disability rates on open-end credit and single premium credit disability rates on installment credit. Compare a 36-month single premium policy with an open-end policy that has a monthly benefit equal to 1/36 of the balance. Under the single premium policy, an insured that is disabled in the first policy month can receive 36 monthly benefits. An insured that is disabled in the second month can receive 35 monthly benefits, and so on. Under the open-end policy, every insured has the opportunity to receive 36 monthly benefits, regardless of the policy month in which disablement occurs.

In most states, the standard formula that applies to credit life insurance has been accepted:

$$MOB = OP_n = SP_n \times \left(\frac{2}{n+1}\right)$$

Where, *MOB* (or OP_n) is the monthly premium rate per $100 of balance

SP_n is the single premium rate per $100 of initial gross indebtedness with an original term of *n* months, and

n is the original term of insurance

The principal difficulty is choosing *n*, since open-end credit does not have a specific term. Consider a monthly premium credit disability policy with a maximum benefit equal to the outstanding balance on the initial date of disability [= $100] and a monthly benefit equal to 5% of the outstanding balance on the date of initial disability [= $5]. The most common procedure is to determine *n* as the number of months of disablement that are required to reach the maximum benefit. In this case, *n* equals 20 months [= $100 / $5]. If the single premium credit disability rate for a term of 20 months is $2.40, the MOB rate rounds to 23¢ [= $2.40 x (2 / {20 + 1})]. The choice of *n* makes a significant difference in the final rate. Using a term of 48 months in this particular state results in an MOB premium rate of 14¢.

(There is a monthly premium type of credit disability insurance on installment credit used in the credit union market, *closed-end monthly outstanding balance disability insurance*. The conversion formula shown above is correct for that product. Since that product has been around for many years, many people assume it is the correct formula for any monthly premium credit disability product. Its pattern of benefits is the same as the single premium policy, not the open-end policy.)

Single premium credit disability rates vary widely from state to state, so MOB premium rates vary considerably by state. Rates may also vary significantly based upon the particular policy and its corresponding benefit structure. Most open-end disability insurance policies have rates of 12¢ to 25¢ per $100 of balance per month.

The monthly payment is allocated into four segments in an order specified in the credit obligation. The typical order is:

1. Finance charges
2. Penalties
3. Insurance premiums
4. Principal reduction

As an example, suppose the balance on a credit card equals $2,000. Given a credit disability insurance rate of 20¢ per $100, the premium charge on the insured’s monthly credit card billing statement will be $4 for that month.

($2,000 ÷ 100) x 20¢ = $4

Further, assume that the minimum monthly payment is 3% of the balance, there are no penalties, and the monthly finance charge is 1.5%. Based upon this priority order, the minimum monthly payment of $60 [= $2,000 x .03] will be allocated as follows:

$30	Monthly finance charge [= $2,000 x .015]
0	Penalties
$4	Monthly disability insurance premium
$26	Principal reduction
$60	Minimum monthly payment

Payment of insurance premiums always comes before any principal reduction, and the sum of all charges before principal reduction is always less than the minimum monthly payment. The insurance premium is not added to the balance before the finance charges are calculated; the premium is not financed.

The only time there are finance charges on the insurance premium is when the insured borrower misses a payment. In this case, the interest and insurance premiums are added to the outstanding principal balance for the purpose of calculating the next billing cycle's finance charges and minimum monthly payment. At this point, the credit obligation is technically in default, so this situation is not permitted to persist for very long.

Some policies waive the premium for all insurance products while the insured is in a claim status in addition to paying the defined monthly benefit.

Premium Refunds

Most programs charge the premium at the end of the month of insurance. The insured borrower only pays for insurance that has been provided based on the known balance during the month of insurance. When insurance terminates, all prior premiums that have been charged are fully earned by the insurer, so no premium refund is due. For the final month of insurance, either 1) no charge will be made for the partial month of insurance, or 2) the insurance is defined as terminating at the end of the billing month following the termination and a final charge is made.

For all of these situations, no premium refund is due. A few premium refunds are paid, but they usually relate to premiums that a borrower claims were charged in error.

Agent Licensing

Disability insurance is offered using 1) the group enrollment exemption that applies if the product is structured as a group policy, or 2) a limited credit insurance license.

Direct Response Solicitations (direct mail and telemarketing). The bank or retailer whose cardholders are solicited through direct mail must be licensed to collect commissions from the insurer. This licensing can be accomplished through the use of a licensed agency owned by the bank or retailer, or a corporate license issued to the bank or retailer. For direct mail solicitations, no additional licenses are needed.

Telemarketing is often conducted by the insurer or by a third party service firm. The rules concerning the licensing requirements for individual telemarketers are far from clear, and different organizations interpret the rules differently.

Point of Sale (POS) Marketing. Typically, one person at the location where credit is extended, such as a branch office of a finance company, holds a full life or P&C license in accordance with the laws and regulations of that state. The branch manager, for example, will be licensed. Individual credit processors who present the insurance do not need a full life or P&C license. Instead, they rely on the group enrollment exemption or a limited credit insurance license. For finance companies, these requirements are a substantial obstacle, because of employee turnover and job responsibility changes.

Available States

Disability insurance is available in one form or another in all states. A few states place limitations on packaging disability insurance with credit life insurance, involuntary unemployment insurance, or other auxiliary products. In general, these restrictions require that one or more unbundled options be offered along with the package. For mail solicitations in these states, the insurer may choose to offer the full package plus one limited package, such as credit disability and involuntary unemployment insurance only, in order to maintain simplicity in the presentation. Most commonly, the cardholder must request a special application to apply for one of the unbundled options.

Advantages to the Producer

The product provides an additional service to borrowers. Open-end credit has become a way of life in the United States, and the minimum monthly payments for a family’s credit cards and revolving charge cards may be significant. These obligations can be so substantial that savings erode rapidly without wage income. By offering the cardholder the opportunity to purchase disability insurance to protect against this risk, the creditor is providing the cardholder with a valuable and necessary service. Even young cardholders perceive a need for the insurance, since they are often in occupations involving physical activities.

The policy benefits reduce collections and associated legal and administrative expenses. Credit disability insurance makes a borrower’s minimum monthly payments during the time the borrower is recovering from the event of disability. The creditor experiences fewer defaults and, consequently incurs lower costs. The borrower does not default, and the open-end credit remains active during this period. As a result, costs associated with attempted collections, write-offs, and account closings are lowered.

Sale of the product provides an additional source of fee income. Marketing of credit disability insurance to an established card base requires a minimum capital investment by the creditor. From a return on investment standpoint, fee income is an attractive proposition to creditors. However, the return is only available because of the initial capital investment made by the creditor to build the card base. The product also serves to support the expenditures needed to maintain the card base.

Reserves

Policy Reserves. Since credit disability insurance on open-end credit is a monthly renewable term product, the premium is earned on an "as written" basis in most cases. The premium is collected from the borrower after the insurance is provided and is remitted by the policyholder several weeks later. The premium is earned when the insurer receives it. Given these conditions, no unearned premium reserves are required.

Loss Reserves. Loss reserves for unreported losses, *IBNR (Incurred But Not Reported),* are an estimate usually based on factors that are developed as a function of a rolling, last *n* months of earned premiums, such as 20% of the last 12 months of earned premiums. Other factor bases, such as *n* months of paid claims, are also used.

In the life insurance world, reported claims are segregated into two categories, and the reserves are called by a variety of terms:

1. Pending claims (*claims in course of settlement*)
2. Continuing claims (*continuing claims reserve, the present value of amounts not yet due, case reserves)*

In the P&C world, the term *case reserves* generally applies to both categories. Reserves for the future payments on reported claims are estimated by various methods, including:

- Case reserves set by knowledgeable claims personnel
- Calculations using completion factors based on duration of disablement and possible months of future benefits
- Calculations using an average claim duration factor that is a function of the monthly benefit

Loss adjustment expenses are not explicitly reserved for in profitability studies and in the statutory financial statement of most life insurance companies. P&C insurers include a provision for loss adjustment expenses, but the expense level for disability is small, generally under 5% of premium. Overall reserve adequacy is usually tested with lag studies.

Chapter Three

Credit Involuntary Unemployment Insurance on Open-End Credit

Definition

Credit involuntary unemployment insurance (IUI) on open-end credit is monthly premium, monthly renewable loss of income insurance purchased in conjunction with open-end credit that provides a monthly benefit while the insured is involuntarily unemployed, up to the limits specified in the policy. The monthly benefit usually equals the minimum monthly payment due under the open-end credit obligation on the initial date of involuntary unemployment.

Policy Structure

This insurance is generally written under a master insurance policy or a group insurance policy. The creditor is the policyholder (master policyholder or group policyholder). A borrower of the creditor who elects insurance becomes an insured borrower or a certificateholder and receives a certificate of insurance. About five states will not approve a group policy.

Many policies have a "30-day free look" provision. This provision allows the borrower to purchase the insurance, think about it for 30 days, and, if not satisfied for any reason, cancel the policy during the 30-day period without any obligation.

Eligibility for Insurance

Only the primary borrower is eligible for involuntary unemployment insurance in most policies, but joint IUI protection is being offered. To be eligible for IUI, the borrower must meet all of the following conditions:

- Be working for wages for a minimum number of hours per week in accordance with the terms of the policy, such as 30 hours per week
- Be continuously employed for some period as of, and including, the effective date of the insurance, ranging from 30 days to 12 months
- Be employed for a period of time by the same employer in a non-seasonal occupation as of, and including, the effective date of the insurance, such as 90 days
- Not be self-employed, not be in full-time military service, and not be an independent contractor

Some insurers have more liberal policies and do not impose all of these conditions. In general, the smaller the average balance, the fewer the eligibility conditions and the shorter the period of time required to qualify.

The Insured Event

Benefit payments are made to the creditor when the insured borrower loses employment income as the result of involuntary unemployment caused by one of the following:

- Individual termination for cause, unless the particular cause is excluded
- Individual or mass layoff, typically defined as a temporary or permanent suspension of employment of a person at the employer's demand
- Termination of an employer's business
- General strike against an employer
- Unionized labor dispute
- Lockout

Some states prohibit insurance for strikes or other unionized labor disputes.

The Underlying Credit

IUI can be offered with most open-end credit obligations, but it is usually offered in conjunction with credit limits of $10,000 or less and maximum monthly payments of $500 or less. Credit obligations that fit into this category are:

- Credit cards (banks)
- Revolving charge cards (retailers)
- Unsecured personal lines of credit or overdraft checking protection (banks, credit unions, finance companies)
- Home equity lines of credit (banks, credit unions, finance companies)

Credit limits continue to increase, and a number of credit card programs have reached the $10,000 level. Gold and platinum cards have limits from $10,000 to $25,000. Personal lines of credit and real estate secured programs have much higher credit limits, but few insurers have been willing to offer an IUI product for these programs. IUI generally insures the full minimum monthly payment, but some policies have internal limits that define a maximum monthly benefit.

IUI can only be purchased in conjunction with certain credit obligations. P&C insurers do not offer IUI as a stand-alone financial product to cover other obligations, nor can consumers go to their local insurance agent and purchase involuntary unemployment insurance. The few P&C insurers who have offered such a product have found it difficult to underwrite and have experienced considerable adverse selection (or *anti-selection*)—the tendency of people to buy insurance products when they believe that they have a higher-than-average probability of a loss.

Markets and Marketing

The market for IUI has grown dramatically in recent years. All financial institutions making open-end credit obligations can potentially offer IUI, including banks, credit unions, and finance companies. Most banks and finance companies offer this product in one form or another. Retailers market the product extensively.

The Insurers

Independent insurers offer the product through a variety of creditors and retailers. To participate in this marketplace, an insurer needs approved forms in almost every state, since a producer's cardholders may be spread over a large number of states.

In most states, the direct writing insurance company must be licensed as a property and casualty insurer. In 1997, a life insurer could issue IUI policies in Ohio, Minnesota, North Carolina, and Washington. The trend in the regulatory process is for more states to consider this product akin to credit disability insurance and to permit life insurers to issue the product. Insurers have encouraged the trend by grouping both products under the title, *loss of income insurance*.

A number of insurers issuing IUI are owned by or affiliated with a retailer or a creditor, such as a bank or a finance company. By federal law, a bank holding company or a subsidiary is specifically authorized to offer this product, and an affiliated insurance company can underwrite the product. Because of the specialized nature of the product, some corporations use an independent insurer, even though an affiliated insurer could issue the product.

Underwriting Criteria

For Borrowers. As with most credit-related insurance, the IUI underwriting process piggybacks on the credit underwriting process. If the borrower's financial condition passes the creditor's normal credit risk analysis, the credit limit is approved by the creditor. Typically, specific underwriting for IUI is not done. Applications from all eligible insureds with open-end credit accounts in good standing are approved.

This underwriting process succeeds because the creditor's credit risk analysis adequately serves as an involuntary unemployment risk analysis. It is important that the creditor maintain the quality of its credit risk analysis on IUI-insured credit.

For Creditors. Insurers underwrite at the group level for this product by considering the financial condition of the policyholder, the nature of the underlying credit obligations, and the financial profile of the policyholder's customers. Since the product is tied to the quality of credit extended by the financial institution or the retailer, the insurer's interest is reasonably well protected.

Term of Insurance

For Borrowers. The inception dates of the credit and the IUI do not need to coincide. Insurance can be offered at the time the credit application is taken, at the credit closing (if applicable), or via direct response marketing techniques, such as direct mail, card carriers, billing inserts, or telemarketing.

Most applications for open-end credit are simple brochures. They are available to customers at "take away" displays or sent by mail. The insurance is mentioned, and the applicant has the opportunity to elect the insurance. A portion of the brochure contains a surprising quantity of disclosures and information about the insurance products. If elected, the insurance becomes effective as soon as the credit is approved.

Existing accounts are solicited for the insurance by mail and telemarketing. If the cardholder elects insurance, some insurers make the insurance effective immediately. They generally provide free insurance for the partial month and do not levy a premium until the end of the first full month of insurance. Alternatively, the initial date of insurance is the monthly billing date following election of the insurance by the borrower.

Each month, the insurance is renewed when the monthly premium is paid. Since the premium amount is calculated on the basis of the balance, the insurance can be renewed and remains in force as long as there is a balance. The term of the insurance is not limited if the open-end credit is active, has a balance, and monthly premiums are current. Insurance is suspended when the open-end credit balance is zero, but it is automatically reactivated when additional charges are made.

If the borrower cancels the insurance, the insurance ceases; however, the open-end credit remains available. If the credit is canceled, all insurance ceases. Insurance is structured 1) to cease immediately without a charge for the final partial month of insurance, or 2) to cease at the end of the billing month in which the cancellation occurs.

Most policies have a maximum age limit for insurance. All insurance generally ceases on the first billing date after the borrower attains age 66, unless a state requires a higher maximum age. Some states require insurance up to age 70 or 71; some insurers provide insurance up to these higher ages in all states. A few states do not permit an age limit.

The premium is charged at the end of the month of insurance, i.e., "monthly in arrears" premiums. The premium rate is multiplied times either the outstanding balance on the billing date or the average daily balance during the preceding month.

Benefit Conditions

Benefits vary significantly based upon the particular IUI policy. The general structure of the benefits provided, eligibility to receive benefits, elimination periods, and policy maximums are described below. Alternatives are shown in *italics*.

Benefit Provided. The policy benefit is paid for any billing date that occurs during the period of involuntary unemployment—only whole monthly benefits are paid.

- *Alternatively, a daily benefit may be provided for partial months of unemployment.*

The monthly benefit is a level dollar amount that is determined as of the date of involuntary unemployment. It equals the minimum monthly payment, as defined in the credit obligation, on the date of involuntary unemployment. A credit card might define the minimum monthly payment as 3% of the balance, subject to a $20 minimum. Subsequent charges to the card do not affect the monthly benefit.

- *Alternatively, the benefit may include the insurance premiums falling due during the period of involuntary unemployment.*
- *Alternatively, subsequent charges are included in the calculation—a "keep charging benefit." (This benefit is only granted in conjunction with a maximum benefit that is equal to a stated number of monthly payments, usually 12 or less.)*
- *Alternatively, the monthly benefit is a stated percentage of the balance on the date of loss for all cards under one group policy, where the stated percentage is unrelated to the percentage in the credit obligation for a particular card. For example, the benefit percentage might be 5% or $25, whichever is higher; but not less than the particular card's minimum monthly payment. Using one percentage rate for all card programs simplifies the administration and provides a more substantial benefit when the percentage specified in a particular credit obligation is low.*
- *Alternatively, in the retail market, the monthly benefit is the minimum monthly payment, as defined in the credit obligation, on each successive billing date based on the balance on the initial date of involuntary unemployment.*

Eligibility for Benefits. To be eligible for benefits initially, the borrower must:

- Be involuntarily unemployed for the elimination period specified in the policy (such as 14, 30 or 31 days),
- Qualify for unemployment benefits under state unemployment laws, *and*
- Provide the insurer with verification of loss of employment.

For benefits to continue, the insured must prove continued unemployment at monthly intervals by:

- Qualifying for state unemployment benefits, *or*
- Registering with an employment agency.

There are a few exceptions where the requirement of qualifying for state unemployment benefits does not apply. The insured must prove continued unemployment at monthly intervals to receive the benefit payments at monthly intervals. Otherwise, the insured must make timely monthly payments to keep from incurring late charges under the credit obligation. Insurers will accept claims covering periods longer than one month, but they will not pay a claim until proof of the continuance of the claim has been received.

Elimination or Waiting Period. A 30-day elimination period is prevalent, but a 14-day period is occasionally used.

Retroactive Clause. Most policies have retroactive benefits after 30 days of involuntary unemployment; benefits are paid from the first day of involuntary unemployment. Non-retroactive benefits are an alternative; benefits begin on the first day of involuntary unemployment following the elimination period.

Maximum Benefit. All IUI policies have provisions defining the maximum amount of benefits payable. Most commonly, total benefits are limited to a stated number of benefits, such as 12 monthly payments, subject to a stated dollar maximum.

- *Alternatively, total benefits are limited to the outstanding indebtedness on the date of involuntary unemployment.*
- *Alternatively, benefits will not exceed the gross indebtedness of the credit balance on the date of involuntary unemployment, subject to a flat dollar maximum. In other words, the maximum includes the interest accruing on the balance from the date of loss.*

Exclusions. IUI benefits are not payable in the following cases:

- Voluntary unemployment
- Resignation
- Retirement
- Unemployment due to disability
- Termination because of willful or criminal misconduct
- Seasonal unemployment

Some states require that strikes or other unionized labor disputes be excluded.

Lump Sum Benefit Riders. Depending on the minimum monthly payment percentage and the maximum benefit, monthly benefits may be payable for a long period of time. The trend in the underlying credit obligations is to reduce the minimum monthly payment percentage. If the minimum monthly payment is 1/48 of the balance, it takes 48 months of unemployment for benefits to reach the outstanding balance on the date of loss. Since there are fewer recoveries from unemployment as time progresses, some insurers provide a lump sum benefit at the end of certain periods of continuous unemployment.

For example, a lump sum benefit may be paid at the end of 12 months under a plan where the maximum benefit equals the outstanding balance on the date of loss. Up to 12 monthly benefits are paid. If a claimant remains unemployed for 12 complete months, a benefit is paid at the end of the twelfth month that is equal to the outstanding balance on the date of loss, less all monthly benefits that have been paid relative to that particular loss. If the monthly benefit is $5 and the outstanding balance on the date of loss was $100, the lump sum benefit at the end of the twelfth month is $40 [= $100 – (12 x $5)].

Lump Sum Coverage Policies. From the early days of credit-related insurance, a few credit disability insurance policies have provided only a lump sum benefit that is equal to the outstanding balance on the date of loss in the event of total and permanent disability. This concept is now being applied in the retail market to IUI. The *qualifying period* is long, generally 90 or 180 days. If an insured remains unemployed for the qualifying period, the benefit is the outstanding balance on the date of unemployment. Accrued interest until the end of the qualifying period may be included.

Premium Rates

When IUI is purchased in conjunction with open-end credit, the premium rates are commonly expressed as a monthly rate per $100 of balance, such as 30¢ per $100 of balance per month.

Unlike credit life and credit disability insurance, prima facie rates have not been promulgated in most states. Rates must be filed in each state by the insurer and be supported by an actuarial memorandum. As IUI is drawn into the scope of credit life and credit disability insurance regulations, more states are expected to promulgate prima facie rates.

Unemployment levels vary widely from state to state, so premium rates vary considerably by state. Rates also vary significantly based upon the particular policy and its corresponding benefit structure. Most open-end IUI policies have rates of 20¢ to 40¢ per $100 of balance per month.

The monthly payment is allocated into four segments in an order specified in the credit obligation. The typical order is:

1. Finance charges
2. Penalties
3. Insurance premiums
4. Principal reduction

As an example, suppose the balance on a credit card equals $2,000. Given an IUI rate of 30¢ per $100, the premium charge on the monthly credit card billing statement will be $6 for that month.

($2,000 ÷ 100) x 30¢ = $6

Further, assume that the minimum monthly payment is 3% of the balance, there are no penalties, and the monthly finance charge is 1.5%.

Based on this order, the minimum monthly payment of $60 [= $2,000 x 3%] will be allocated as follows:

$30	Monthly finance charge [= $2,000 x .015]
0	Penalties
$6	Monthly IUI premium
$24	Principal reduction
$60	Minimum monthly payment

Regardless of the order, payment of insurance premiums always comes before any principal reduction, and the sum of all charges before principal reduction is always less than the minimum monthly payment. Therefore, the insurance premium is not added to the balance before the finance charges are calculated; the premium is not financed.

The only time there are finance charges on the insurance premium is when the insured borrower misses a payment. In this case, the interest and insurance premiums are added to the outstanding principal balance for the purpose of calculating the next billing cycle's finance charges and minimum monthly payment. At this point, the credit obligation is technically in default, so this situation is not permitted to persist for very long.

Some policies waive the premium for all insurance products while the insured is in a claim status in addition to paying the defined monthly benefit.

Premium Refunds

Most programs charge the premium at the end of the month of insurance. The insured borrower only pays for insurance that has been provided based on the known balance during the month of insurance. When insurance terminates, all prior premiums that have been charged are fully earned by the insurer, so no premium refund is due. For the final month of insurance, either 1) no charge will be made for the partial month of insurance, or 2) the insurance is defined as terminating at the end of the billing month following the termination and a final charge is made.

For all of these situations, no premium refund is due. A few premium refunds are paid, but they usually relate to premiums that a borrower claims were charged in error.

Agent Licensing

The regulatory trend is for IUI to be viewed in the same light as credit life and credit disability insurance for licensing purposes. Licensing regulations are being changed to match the requirements for credit life and credit disability insurance. A few states have already enacted regulations permitting IUI to be offered using a limited credit insurance license, while other states have expanded the group enrollment exemption that applies if the product is structured as a group policy.

Direct Response Solicitations (direct mail and telemarketing). The bank or retailer whose cardholders are solicited through direct mail must be licensed to collect commissions from the insurer. This licensing can be accomplished through the use of a licensed agency owned by the bank or retailer, or a corporate license issued to the bank or retailer. For direct mail solicitations, no additional licenses are needed.

Telemarketing is often conducted by the insurer or by a third party service firm. The rules concerning the licensing requirements for individual telemarketers are far from clear, and different organizations interpret the rules differently.

Point of Sale (POS) Marketing. Typically, one person at the location where credit is extended, such as a branch office of a finance company, holds a full P&C license in accordance with the laws and regulations of that state. The branch manager, for example, will be licensed. Individual credit processors who present the insurance may not need a full P&C license. Instead, they rely on a limited credit insurance license or the group enrollment exemption. For finance companies, these requirements are a substantial obstacle due to employee turnover and job responsibility changes.

Available States

IUI is available in one form or another in all states. There are a few markets where the regulatory environment makes it difficult to offer the product at this time, but these obstacles are gradually being overcome. As an example, banking regulations prohibit the sale of the product in Vermont to bank credit cardholders.

A few states place limitations on packaging IUI insurance with credit life insurance, disability insurance, or other auxiliary products. In general, these restrictions require that one or more unbundled options be offered along with the package. For mail solicitations in these states, the insurer may choose to offer the full package plus one limited package, such as credit disability and involuntary unemployment insurance only, in order to maintain simplicity in the presentation. Most commonly, the cardholder must request a special application to apply for one of the unbundled options.

Advantages to the Producer

The product provides an additional service to the borrower. Open-end credit has become a way of life in the United States, and the minimum monthly payments for a family’s credit cards and revolving charge cards may be significant. These obligations can be so substantial that savings erode rapidly without wage income. By offering the cardholder the opportunity to purchase IUI to protect against this risk, the creditor is providing the customer with a valuable and necessary service. Even young cardholders perceive a need for the insurance. Most young people consider the possibility of death as remote and the possibility of disability as unlikely, but unemployment is another matter.

The policy benefits reduce collections and associated legal and administrative expenses. IUI makes a borrower’s minimum monthly payments during the time the borrower is seeking re-employment. The creditor experiences fewer defaults and, consequently incurs lower costs. The borrower does not default, and the open-end credit remains active during this period. As a result, costs associated with attempted collections, write-offs, and account closings are lowered.

Sale of the product provides an additional source of fee income. Marketing of IUI to an established card base requires a minimum capital investment by the creditor. From a return on investment standpoint, fee income is an attractive proposition to creditors. However, the return is only available because of the initial capital investment made by the creditor to build the card base. IUI also serves to support the expenditures needed to maintain the card base.

Reserves

Policy Reserves. Since IUI on open-end credit is a monthly renewable term product, the premium is earned on an “as written” basis in most cases. The premium is collected from the borrower after the insurance is provided and is remitted by the policyholder several weeks later.

The premium is earned when the insurer receives it. Given these conditions, no unearned premium reserves are required.

Loss Reserves. Loss reserves for unreported losses, *IBNR (Incurred But Not Reported),* are an estimate usually based on factors that are developed as a function of a rolling, last *n* months of earned premiums, such as 20% of the last 12 months of earned premiums. Other factor bases, such as *n* months of paid claims, are also used.

In the life insurance world, reported claims are segregated into two categories, and the reserves are called by a variety of terms:

1. Pending claims (*claims in course of settlement*)
2. Continuing claims (*continuing claims reserve, the present value of amounts not yet due*, *case reserves)*

In the P&C world, the term *case reserves* generally applies to both categories. Reserves for the future payments on reported claims are estimated by various methods, including:

- Case reserves set by knowledgeable claims personnel
- Calculations using completion factors based on duration of unemployment and possible months of future benefits
- Calculations using an average claim duration factor that is a function of the monthly benefit

P&C insurers make a provision for loss adjustment expenses, but the expense level for IUI is small, generally under 5% of premium. In states where a life insurance company can issue IUI, there is rarely a requirement to hold loss adjustment expense reserves.

Overall reserve adequacy is usually tested using lag studies.

Claim Fluctuation Reserves. The unemployment level is volatile. A prudent insurer should consider the need for the establishment of fluctuation reserves. A review of the unemployment levels over the last twenty years presents a strong case for the need for such a reserve. New York specifically authorizes the establishment of such a reserve; it is acceptable to include the claim fluctuation reserve in the determination of incurred claims for purposes of rate determination.

Chapter Four

Family Leave Insurance on Open-End Credit

Definition

Family leave insurance on open-end credit is monthly premium, monthly renewable loss of income insurance purchased in conjunction with open-end credit that provides a monthly benefit during an unpaid leave of absence from employment resulting from specified causes, up to the limits specified in the policy. The monthly benefit usually equals the minimum monthly payment due under the open-end credit obligation on the date that the leave begins.

Policy Structure

This insurance is generally written under a master insurance policy or a group insurance policy. The creditor is the policyholder (master policyholder or group policyholder). A borrower of the creditor who elects insurance becomes an insured borrower or a certificateholder and receives a certificate of insurance. About five states will not approve a group policy. In some cases, the insurance is simply an additional benefit within an IUI or disability policy, or a rider to an IUI or disability policy.

Many policies have a “30-day free look” provision. This provision allows the borrower to purchase the insurance, think about it for 30 days, and, if not satisfied for any reason, cancel the policy during the 30-day period without any obligation.

Eligibility for Insurance

Only the primary borrower is eligible for family leave insurance, but joint protection is being considered by some insurers. To be eligible for insurance, the borrower must meet all of the following conditions:

- Be working for wages for a minimum number of hours per week in accordance with the terms of the policy, such as 30 hours per week
- Be continuously employed for some period as of, and including, the effective date of the insurance, ranging from 30 days to 12 months
- Be employed for a period of time by the same employer in a non-seasonal occupation as of, and including, the effective date of the insurance, such as 90 days
- Not be self-employed, not be in full-time military service, and not be an independent contractor

Some insurers have more liberal policies and do not impose all of these conditions. In general, the smaller the average balance, the fewer the eligibility conditions and the shorter the period of time required to qualify.

The Insured Event

Benefit payments are made to the creditor when the insured borrower takes an unpaid leave of absence as a result of certain specified events. The employer must provide written authorization of the leave. It is not necessary for an insured to be covered under the Family and Medical Leave Act to qualify for the insurance benefit. The specified events are:

- Birth of a child
- Adoption of a child
- Accident or sickness of an immediate family member—spouse, child (natural or adopted), or parent—that requires the insured to attend to the family member’s needs

Some insurers include leave associated with:

- Living in a federal disaster area
- Being recalled to active military duty
- Being called to jury duty

The Underlying Credit

Family leave insurance can be offered with most open-end credit obligations, but it is usually offered in conjunction with credit limits of $10,000 or less and maximum monthly payments of $500 or less. Credit obligations that fit into this category are:

- Credit cards (banks)
- Revolving charge cards (retailers)

- Unsecured personal lines of credit or overdraft checking protection (banks, credit unions, finance companies)
- Home equity lines of credit (banks, credit unions, finance companies)

Credit limits continue to increase, and a number of credit card programs have reached the $10,000 level. Gold and platinum cards have limits from $10,000 to $25,000. Personal lines of credit and real estate secured programs have much higher credit limits. Since the election to take an unpaid leave creates an opportunity for adverse selection, the product is limited to credit cards and revolving charge cards.

Family leave insurance can only be purchased in conjunction with certain credit obligations. P&C insurers do not offer family leave insurance as a stand-alone financial product to cover other obligations, nor can consumers go to their local insurance agent and purchase family leave insurance. A clear problem is adverse selection (or *anti-selection*)—the tendency of people to buy insurance products when they believe that they have a higher-than-average probability of a loss. One reason that benefits are usually limited to a stated number of monthly benefits is to reduce adverse selection.

Markets and Marketing

The market for family leave insurance has grown dramatically since its introduction in 1994. All financial institutions with open-end credit obligations can potentially offer family leave insurance, including banks, credit unions, and finance companies. Many open-end credit insurance programs now include family leave insurance in the package.

The Insurers

Independent insurers offer the product through a variety of creditors and retailers. To participate in this marketplace, an insurer needs approved forms in almost every state, since a producer's cardholders may be spread over a large number of states.

In most states, the direct writing insurance company must be licensed as a property and casualty insurer. A number of insurers issuing family leave insurance are owned by or affiliated with a creditor (bank or finance company) or a retailer.

Underwriting Criteria

For Borrowers. As with most credit-related insurance, the family leave insurance underwriting process piggybacks on the credit underwriting process. If the borrower's financial condition passes the creditor's normal credit risk analysis, the creditor approves the credit limit. Specific underwriting for family leave insurance is not done. Applications from all eligible insureds with open-end credit accounts in good standing are approved.

This underwriting process succeeds because the creditor's credit risk analysis adequately serves to underwrite the family leave risk. It is important that the creditor maintain the quality of its credit risk analysis on insured credit.

For Creditors. Insurers underwrite at the group level for this product by considering the financial condition of the policyholder, the nature of the underlying credit obligations, and the financial profile of the policyholder's customers. Since the product is tied to the quality of credit extended by the financial institution or the retailer, the insurer's interest is reasonably well protected.

Term of Insurance

For Borrowers. The inception dates of the credit and the family leave insurance do not need to coincide. Insurance can be offered at the time the credit application is taken, at the credit closing (if applicable), or via direct response marketing techniques, such as direct mail, card carriers, billing inserts, or telemarketing.

Most applications for open-end credit are simple brochures. They are available to customers at "take away" displays or sent by mail. The insurance is mentioned, and the applicant has the opportunity to elect the insurance. If elected, the insurance becomes effective as soon as the credit is approved.

Existing accounts are solicited for the insurance by mail and telemarketing. If the cardholder elects insurance, some insurers make the insurance effective immediately. They generally provide free insurance for the partial month and do not levy a premium until the end of the first full month of insurance. Alternatively, the initial date of insurance is the monthly billing date following election of the insurance by the borrower.

Each month, the insurance is renewed when the monthly premium is paid. Since the premium amount is calculated on the basis of the balance, the insurance can be renewed and remains in force as long as there is a balance. The term of the insurance is not limited if the open-end credit is active, has a balance, and monthly premiums are current. Insurance is suspended when the open-end credit balance is zero, but it is automatically reactivated when additional charges are made.

If the borrower cancels the insurance, the insurance ceases; however, the open-end credit remains available. If the credit is canceled, all insurance ceases. Insurance is structured 1) to cease immediately without a charge for the final partial month of insurance, or 2) to cease at the end of the billing month in which the cancellation occurs.

The premium is charged at the end of the month of insurance, i.e., "monthly in arrears" premiums. The premium rate is multiplied times either the outstanding balance on the billing date or the average daily balance during the preceding month.

Benefit Conditions

Benefits are fairly standard, but the policies have some variation. The general structure of the benefits provided, eligibility to receive benefits, elimination periods, and policy maximums are described below. Alternatives are shown in *italics*.

Benefit Provided. The policy benefit is paid for any billing date that occurs during the period of leave—only whole monthly benefits are paid.

- *Alternatively, a daily benefit may be provided for partial months of leave.*

The monthly benefit is a level dollar amount that is determined as of the date of leave. It equals the minimum monthly payment, as defined in the credit obligation, on the date of leave. A credit card might define the minimum monthly payment as 3% of the balance, subject to a $20 minimum. Subsequent charges to the card do not affect the monthly benefit.

- *Alternatively, the benefit may include the insurance premiums falling due during the period of leave.*
- *Alternatively, subsequent charges are included in the calculation—a "keep charging benefit." (This benefit is only granted in conjunction with a maximum benefit equal to a stated number of monthly payments.)*
- *Alternatively, the monthly benefit is a stated percentage of the balance on the date of leave for all cards under one group policy, where the stated percentage is unrelated to the percentage in the credit obligation for a particular card. For example, the benefit percentage might be 5% or $25, whichever is higher; but not less than the particular card's minimum monthly payment. Using one percentage rate for all card programs simplifies the administration and provides a more substantial benefit when the percentage specified in a particular credit obligation is low.*
- *Alternatively in the retail market, the monthly benefit is the minimum monthly payment, as defined in the credit obligation, on each successive billing date based on the balance on the initial date of leave.*

Eligibility for Benefits. To initially be eligible for benefits the borrower must:

- Elect to take an unpaid leave as a result of one of the specified reasons covered by the insurance, and
- Be on leave for the elimination period specified in the policy (such as 14, 30 or 31 days), and
- Provide the insurer with the employer's written approval of the leave.

For benefits to continue at monthly intervals, the insured must prove continued leave at monthly intervals to receive monthly benefit payments. Otherwise, the insured must make timely monthly payments to keep from incurring late charges under the credit obligation. Insurers will accept claims covering periods longer than one month, but they will not pay a claim until proof of the continuance of the claim has been received.

Elimination or Waiting Period. A 30-day elimination period is prevalent, but a 14-day period is occasionally used.

Retroactive Clause. Most policies have retroactive benefits after 30 days of leave; benefits are paid from the first day of leave. Non-retroactive benefits are an alternative; benefits begin on the first day of leave following the elimination period.

Maximum Benefit. Most family leave insurance policies have provisions defining the maximum number of benefits payable for any one leave of absence. Benefits are limited to a stated number of monthly benefits, either three or six monthly benefits. Since most unpaid leaves last less than one year, these benefit periods meet the needs of the insureds. Limitations are also needed to reduce adverse selection.

Exclusions. Family leave insurance benefits are not payable in the following cases:

- Voluntary resignation
- Retirement
- Seasonal unemployment, involuntary unemployment, and disability
- Termination because of willful or criminal misconduct

Lump Sum Coverage Policies. A few insurers have filed a policy with a benefit equal to the outstanding balance on the date of leave if the leave lasts at least 90 days. The coverage is expensive (about 40¢ per $100 of balance per month), because the expected claim costs and the potential for adverse selection are significant.

Premium Rates

Premium rates are commonly expressed as a monthly rate per $100 of balance. A premium rate of 12¢ per $100 of balance per month is common if the maximum number of monthly benefits is three, and 16¢ per $100 of balance per month is common if the maximum number of monthly benefits is six.

Unlike credit life and credit disability insurance, prima facie rates have not been promulgated in most states. Rates must be filed in each state by the insurer and be supported by an actuarial memorandum.

Some policies waive the premium for all insurance products while the insured is in a claim status in addition to paying the defined monthly benefit.

Premium Refunds

Most programs charge the premium at the end of the month of insurance. The insured borrower only pays for insurance that has been provided based on the known balance during the month of insurance. When insurance terminates, all prior premiums that have been charged are fully earned by the insurer, so no premium refund is due. For the final month of insurance, either 1) no charge will be made for the partial month of insurance, or 2) the insurance is defined as terminating at the end of the billing month following the termination and a final charge is made.

For all of these situations, no premium refund is due. A few premium refunds are paid, but they usually relate to premiums that a borrower claims were charged in error.

Agent Licensing

The rules for family leave insurance are not spelled out in the regulations. In general, the rules of IUI are likely to apply.

Available States

Family leave insurance is available in one form or another in over 40 states. A few states have objected to the insurance on the grounds that the election to take the leave is not an insurable event or that the state laws and regulations do not specifically permit the insurance.

A few states place limitations on packaging family leave insurance with credit life insurance, involuntary unemployment insurance, or other auxiliary products. In general, these restrictions require that one or more unbundled options be offered along with the package. For mail solicitations in these states, the insurer may choose to offer the full package plus one limited package, such as credit involuntary unemployment and family leave insurance only, in order to maintain simplicity in the presentation. Most commonly, the cardholder must request a special application to apply for one of the unbundled options.

Advantages to the Producer

The product provides the same benefits as IUI.

Reserves

Policy Reserves. Since family leave insurance on open-end credit is a monthly renewable term product, the premium is earned on an "as written" basis in most cases. The premium is collected from the borrower after the insurance is provided and is remitted by the policyholder several weeks later. The premium is earned when the insurer receives it. Given these conditions, no unearned premium reserves are required.

Loss Reserves. Loss reserves for unreported losses, *IBNR (Incurred But Not Reported),* are an estimate usually based on factors that are developed as a function of a rolling, last *n* months of earned premiums, such as 20% of the last 12 months of earned premiums. Other factor bases, such as *n* months of paid claims, are also used.

In the life insurance world, reported claims are segregated into two categories, and the reserves are called by a variety of terms:

1. Pending claims (*claims in course of settlement*)
2. Continuing claims (*continuing claims reserve, the present value of amounts not yet due, case reserves)*

In the P&C world, the term *case reserves* generally applies to both categories. Reserves for the future payments on reported claims are estimated by various methods.

Since the maximum benefit period is short, most insurers assume that all claims last the maximum duration or make a highly conservative assumption. Loss adjustment expense reserves are quite small.

Claim Fluctuation Reserves. This is a new insurance product and the level of utilization is unknown. A prudent insurer should consider the need for the establishment of claim fluctuation reserves.

Chapter Five

Credit Property Insurance on Open-End Credit

Definition

Credit property insurance on open-end credit is monthly premium, monthly renewable property insurance purchased in conjunction with open-end credit insuring consumer products that are bought (or pledged as collateral) against specified loss occurrences causing damage to, or disappearance of, the property. The benefit is repair or replacement of the property.

Policy Structure

This insurance is generally written under a master insurance policy or a group insurance policy. The creditor is the policyholder (master policyholder or group policyholder). A borrower of the creditor who elects insurance becomes an insured borrower or a certificateholder and receives a certificate of insurance. About five states will not approve a group policy.

Many policies have a “30-day free look” provision. This provision allows the borrower to purchase the insurance, think about it for 30 days, and, if not satisfied for any reason, cancel the policy during the 30-day period without any obligation.

Both *single interest* and *dual interest* coverages are available in the credit property insurance marketplace. *Single interest coverage* protects only the creditor’s financial interest in the consumer product (the indebtedness). In the event of an insured loss, benefits are limited to the extent of the creditor’s interest in the collateral. In other words, the benefits are the lesser of:

1. The cost to repair or replace the covered item, or
2. The indebtedness at the time of loss.

The borrower may have an interest in the property that exceeds the indebtedness. If the value of the item, or the cost to replace or repair the item, exceeds the indebtedness, the borrower's interest is the excess over the creditor's interest. *Dual interest coverage* protects the interests of both the creditor and the borrower. The benefit payable is typically equal to the cost to repair or replace the covered item.

Most credit property insurance on open-end credit is dual interest coverage offered as a part of a package that includes life, disability, and involuntary unemployment insurance.

Eligibility for Insurance

This insurance is predominately associated with revolving charge cards issued by retailers. Anyone eligible for the revolving charge card and the other insurance products is automatically eligible for credit property insurance. If an application for the card is accepted and insurance is elected, any purchase of a consumer product that is charged to the revolving charge card is automatically insured. (When a cardholder does not qualify for one or more of the package products, most solicitations do not place any of the products, but some programs have partial coverage alternatives.)

For open-end credit other than revolving charge cards, the insuring relationship can be complex, depending upon the needs and objectives of the creditor and the insurer. The factors that must be considered in the product's definition of eligibility are:

- What are the insurable interests of the creditor and the borrower?
- How should insured perils be defined?
- How much of the risk does the insurer (and perhaps the policyholder) wish to bear?
- What are the limitations of the coverage and the regulatory constraints?
- Is there a potential for adverse selection?

In insurance markets around the world, these factors result in a myriad of insuring relationships, such as retrospective and prospective rating programs, self-insured programs, stop loss programs, and reinsurance. The product design depends upon the situation. The answers to these questions differ between 1) credit property insurance written on a piece of property used as collateral for open-end, general purpose credit, and 2) credit property insurance written on a new purchase financed by a retailer's affiliate.

The Insured Event

Perils covered by credit property insurance vary from policy to policy. In general, the policy insures against occurrences that cause direct and accidental damage to the insured property up to and including a total loss. Perils that occur while the property is being transported, such as collision, may be included. Protection is generally provided on a worldwide basis. The occurrences that can result in a loss include:

1. Fire
2. Smoke
3. Lightning
4. Wind or Windstorm
5. Cyclone
6. Tornado
7. Flood
8. Hail
9. Earthquake
10. Explosion
11. Riot
12. Riot Attending a Strike
13. Civil Commotion
14. Marine Perils While on Ferries and in Automobiles
15. Damage Caused by Aircraft or Falling Objects
16. Damage Caused by Vehicles
17. Collision
18. Vandalism and Malicious Mischief
19. Burglary

A significant consideration in product pricing is whether the contingencies of theft and mysterious disappearance are covered. The definitions of burglary and vandalism require evidence of forcible entry. Theft and mysterious disappearance are basically burglary or vandalism without clear evidence that a crime occurred, other than the reported disappearance of the item. Inclusion of this contingency may raise the claim costs significantly; most policies do not cover mysterious disappearance.

The insurance can be *named peril* or *all risk*. *Named peril* coverage insures only the specific perils that are itemized in the policy, such as the list above. *All risk* policies provide coverage insuring all causes of loss, except for certain specifically excluded events and other specific exclusions. Most credit property policies are named peril policies.

The Underlying Credit

Revolving Charge Card Programs. The most common credit obligation is a retailer's charge card. Most retailers offer a private label revolving charge card that often includes credit property insurance as a part of its package of insurance products. For example, credit property insurance is one portion of the package offered to Montgomery Ward department store customers. Other retailers of furniture, appliances, and electronic equipment offer the product.

Other Programs. Most general-use credit cards are not practical applications for credit property insurance, as they are primarily used to purchase items that by their nature are uninsurable, such as meals. If a credit card is used for non-durable goods and retail purchases, and there are no regulatory barriers, the issue remains of how to charge a premium corresponding to the property purchase only. Administrative systems are rarely able to separate the non-property balance from the property balance.

Markets and Marketing

The markets for credit property insurance can be defined as any open-end credit where:

1. The credit proceeds are used to purchase the property (revolving charge card), but the consumer product is not used as collateral to secure the credit. Purchases under a

revolving charge card are *unsecured* open-end credit used to purchase consumer products offered by the retailer.

2. The insured property is used as collateral to secure the credit, but the credit proceeds are not used for the purchase of the property.
3. The insured property is used as collateral to secure the credit, and the credit proceeds are used to purchase the property.

This definition allows one to determine open-end credit situations where an insurable interest exists on the part of the creditor, the borrower, or both. There must be an open-end credit or payment obligation of some sort associated with the property—whether the property is purchased with the credit, used as collateral, or both.

The move to open-end leasing of many products provides situations where property insurance may apply. A specific example is cellular telephones. Many cellular telephone companies provide inexpensive monthly lease fees on cellular telephones with an open-ended term, however, a minimum term is required. Office products, such as computers and fax machines, can be leased in similar fashion. The "rent-to-own" industry is another example where such situations may exist.

The Insurers

The insurers providing credit property insurance are typically considered specialty lines P&C insurers. Almost all of these insurers offer other credit-related insurance products.

Underwriting Criteria

For Borrowers. No underwriting takes place at the borrower level. Any consumer product purchased with the revolving charge card or the open-end credit line, or pledged as collateral, is automatically insured, subject to policy limits.

For Creditors. Underwriting takes place at the policyholder level. The underwriting criteria depend upon the particular borrowing situation or retailer. In general, the form of underwriting used in this product line is most similar to experience-based group underwriting.

This product is usually offered on a stand-alone basis only where there are regulatory constraints on packaging. Purchase of credit property insurance or of the package of insurance products is voluntary. The borrower must elect to purchase the insurance.

Term of Insurance

For Borrowers. The inception dates of the credit and the credit property insurance do not need to coincide. Insurance can be offered at the time the credit application is taken, at the credit closing (if applicable), or via direct response marketing techniques, such as direct mail, card carriers, billing inserts, or telemarketing.

Most applications for open-end credit are simple brochures. They are available to customers at "take away" displays or sent by mail. The insurance is mentioned, and the applicant has the opportunity to elect the insurance. If elected, the insurance becomes effective as soon as the credit is approved.

Existing cardholders are solicited for the insurance by mail and by telemarketing. If the cardholder elects insurance, some insurers make the insurance effective immediately. They generally provide free insurance for the partial month and do not levy a premium until the end of the first full month of insurance. Alternatively, the initial date of insurance is the monthly billing date following election of the insurance by the borrower.

Each month, the insurance is renewed when the monthly premium is paid. Since the premium amount is calculated on the basis of the balance, the insurance can be renewed and remains in force as long as there is a balance. The term of the insurance is not limited if the open-end credit is active, has a balance, and monthly premiums are current. Insurance is suspended when the open-end credit balance is zero, but it is reactivated automatically when additional charges are made.

If the borrower cancels the insurance, the insurance ceases; however, the open-end credit remains available. If the credit is canceled, all insurance ceases. Insurance is structured 1) to cease immediately without a charge for the final partial month of insurance, or 2) to cease at the end of the billing month in which the cancellation occurs.

Insurance for the purchase of a particular consumer product begins on the day of purchase, but the *term of insurance* is not consistent among insurers. For many credit property insurance programs, there is a stated term of insurance, such as 36 months from the date the consumer product was purchased. (For borrowers electing insurance after the account was established, some policies immediately insure all purchases made within the prior 36 months; insurance continues until 36 months from the date of purchase elapses. Other policies only cover purchases after the effective date of the insurance.)

It is clear that insurance is provided for all 36 months if a balance exists for all 36 months. Policies differ as to whether insurance is provided in months with a zero balance within the 36 months or whether the term of insurance for a particular consumer product terminates completely if a zero balance occurs anytime during the 36 months.

In the case of general purpose open-end credit that is secured with a specific piece of collateral, the insurance term is indeterminate at the time of policy issue. The insurance protection is in force as long as there is a balance and a premium is paid.

For Creditors. The policy can be terminated by the insurer or the policyholder following the termination procedures in the policy, normally 30 days written notice. In most situations, a new insurer immediately replaces the terminating insurer. The terminating insurer remains responsible for all claim payments on claims that occur prior to the date of termination, unless it makes arrangements for the new insurer to assume the liability.

Benefit Conditions

When a covered loss occurs, benefits are paid pursuant to the provisions of the particular credit property insurance policy. The general structure of the benefits provided and policy maximums are described below.

Benefit Provided. Specific policy provisions vary from policy to policy. Typical benefit provisions might read as follows:

> *Single interest coverage***.** The benefit payable in the event of a covered loss will not exceed the least of the:
>
> - Cost to repair or replace the property with like kind and quality;
> - Actual cash value (ACV) at time of loss;
> - Amount of impairment of creditor's interest, as represented by the unpaid balance of the corresponding credit; *or*
> - Maximum amount of insurance as shown in the policy.
>
> *Dual interest coverage***.** The benefit payable in the event of a covered loss will not exceed the lesser of the:
>
> - Cost to repair or replace the property with like kind and quality; *or*
> - Maximum amount of insurance as shown in the policy.

Coverage. Coverage can be *all risk* or *named peril* coverage. Both of these coverages can be provided using either single interest or dual interest protection.

Minimum Benefit. One unusual aspect of about five states' laws and regulations is the requirement for a minimum benefit stated as a flat dollar amount. The state requirements vary from $300 to $900.

Maximum Benefit. Most policies contain some limitation on the insurer's liability. Such limits are typically broken into two categories, *per occurrence* and *aggregate* limits. Both per occurrence and aggregate limits are typically set in a dollar amount, such as $10,000 and $1,000,000, respectively.

Per occurrence refers to the individual policies/certificates corresponding to individual credit. The insurer's liability, as defined in the coverage provision, is subject to a maximum limit for any one loss occurrence.

Aggregate limit applies at the policyholder level, where the policyholder is the creditor or retailer. The policyholder is treated as a group, and the insurer limits its aggregate claims exposure corresponding to that group. The limit can vary depending upon the size of the creditor, the type of creditor, the average balance of the insured credit, geography, the catastrophe exposure, the type of credit, the type of consumer products that are insured, and the average credit maturity.

The aggregate limit also varies by situation, based upon type of credit, as well as by creditor within the type of credit. For example, the credit type may be categorized as retail, however, within this category, the size of creditor, the average balance of the credit, and the type of collateral can affect the aggregate limit of liability.

Exclusions. Coverage exclusions vary from policy to policy, however, the following exclusions are found in most credit property insurance policies:

- Loss or damage due to wetness or dampness, scratching, molding, freezing, rotting, or generally decaying unless the same is a direct result of an insured peril

- Mechanical breakdown, short circuit, power surge, or some other electrical disturbance, except lightning
- Loss or damage caused by neglect to use all reasonable means to save and preserve the property during and subsequent to any insured event
- Normal wear and tear
- Damage caused by blatant neglect or misuse
- Loss or damage caused by or resulting from:
  - War or warlike action during peacetime or war
  - Any weapon of war used during peacetime or war
  - Insurrection, rebellion, revolution, or civil war
  - Seizure or confiscation by a governmental or public authority
  - Any illegal activity
- Loss or damage under any coverage due to radioactive contamination
- Loss or damage to radio or television antennae or outside/lead in wiring
- Loss or damage resulting from use of the property in committing a criminal act

Loss Reporting Procedures and Requirements. The insured borrower must report claims to the insurer as soon as it is practical. Credit property insurance policies contain provisions setting forth the insured borrower's responsibility with respect to timely reporting of losses. This procedure will state that the insured borrower must report losses within some reasonable period of time after loss occurrence, such as 90 days. Insurers will consider the circumstances of the loss in deciding whether to impose the time limit.

Additionally, the policy will likely contain language referring to evidence of loss or sworn proof of loss. It is the insured borrower's responsibility to provide adequate proof to the insurer that an insured loss event has caused damage to the insured property. First, proof of purchase must be presented; a sales receipt will normally suffice. The form of evidence of loss depends on the insured event. For example, a police report will generally suffice for burglary or vandalism.

Premium Rates

Rates are expressed as a monthly rate per $100 of balance. A monthly rate of 29¢ per $100 of balance is common. Only a few states have adopted prima facie rates.

Most programs levy premiums on the balance, regardless of the possible inclusion of non-durable goods in such balance. Segregation of the balance between durable and non-durable goods is administratively difficult, if not impossible, and the proportion of non-durable goods is small. Any inequity is offset by 1) a fixed term of insurance, such as 36 months, even though the balance associated with a particular good may be "paid off," or 2) by an adjustment in the development of the premium rate for the expected proportion of non-durable goods.

Premium Refunds

Most programs charge the premium at the end of the month of insurance. The insured borrower only pays for insurance that has been provided based on the known balance during the month of insurance. When insurance terminates, all prior premiums that have been charged are fully earned by the insurer, so no premium refund is due.

For the final month of insurance, either 1) no charge will be made for the partial month of insurance, or 2) the insurance is defined as terminating at the end of the billing month following the termination and a final charge is made.

For all of these situations, no premium refund is due. A few premium refunds are paid, but they usually relate to premiums that a borrower claims were charged in error.

Agent Licensing

The regulatory trend is for credit property to be viewed in the same light as credit life and credit disability insurance for licensing purposes. Licensing regulations are being changed to match the requirements for credit life and credit disability insurance. A few states have already enacted regulations permitting credit property to be offered using a limited credit insurance license, while other states have expanded the group enrollment exemption that applies if the product is structured as a group policy.

Direct Response Solicitations (direct mail and telemarketing). The retailer whose cardholders are solicited through direct mail must be licensed to collect commissions from the insurer. This licensing can be accomplished through the use of a licensed agency owned by the retailer or a corporate license issued to the retailer. For direct mail solicitations, no additional licenses are needed.

Telemarketing is often conducted by the insurer or by a third party service firm. The rules concerning the licensing requirements for individual telemarketers are far from clear, and different organizations interpret the rules differently.

Point of Sale (POS) Marketing. Typically, one person at the location where credit is extended, such as a branch office of a finance company, holds a full P&C license in accordance with the laws and regulations of that state. The branch manager, for example, will be licensed. Individual credit processors who present the insurance may not need a full P&C license. Instead, they rely on a limited credit insurance license or the group enrollment exemption. For finance companies, these requirements are a substantial obstacle.

Available States

Credit property insurance is available in one form or another in all states. A few states place limitations on packaging property insurance with credit life insurance, involuntary unemployment insurance, or other auxiliary products. In general, these restrictions require that one or more unbundled options be offered along with the package. For mail solicitations in these states, the insurer may choose to offer the full package plus one limited package, such as credit property and involuntary unemployment insurance only, in order to maintain simplicity in the presentation. Most commonly, the cardholder must request a special application to apply for one of the unbundled options.

Advantages to the Producer

The product provides an additional service to the borrower. Retailers provide a valuable service to their customers when they offer credit property insurance in conjunction with purchases made using a private label charge card. It provides protection to the borrower, who also happens to be the customer of the retailer. In the event of a claim, customers will invariably associate the insurance with the retailer. They will often settle their claim by replacing or repairing the product at the retail establishment where the insurance was purchased. This creates customer goodwill and promotes customer retention.

The product secures the creditor's interest. In some cases, the creditor is dependent upon the property in question as collateral to secure the open-end credit. The creditor (and perhaps the borrower, depending upon the situation) has an interest in the collateral asset being protected. There is certainly a need for some form of credit property insurance in these cases. However, the manner in which it may be obtained and paid for, if at all, is subject to the regulatory environment in which the particular creditor operates.

Relative to other lines of insurance, credit property insurance is inexpensive in total dollar outlay. Premium rates are typically between 10¢ and 30¢ per $100 of balance, depending on the extent of coverage provided. Most balances in this marketplace are under $1,000, so the average monthly premium is under $3.00.

Purchase of credit property insurance is convenient. The billing mechanism is the billing statement for the credit payment (the monthly revolving charge card statement). This situation makes the payment of the premiums convenient for the borrower.

Credit property insurance is easy to administer. The billing situation is convenient, since premium rates can be programmed into the computer system that generates the monthly statement, creating automatic premium billings. Most insurers have an infrastructure so that premium remittance, accounting, and claims handling produce minimal administrative burden on the creditor.

Sale of the product provides an additional source of fee income. Marketing of credit property insurance to an established card base requires a minimum capital investment by the creditor. From a return on investment standpoint, fee income is an attractive proposition to creditors. However, the return is only available because of the initial capital investment made by the creditor to build the card base. The product also serves to support the expenditures needed to maintain the card base.

Reserves

Policy Reserves. Since credit property insurance on open-end credit is a monthly renewable term product, the premium is earned on an "as written" basis in most cases. The premium is collected from the borrower after the insurance is provided and is remitted by the policyholder several weeks later. The premium is earned when the insurer receives it. Given these conditions, no unearned premium reserves are required.

Loss Reserves. Loss reserves for unreported losses, *IBNR (Incurred But Not Reported)*, are an estimate usually based on factors that are developed as a function of written premiums, such as the last *n* months of written premiums, or a function of paid claims. Reserves for reported claims are *case reserves* that are estimated from an inventory of claims that have been reported but not yet paid.

Losses are typically reported and paid quickly. IBNR and pending claim levels are low. Since the claim typically involves a single claim payment, there are no continuing claim reserves. Loss adjustment expenses are low, generally under 5% of premium.

Chapter Six

Auxiliary Products on Open-End Credit

Every state has credit-related insurance laws and/or regulations that are generally a part of the state's life insurance laws. If a product falls within the scope of credit-related insurance laws and regulations, it must conform to certain standards. Two constraining factors on credit-related insurance are:

- The benefit must be tied to the underlying credit, *and*
- The maximum benefit cannot exceed the indebtedness.

In general, this prohibits the sale of common auxiliary products, such as an accidental death rider with a benefit equal to the underlying standard death benefit, a double indemnity rider. These credit-related insurance laws and regulations usually apply only to credit life and credit disability insurance. The 1994 NAIC Model Law and the 1995 NAIC Model Regulation for credit-related insurance include involuntary unemployment insurance, but they do not include other credit-related P&C products. In 1997, the laws and regulations of fewer than ten states address IUI specifically.

Agent licensing laws are another obstacle to offering additional products. Producers of credit-related insurance can take advantage of the group exemption or a limited credit insurance license. Some auxiliary products are designed for groups and can utilize this exemption; however, it does not apply in other situations. Lacking the group exemption, the producer must have a full life or P&C license in order to solicit a product that falls outside the scope of credit-related insurance definitions. This is a major disadvantage in closed-end installment credit, but is less of a concern in open-end credit where insurance is usually offered by mail or by telemarketing.

While no law prohibits offering other insurance products in addition to credit life and disability insurance at the time a credit obligation is established, practical limitations must be considered. If the insurance benefits are tied to the credit, the product must not be considered life or disability insurance; if so, it must comply with credit-related insurance requirements. Finance companies often offer simple term life products during the credit closing, but the presenter must comply with agent licensing requirements.

One solution is that various P&C products may be solicited in conjunction with open-end insurance packages. Several of the products that could be filed as life insurance are filed as P&C insurance to avoid the credit-related insurance limitations. Available products include:

- Accidental death insurance
- Credit card protection from unauthorized use
- Dismemberment benefits

These products may be filed as a rider to the IUI group policy or may be filed as a stand-alone group or individual policy. The policyholder will select the various products that will be offered to its customers. The customer is generally presented a package of products at a unified rate.

Accidental Death Insurance. The benefit is a stated amount of insurance if death occurs as a result of accidental means within 90 (or so) days following an accident. It is paid in addition to any standard life insurance benefit.

Accidental death insurance has commonly been offered as a rider to ordinary life insurance, but legally, it is considered accident and health insurance. Stand-alone accidental death policies are offered in the mortgage life and disability market and in a few specialty product situations. If sold by a life insurer, it is classified as accident and health (often group A&H), but it can also be sold as a P&C product by a P&C insurer. Except as noted, the following uses must be filed as P&C insurance to be offered in conjunction with open-end credit obligations.

There are several uses of accidental death insurance in open-end credit insurance programs. One option is for the amount of accidental death insurance to equal the amount of credit life insurance. In a few states, this is permitted as a rider to a credit life insurance policy.

A more common use is found in several revolving charge programs. Credit-related insurance regulations require that credit life insurance be provided up to some maximum age (age 66 in most states, but up to age 71 in others). Most credit card programs terminate all insurance—life, disability, and IUI—at the life maximum age. Under some revolving charge card programs, disability insurance and IUI continue, and the life insurance benefit converts from standard credit life insurance (covering death from all causes) to only accidental death insurance.

Another alternative is to include a stated dollar amount of accidental death insurance in the package of products. The amount of insurance, say $5,000, is unrelated to the outstanding credit.

The cost of accidental death insurance varies widely (from 0.8¢ to 2.0¢ per $100 per month). Variations in premium rates are mostly due to policy benefit variations. Policies may insure all accidental causes, just common carriers (travel accident), or automobile travel only. Variations in premium rates also result from the interaction of the fixed expenses and the small dollars of premium income. For example, even at 2.0¢/$100/month, the monthly gross premium for $5,000 of insurance is only $1.00.

Credit Card Insurance for Unauthorized Use. The benefit under this insurance is a payment equal to the deductible that the cardholder must pay when charges are made under the card by an unauthorized user—generally $50. The gross premium is about 1¢ per $100 per month or may be expressed as a flat cost per card.

When a card is lost, stolen, or used by an unauthorized person, the creditor often imposes a deductible, such as the first $50 of charges made by the unauthorized user. If this occurs, a claim is submitted to the insurer with appropriate proof, and the insurer pays the benefit.

Dismemberment. The benefit under this insurance is a payment of the outstanding balance on the date of dismemberment. Each policy will define dismemberment. It will usually include loss of sight.

Proof of claim must be presented, normally just a signed doctor's statement. With today's medical technology, claims may be difficult to adjudicate. Few policies define the benefit when a limb is dismembered but restored.

Chapter Seven

Introduction to Installment Credit

Definition

Installment credit is consumer credit where the borrower agrees to repay the credit in substantially equal monthly payments. Typical transactions are:

- *Cash credit*. The borrower receives cash for the purchase of consumer products or for other expenditures.
- *Installment sale contract*. The purchaser receives a consumer product in exchange for entering into consumer credit requiring periodic payments.

Installment Credit

Since credit-related insurance is tied to a specific credit obligation, it is necessary to understand the basic structure of the installment credit that defines the insurance protection. The primary structure is **installment** or **closed-end credit.**

Installment credit is called closed-end credit because the amount and term of the credit are fixed at inception, and the credit is repayable in equal monthly payments. The **principal** is the cash advanced, or the portion of the purchase price of the product that is financed. A single premium is charged for the insurance. The total amount advanced includes the principal plus the insurance premium. Another term for the total amount advanced is the **initial net indebtedness**. At the credit's inception, the **initial gross indebtedness** is also calculated. The interest charges over the scheduled term of the credit are determined. The initial gross indebtedness is the initial net indebtedness plus the scheduled interest charges.

If the credit is repayable in equal monthly installments, the **monthly payment** is equal to the initial gross indebtedness divided by the term of the credit in months. Each monthly payment provides for the payment of the interest charges for the current month based on the remaining net indebtedness at the beginning of the month. The remainder of the monthly payment is applied to reduce the net indebtedness. The **outstanding balance** of the credit at any time is the remaining net indebtedness. Pages 83-84 display a simple installment credit example.

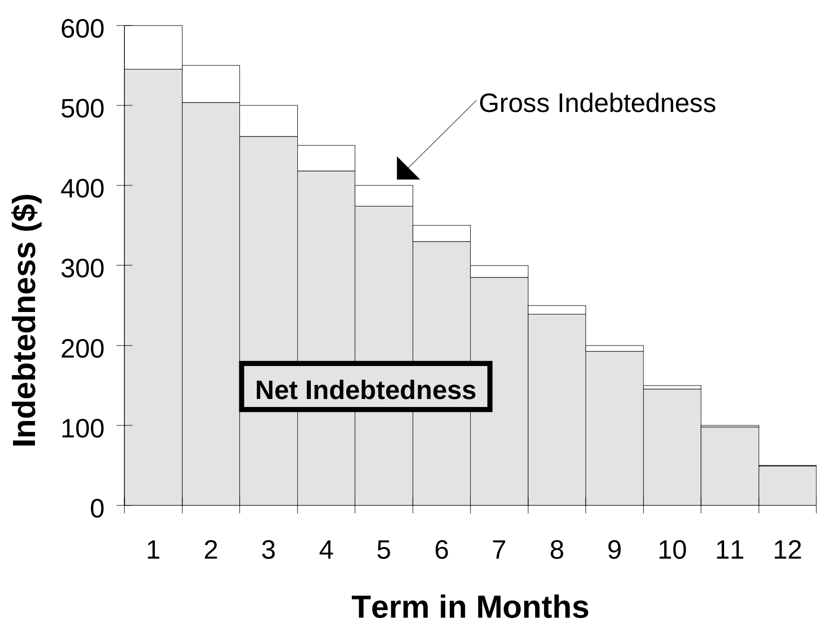
The gross indebtedness declines in equal amounts on a monthly basis. The amount of monthly decrease is equal to the required monthly payment. The net indebtedness declines each month also, but the pattern of the decrease is not uniform, since interest charges consume more of the early payments.

This section of the book addresses credit involuntary unemployment insurance, credit property insurance, and non-filing insurance on installment credit. Credit disability insurance is well documented in the industry literature, so only an introduction to the product has been included as Appendix B. The family leave benefit used on open-end credit has not been extended to installment credit.

Details of Credit: 12-month term with an 18% annual interest rate compounded monthly

Cash Advanced	$542.38	
Insurance Premium	3.00	
Initial Net Indebtedness		$545.38
Finance Charges		54.62
Total of Payments (Initial Gross Indebtedness)		$600.00

Monthly Payment equals $600.00 / 12 or $50.00



End of Month	Remaining Net Indebtedness	Portion of Monthly Payment Applied		Remaining Gross Indebtedness
		For Interest	To Net Indebtedness	
0	$545.38			$600.00
1	503.56	8.18	41.82	550.00
2	461.11	7.55	42.45	500.00
3	418.03	6.92	43.08	450.00
4	374.30	6.27	43.73	400.00
5	329.91	5.61	44.39	350.00
6	284.86	4.95	45.05	300.00
7	239.13	4.27	45.73	250.00
8	192.72	3.59	46.41	200.00
9	145.61	2.89	47.11	150.00
10	97.79	2.18	47.82	100.00
11	49.26	1.47	48.53	50.00
12	0.00	0.74	49.26	0.00
Total		54.62	545.38	

The calculations for the first monthly payment are:

Monthly interest rate

(Annual rate) / (Number of months per year)

= 18% / 12 **= 1.5%**

Portion of first payment for interest

(Beginning net indebtedness) x (Monthly interest rate)

= $545.38 x 1.5% **= $8.18**

Portion applied to net indebtedness

(Monthly payment) - (Part of 1st payment for interest)

= $50.00 - $8.18 **=$41.82**

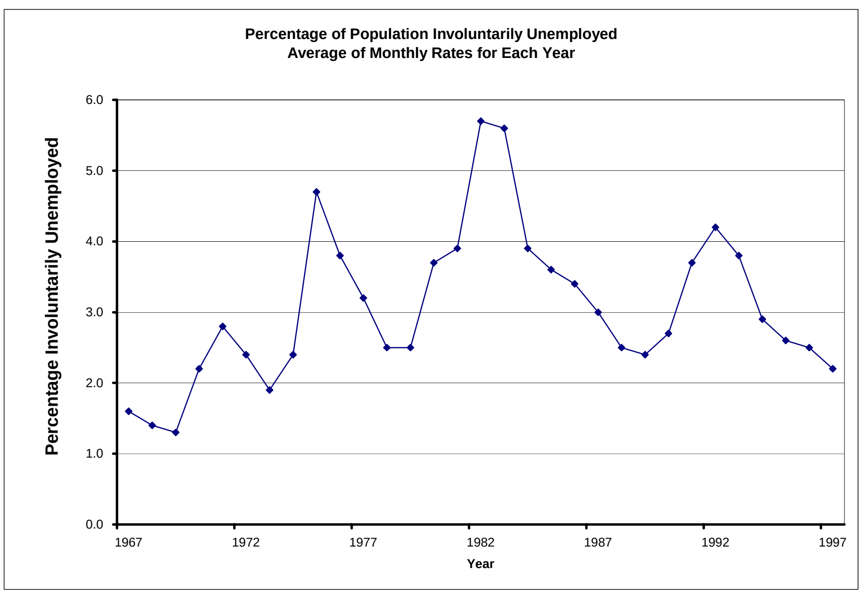
Outstanding net indebtedness at the beginning of the second month

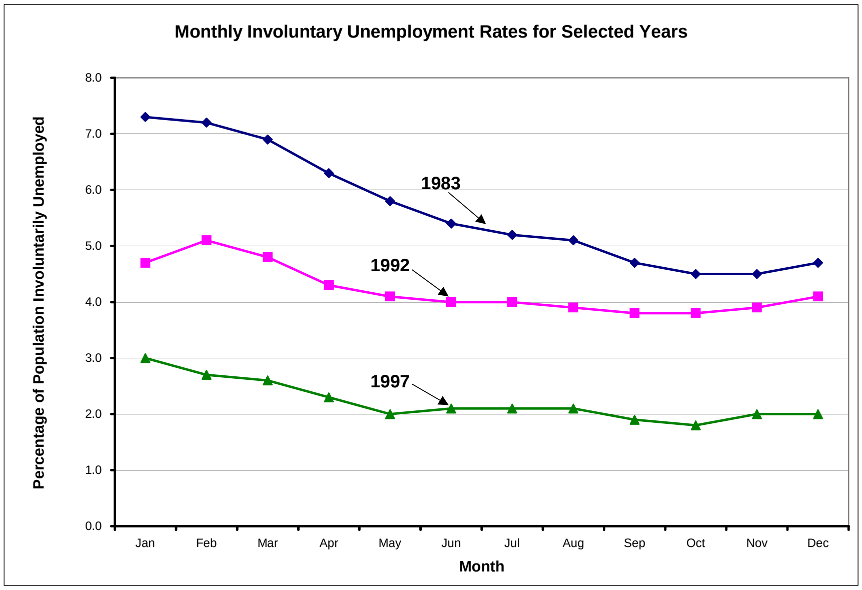
(Beginning net indebtedness) - (Portion applied to net indebtedness)

= $545.38 - $41.82 **= $503.56**

Characteristics of Credit-Related Insurance Offered in Conjunction with Installment Credit

1. At the inception of the installment credit, the producer offers the borrower the opportunity to buy insurance. To be eligible, the borrower must be less than a maximum age, generally 65.
2. Credit life insurance, disability insurance, involuntary unemployment insurance, and property insurance are offered independently as voluntary options on the part of the borrower.
3. Insurance matches the credit. Life insurance in force during the term of insurance equals the sum of the remaining payments due on the credit (gross coverage) or the remaining net indebtedness (net payoff coverage). The monthly disability insurance or involuntary unemployment insurance benefit is equal to the required monthly payment. Credit property insurance insures the indebtedness on the property.
4. The first beneficiary of the policy proceeds is the creditor, who uses the proceeds to extinguish the credit. Any additional proceeds are paid to the insured (if living) or to the insured's estate.
5. The premium charged is a single premium paid at the inception of the insurance. The premium is included in the amount advanced and is financed along with the principal of the credit.
6. Disability insurance and involuntary unemployment insurance rates vary by term of insurance, but there is only one rate for all ages and both sexes.
7. The initial policy size is generally under $20,000, and the term of insurance is short, generally 60 months or less.
8. Policy forms contain few exclusions.
9. Insurance terminates when the credit ceases. If the credit is repaid prior to the scheduled maturity date, a refund of the unearned single premium is paid to the borrower.




Monthly Involuntary Unemployment Rates for Selected Years
Percentage of Population Involuntarily Unemployed
8.0
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
1983
1992
1997
Jan
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
Month

Chapter Eight

Involuntary Unemployment Insurance on Installment Credit

Definition

Credit involuntary unemployment insurance (IUI) on installment credit is single premium loss of income insurance purchased in conjunction with closed-end installment credit that provides a level monthly benefit while the insured is involuntarily unemployed during the term of insurance. The monthly benefit equals the required monthly payment.

Overview

IUI on installment credit pays a monthly benefit if the insured becomes *involuntarily* unemployed. The cause of unemployment must be involuntary, such as layoff, strike, or business closing.

Consumers use finance companies to obtain unsecured cash credit, to borrow money for the purchase of specific consumer products, and for credit that is secured by a lien against real estate based on the borrower's equity in the real estate. Consumers also arrange for financing the purchase of many consumer products from the retailer selling the consumer products under an installment sale contract.

IUI is offered by finance companies in conjunction with both non-real estate secured credit and real estate secured credit, and by retailers on the purchase of appliances, electronics, and other consumer products. About 15 independent credit insurers market specialized insurance products for this type of credit. Several producer-owned, direct-writing insurers offer similar programs.

The primary market is installment credit of 60 months or less with an initial gross indebtedness of $20,000 or less, but a growing market segment is real estate secured credit for larger amounts. The product is occasionally available in the automobile dealer market, but its primary use is in conjunction with lease transactions. Single premium credit life and disability insurance are often offered at the same time, but each purchase is an independent decision; products have not been packaged yet.

IUI on installment credit is purchased with a single premium based on the initial gross indebtedness. The premium is typically financed; the total amount financed includes the principal increased by the amount of the IUI premium and other insurance premiums. Rates are expressed as a rate per $100 of gross indebtedness and are only loosely regulated—at least as compared to credit life and credit disability rates.

Thirty-day retroactive coverage is common. A benefit begins after thirty days of involuntary unemployment, and benefits are retroactive to the first day of involuntary unemployment. Fourteen-day retroactive coverage is also offered.

The term of insurance generally equals the term of the credit, but the maximum number of benefit payments is limited. If the insured satisfies the conditions of involuntary unemployment and the waiting period, a monthly benefit is paid equal to the scheduled monthly payment. If involuntary unemployment continues, benefits continue until the maximum number of benefits is reached or until the term of insurance expires.

Qualification for a claim only requires proof that the insured qualifies for state unemployment benefits in most cases. Proof of continued unemployment must be submitted monthly. Benefits are paid to the creditor.

Policy Structure

This insurance is generally written under a master insurance policy or a group insurance policy. The creditor is the policyholder (master policyholder or group policyholder). A borrower of the creditor who elects insurance becomes an insured borrower or a certificateholder and receives a certificate of insurance. About five states will not approve a group policy.

Many policies have a “30-day free look” provision. This provision allows the borrower to purchase the insurance, think about it for 30 days, and, if not satisfied for any reason, cancel the policy during the 30-day period and receive a full refund of premium.

Eligibility for Insurance

Only the primary borrower is eligible for involuntary unemployment insurance on installment credit. To be eligible for IUI, the borrower must meet all of the following conditions:

- Be working for wages for a minimum number of hours per week in accordance with the terms of the policy, such as 30 hours per week
- Be continuously employed for some period as of, and including, the effective date of the IUI, ranging from 30 days to 12 months
- Be employed for a period of time by the same employer in a non-seasonal occupation as of, and including, the effective date of the IUI, such as 90 days

- Not be self-employed, not be in full-time military service, and not be an independent contractor

Some insurers have more liberal policies and do not impose all conditions. In general, the smaller the average balance, the fewer the eligibility conditions and the shorter the period of time required to qualify.

The Insured Event

Benefit payments are made to the creditor when the insured borrower loses employment income as the result of involuntary unemployment caused by one of the following:

- Individual termination for cause, unless the particular cause is excluded
- Individual or mass layoff, typically defined as a temporary or permanent suspension of employment of a person at the employer's demand
- Termination of an employer's business
- General strike against an employer
- Unionized labor dispute
- Lockout

Some states prohibit insurance for strikes or other unionized labor disputes.

The Underlying Credit

IUI can be offered with most installment credit. The term of the credit can be longer and the monthly payment can be higher than the IUI policy limits. In the event of a loss, however, the policy benefits will be limited by the policy maximums. IUI policies usually have policy limits or are offered in conjunction with credit where:

- Gross indebtedness does not exceed $20,000
- Term of insurance does not exceed sixty months
- Monthly payments do not exceed $1,000

Credit programs that meet these conditions are:

- Short-term installment credit
- Automobile and marine credit, particularly leases

The primary success of this product has been in credit markets where the gross indebtedness is under $10,000, the term is 60 months or less, and the monthly payment is $200 or less. In addition to installment credit, this product can be offered in lease and rent-to-own transactions.

Finance companies commonly offer the product in con-junction with real estate secured credit, such as closed-end second mortgage credit. This credit has a high initial gross indebtedness, up to $100,000, and is structured as long-term credit to minimize the monthly payment, generally 10, 15 or 20 years. The IUI term is normally limited to the first 60 months of the credit term.

IUI can only be purchased in conjunction with certain credit. P&C insurers have not offered IUI as a stand-alone insurance product to cover other obligations, nor can consumers go to their local insurance agent and purchase involuntary unemployment insurance. The few P&C insurers who have offered such a product have found it difficult to underwrite and have experienced considerable adverse selection (or *anti-selection*)—the tendency of people to buy insurance products when they believe that they have a higher-than-average probability of a loss.

Markets and Marketing

The market for IUI has grown in recent years, but the single premium product has been generally limited to finance companies and retailers. In Canada, both automobile dealers and banks offer it using the descriptive name, *loss of time insurance.* All financial institutions extending installment credit can potentially offer IUI, such as:

- Banks
- Consumer finance companies
- Factory-affiliated finance companies, such as those of automobile manufacturers (Ford Motor Credit Corporation, General Motors Acceptance Corporation)
- Credit unions

Automobile dealers and other retailers of consumer products are also viable outlets for the product.

Today's automobiles cost so much that adverse selection is a factor when the product is offered in conjunction with the purchase of new automobiles. This market has an average term approaching 60 months and an average monthly payment of $300 or more. In addition, the sale of IUI will likely cannibalize the sale of credit disability insurance, since many insureds cannot afford the cost of both products. The product's appeal to younger borrowers, however, would likely expand the total market for credit-related products.

The growing lease market offers a viable marketplace. Insurance only applies to the "stream of payments"—the monthly lease payments. Since most leases are for 24 or 36 months, the exposure to changes in unemployment levels is limited. Even with this short insurance term, the benefits are generally limited to a specific number of months.

When IUI is purchased in conjunction with installment credit, the up-front single premium is financed. The premium is added to the amount of credit that is extended.

It is more convenient for the buyer and the creditor if the purchase is made at the time of credit application or closing. IUI can be purchased and financed after the credit closing is completed, but the credit obligation must be rewritten. Consequently, most IUI on installment credit is offered by the creditor at the point-of-sale. The credit officer who is assisting with the credit closing offers the product to the borrower. IUI insurers provide product and sales training to the producer personnel who are responsible for presenting IUI. In some situations, a full property and casualty license is required to offer the product. This is a significant deterrent to its widespread availability, particularly in the automobile market.

The Insurers

Independent insurers offer the product through a variety of creditors and retailers. An insurer needs approved forms in many states to participate in this marketplace, since a producer may have branches or retail outlets in a large number of states.

In most states, the direct writing insurance company must be licensed as a property and casualty insurer. In 1997, a life insurer could issue IUI policies in Ohio, Minnesota, North Carolina, Washington, and some other states. The trend in the regulatory process is for more states to consider this product akin to credit disability insurance and to permit life insurers to issue the product. Insurers have encouraged the trend by grouping both products under the title, *loss of income insurance*.

A number of insurers issuing IUI are owned by or affiliated with a retailer or a creditor, such as a finance company. By federal law, a bank holding company or a subsidiary is specifically authorized to offer this product, and an affiliated insurance company can underwrite the product. Because of the specialized nature of the product, some corporations use an independent insurer, even though an affiliated insurer could issue the product.

Underwriting Criteria

For Borrowers. As with most credit-related insurance, the IUI underwriting process piggybacks on the credit underwriting process. If the borrower's financial condition passes the creditor's normal credit risk analysis, the creditor approves the credit limit. Typically, specific underwriting for IUI is not done. All customers who qualify for installment credit and meet the eligibility for insurance requirements qualify for IUI.

This underwriting process succeeds because the creditor's credit risk analysis adequately serves as an involuntary unemployment risk analysis. Consequently, it is important that the creditor maintain the quality of its credit risk analysis on IUI-insured credit.

Where monthly benefits are substantial (above $200), an underwriting question may be asked, such as, "Have you been told of an impending layoff, plant closure, or other known work stoppage?" Alternatively, the benefit during the first 60 or 90 days of the insurance term can be limited to one monthly benefit or a return of the gross premium. These benefit limitations reduce the effect of adverse selection.

For Creditors. Insurers underwrite at the policyholder level for this product by considering the financial condition of the policyholder, the nature of the underlying credit, and the financial profile of the policyholder's customers. Since the product is tied to the quality of credit extended by the financial institution or the retailer, the insurer's interest is reasonably well protected.

Term of Insurance

For Borrowers. The inception of the insurance and the effective date of the credit typically coincide, because this insurance is customarily offered when the credit application is taken or at closing. The term is usually equal to the term of the credit, subject to any policy limits. A policy limit of 60 months is common, but the limit is usually only a factor on real estate secured credit.

Insurance terminates when the credit is repaid. This occurs at expiry in accordance with the original payment schedule. It also occurs prior to the scheduled expiration from voluntary termination of the credit or the insurance, in which case the unearned gross premium is refunded. A few policies permit the insurer to terminate insurance by paying an unearned premium refund; this termination does not affect any existing claim.

For Creditors. The insurer or the policyholder can terminate the policy for new business, normally with 30 days written notice, by following the termination procedures in the policy. The insurer remains responsible for the remaining term of insurance in force and for all existing claims, unless it makes arrangement for the new insurer to assume the liability through assumption reinsurance or some other transfer of risk agreement.

Benefit Conditions

Benefits vary based upon the particular IUI policy. The structure of the benefits provided, eligibility to receive benefits, elimination periods, and policy maximums are described below.

Benefit Provided. The insurer pays the borrower's scheduled monthly payment to the creditor in accordance with the IUI policy. In the final benefit month, most policies provide a pro-rata daily benefit for a partial month, but some policies pay only the full monthly payments that fall due during the term of involuntary unemployment.

If a claim occurs during the first 60 or 90 days of the insurance term, the benefit is often limited to one monthly payment or a return of the original single premium; the insurance is then terminated.

Eligibility for Benefits. To initially be eligible for benefits the insured borrower must:

- Be involuntarily unemployed for the elimination period specified in the policy (such as 14, 30 or 31 days),
- Qualify for unemployment benefits under state unemployment laws, *and*
- Provide the insurer with verification of loss of employment.

For continued benefits, the insured borrower must prove continued unemployment at monthly intervals by:

- Qualifying for state unemployment benefits, *or*
- Registering with an employment agency.

There are a few exceptions where the requirement of qualifying for state unemployment benefits does not apply. The insured must prove continued unemployment at monthly intervals if the insured wants to receive the benefit payments at monthly intervals. Otherwise, the insured must make timely monthly payments to keep from incurring late charges under the credit obligation. Insurers will accept claims covering periods longer than a month, but they will not pay a claim until proof of the continuance of the claim has been received.

Elimination or Waiting Period. A 30-day elimination period is prevalent, but a 14-day period is occasionally used.

Retroactive Clause. Most policies have retroactive benefits after 30 days of involuntary unemployment; benefits are paid from the first day of involuntary unemployment. Non-retroactive benefits are an alternative; benefits begin on the first day of involuntary unemployment following the elimination period.

Maximum Benefit. IUI policies have provisions defining the maximum amount of benefits payable. The broadest (and rarest) coverage provides benefits until the expiry of the credit, subject to continued involuntary unemployment. Most IUI policies on installment credit place limits on the maximum benefit by limiting either 1) the maximum number of continuous monthly benefits, or 2) the maximum number of benefits during a period of time. A maximum is also imposed on the total benefit that is payable during the term of insurance, stated as a maximum number of monthly benefits or as a flat dollar amount. These policy maximums often vary based on the term of the individual insurance.

Example 1. The maximum number of continuous benefits and the maximum number of total benefits are selected from a grid that is contained in the policy, such as:

Insurance Term in Months	Maximum Number of Consecutive Monthly Benefits	Total Maximum Number of Monthly Benefits
1-23	3	6
24-35	4	8
36-48	6	12
49-60	8	12

Under this policy, the benefits for any one episode of involuntary unemployment are limited to the consecutive maximum number. More than one insured episode of involuntary unemployment is possible, but each episode must be separated by a period of employment, typically from 30 days to six months. The total maximum limits the benefits from all episodes of involuntary unemployment.

Example 2. The maximum number of benefits equals four monthly payments during any 12-month period during the term of the policy, with a maximum of $5,000 in total benefit payments.

Exclusions. IUI benefits are not payable in the following cases:

- Voluntary unemployment
- Resignation
- Retirement
- Unemployment due to disability
- Termination because of willful or criminal misconduct
- Seasonal unemployment

Some states require that strikes or other unionized labor disputes be excluded.

Lump Sum Benefit Policies. Since the early days of credit-related insurance, a small portion of credit disability insurance products have provided a lump sum benefit equal to the insured balance on the date of loss in the event of total and permanent disability. This concept can be applied to IUI products. The waiting period is long, generally 90 days or 180 days. If an insured remains involuntarily unemployed for the waiting period, the benefit equals the indebtedness. This coverage is rare.

Premium Rates

IUI on installment credit is purchased with a single premium based upon the initial gross indebtedness of the insured credit. Where the insurance term is shorter than the credit term, the gross indebtedness for IUI premium calculation purposes is the monthly payment times the insurance term in months.

Premium rates are most commonly expressed as a rate per $100 of gross indebtedness ($5.00 per $100 of gross indebtedness) or as a rate per $100 of gross indebtedness per year of insurance, ($2.00 per $100 per year of insurance term). Rates vary significantly based upon the particular policy and its corresponding benefit structure. Most IUI policies have rates in the range of $3.00 to $5.50 per $100 of gross indebtedness; or $1.00 to $2.50 per $100 of gross indebtedness per year of insurance term.

For example, suppose the principal equals $5,000 and the term of insurance equals 48 months. Assuming an annual percentage rate of interest equal to 12%, the monthly payment equals $131.67. The gross indebtedness equals the sum of the payments (before insurance premiums in this case)—$6,320.16.

If the borrower purchases IUI at a rate of $2.00 per $100 per year and pays for the insurance separately, the single premium equals:

$$\$2.00 \times (\$6{,}320.16 \div 100) \times (48 \div 12) = \$505.61$$

If the borrower purchases IUI at a rate of $5.00 per $100 and pays for the insurance separately, the single premium equals:

$$\$5.00 \times (\$6{,}320.16 \div 100) = \$316.01$$

Most borrowers elect to finance the IUI premium. Since the IUI premium is calculated based on the total amount borrowed, the calculation is circular, but the premium can be calculated by iteration.

In order to deal with this circular relationship and to avoid laborious manual calculations, insurers of credit-related products originally developed rate charts containing an array of gross premiums for various terms, interest rates, and amounts borrowed. These rate charts were provided to the creditors so that insurance premiums and monthly payments could be easily quoted at the point of sale. Now, most creditors are provided pre-programmed handheld calculators or have PC-based programs.

The standard premium basis—a rate per $100 of gross indebtedness regardless of term—seems unusual at first, but it implicitly reflects the term of insurance. Given the gross indebtedness of $100 and a rate of $5.00 per $100 of gross indebtedness, the monthly benefit varies by term as shown in the following table.

Term in Months	Initial Gross Indebtedness (IGI)	Monthly Payment [= IGI / Term]
12	$100	$8.33
24	$100	$4.17
36	$100	$2.78
48	$100	$2.08
60	$100	$1.67

In other words, if the initial gross indebtedness is $100, a premium of $5.00 buys a monthly benefit of $8.33 under a 12-month term policy, but it buys a monthly benefit of only $1.67 under a 60-month term policy. The exposure period on 60-month credit is five times the exposure period on 12-month credit, but the monthly benefit is only one-fifth as much.

Due to adverse selection and other factors, the actual claim costs per month are higher for shorter-term insurance. The claim costs are leveled among the various insurance terms by providing a lower maximum number of benefits for shorter-term insurance.

A few states have adopted prima facie rates for this insurance. The general form of most prima facie rates is a rate per $100 of gross indebtedness per year of insurance term. This structure produces very high rates for terms over 36 months. Other states have rates by term (Pennsylvania) or an MOB rate ($2.00/1000/month) and a directive to use the standard credit life conversion formula (Alabama):

$$SP_n = MOB \times \left(\frac{n+1}{20} \right)$$

Where, SP_n is the single premium rate per $100 of initial gross indebtedness with an original term of n months

MOB (or OP_n) is the monthly premium rate per $1000 of outstanding balance, and

n is the original term of insurance.

Some regulations state the prima facie rate without any limitation on the benefit structure; others require a set of minimum benefits and place constraints on the eligibility requirements and exclusions.

Premium Refunds

If the insurance is canceled or the credit is paid off early, the unearned portion of the original single premium is refunded. In most states, the insurer is permitted to calculate premium refunds using the Rule of 78. Some states require the straight-line basis, so the unearned premium is refunded in accordance with the pro rata method.

If the IUI is canceled but the credit is not paid off, the outstanding principal balance of the credit is reduced by the amount of the unearned premium. The payment amount does not change, but the term of the credit is reduced. The credit obligation does not need to be rewritten.

Agent Licensing

The regulatory trend is for IUI to be viewed in the same light as credit life and credit disability insurance for licensing purposes. Licensing regulations are being changed to match the requirements for credit life and credit disability insurance. A few states have already enacted regulations permitting IUI to be offered using a limited credit insurance license, while other states have expanded the group enrollment exemption that applies if the product is structured as a group policy.

Point of Sale (POS) Marketing. Typically, one person at the location where credit is extended, such as a branch office of a finance company, holds a full P&C license in accordance with the laws and regulations of that state. The branch manager, for example, will be licensed. Individual credit processors who present the insurance may not need a full P&C license. Instead, they may rely on a limited credit insurance license or the group enrollment exemption. Still, for small finance companies, these requirements are a substantial obstacle.

Available States

Single premium IUI is available in most states.

Advantages to the Producer

The product provides an additional service to borrowers. By offering the borrower the opportunity to purchase IUI to insure this risk, the creditor is providing the borrower with a valuable and necessary service. Even young borrowers perceive a need for the insurance. Young people consider the possibility of death as remote, the possibility of disability as unlikely, but see involuntary unemployment as possible.

The policy benefits reduce collections and associated legal and administrative expenses. IUI makes the borrower's monthly payments during the time the borrower is seeking reemployment. The creditor experiences fewer defaults and, consequently, incurs lower costs. The borrower does not default during this period. The protection results in lower costs associated with attempted collections, write-offs, and account closings.

Sale of the product provides an additional source of fee income. From a return on investment standpoint, fee income is an attractive proposition to creditors. However, the return is only available because of the initial capital investment made by the creditor to build the installment credit base. Marketing of IUI in conjunction with the credit requires minimum additional capital investment by the creditor. Since IUI produces a good return in dollars on a small capital investment, its return is attractive.

Reserves

Policy Reserves. Policy reserves are based on unearned premiums. The "proper" unearned premium method is to earn the premium in accordance with the pattern of incurred claims. For this product, the incurred claim pattern is between the Rule of 78 and pro rata. If the policy has a relatively long term and a low number of maximum benefits, the pattern approaches pro rata. A 48-month insurance term with a maximum of six continuous monthly benefits is an example of such a policy. As the term becomes shorter or the maximum number of benefits becomes higher, the pattern of incurred claims approaches Rule of 78. Pro rata unearned premiums are always appropriate and contain a margin of conservatism, but other methods may be appropriate.

Loss Reserves. Loss reserves for unreported losses, *IBNR (Incurred But Not Reported)*, are an estimate usually based on factors that are developed as a function of a rolling, last *n* months of earned premiums, such as 20% of the last 12 months of earned premiums. Other factor bases, such as *n* months of paid claims, are also used.

In the life insurance world, reported claims are segregated into two categories, and the reserves are called by a variety of terms:

1. Pending claims (*claims in course of settlement*)
2. Continuing claims (*continuing claims reserve, the present value of amounts not yet due, case reserves)*

In the P&C world, the term *case reserves* generally applies to both categories. Reserves for the future payments on reported claims are estimated by various methods, including:

- Case reserves set by knowledgeable claims personnel
- Calculations using completion factors based on duration of unemployment and possible months of future benefits
- Calculations using an average claim duration factor that is a function of the monthly benefit

P&C insurers make a provision for loss adjustment expenses, but the expense level for IUI is small, generally under 5% of premium. In states where a life insurance company can issue IUI, there is rarely a requirement to hold loss adjustment expense reserves.

Overall loss reserve adequacy is usually tested using lag studies.

Claim Fluctuation Reserves. The unemployment level is volatile. A prudent insurer should consider the need to establish claim fluctuation reserves. A review of the unemployment levels over the last twenty years presents a strong case for the need for such a reserve. New York specifically authorizes the establishment of such a reserve; it is acceptable to include the claim fluctuation reserve in the determination of incurred claims for purposes of rate determination.

Chapter Nine

Credit Property Insurance on Installment Credit

Definition

Credit property insurance on installment credit is single premium property insurance purchased in conjunction with closed-end installment credit that insures consumer products purchased with the credit proceeds (or pledged as collateral) against specified loss occurrences causing damage to, or disappearance of, the property.

Overview

When purchasing a consumer product, such as a sofa or a television, a buyer often uses installment credit to finance the purchase. It is common for the sofa or television to be the collateral that secures the credit. In other installment credit situations, borrowers pledge personal property in order to collateralize the credit. In such instances, the credit proceeds are used for some purpose other than the purchase of the collateral.

In either case, the property represents collateral. Consequently the creditor (as well as the buyer/borrower) has an interest in protecting the value of the property. At a minimum, the creditor wants the property's actual cash value to exceed the borrower's indebtedness at each point in time during the term of the credit. This goal cannot be achieved if the property is damaged, destroyed, or stolen unless it is adequately insured.

Credit laws permit creditors to require that the borrower insure the collateral against physical loss. The borrower can comply with this insurance requirement by adding a loss payee endorsement to an existing homeowners or tenants insurance policy. Adding such an endorsement can be a cumbersome process, and the borrower may not be fully protected.

Homeowners policies contain deductibles and exclusions for common perils, such as flooding. Standard homeowners insurance does not reimburse losses on a replacement cost basis. Moreover, many borrowers do not have homeowners or tenants insurance. The need for first dollar, primary property insurance on the collateral used to secure credit can be conveniently satisfied with credit property insurance.

Credit property insurance is protection for the creditor and the borrower in the event of a covered loss occurrence. A covered loss occurrence is defined by the credit property insurance policy, but in general, protection is provided against perils such as fire, collision, and burglary. Some policies provide a benefit up to the outstanding balance of the credit, while others provide a benefit up to the replacement value of the damaged good.

Retailers of appliances, electronics, and other consumer products offer this insurance at the time these products are purchased. Finance companies offer this product in conjunction with non-real estate secured credit. About 25 independent credit insurers offer this specialized insurance product. Several producer-owned, direct-writing insurers offer similar programs.

Policy Structure

This insurance is generally written under a master insurance policy or a group insurance policy. The creditor is the policyholder (master policyholder or group policyholder). A borrower of the creditor who elects insurance becomes an insured borrower or a certificateholder and receives a certificate of insurance. About five states will not approve a group policy.

Both *single interest* and *dual interest* coverages are available in the credit property insurance marketplace. *Single interest coverage* protects only the creditor's financial interest in the consumer product. In the event of an insured loss, benefits are limited to the extent of the creditor's interest in the collateral. In other words, the benefits do not exceed the lesser of:

1. The cost to repair or replace the covered item, or
2. The indebtedness at the time of loss.

The borrower may have an interest in the property that exceeds the indebtedness. If the value of the item, or the cost to replace or repair the item, exceeds the indebtedness, the borrower's interest is the excess over the creditor's interest. *Dual interest coverage* protects the interests of both the creditor and the borrower. The benefit payable is typically equal to the cost to repair or replace the covered item.

Most credit property insurance on installment credit is dual interest coverage offered as a voluntary purchase at the same time that life, disability, involuntary unemployment, and other products are offered.

Many policies have a "30-day free look" provision. This provision allows the borrower to purchase the insurance, think about it for 30 days, and, if not satisfied for any reason, cancel the policy during the 30-day period and receive a full refund of premium.

Eligibility for Insurance

When credit is used to finance the purchase of collateral, the following requirements must usually be met to be eligible for insurance:

- There must be a credit instrument—a mortgage, bill of sale, or installment sale contract—pursuant to which the creditor may gain access to the property in the event of a default. Property must not be used differently than the way in which it was intended when purchased.
- Property must remain within the United States.

For general-purpose credit that is secured with personal property, the requirements may include:

- Property must belong to the borrower.
- Ownership of the property must be free of any encumbrances or liens.
- Property must remain in the possession of the borrower.

If the policy conditions are met, insurance is available to all borrowers. Of particular note is the lack of geographical restrictions on where the insurance is offered. In certain locations, credit property insurance may be the only reasonably priced property insurance available. There are a number of urban areas where standard property insurance is difficult to obtain.

The Insured Event

Credit property insurance covered perils vary from policy to policy. In general, the policy insures against occurrences that cause direct and accidental damage to the insured property up to and including a total loss. Perils that occur while the property is being transported, such as collision, may be included. If the terms of the credit permit the property to be taken outside the U. S., damage outside the U. S. is usually covered.

The occurrences that can result in a loss include:

1. Fire
2. Smoke
3. Lightning
4. Wind or Windstorm
5. Cyclone
6. Tornado
7. Flood
8. Hail
9. Earthquake
10. Explosion
11. Riot
12. Riot Attending a Strike
13. Civil Commotion
14. Marine Perils While on Ferries and in Automobiles
15. Damage Caused by Aircraft or Falling Objects
16. Damage Caused by Vehicles
17. Collision
18. Vandalism and Malicious Mischief
19. Burglary

A significant consideration in product pricing is whether the contingencies of theft and mysterious disappearance are covered. The definitions of burglary and vandalism require evidence of forcible entry. Theft and mysterious disappearance are basically burglary or vandalism without clear evidence that a crime occurred, other than the reported disappearance of the item. Inclusion of this contingency may raise the claim costs significantly; most policies do not cover mysterious disappearance.

The insurance can be *named peril* or *all risk*. *Named peril* coverage insures only the specific perils that are itemized in the policy, such as those listed above. *All risk* policies provide coverage insuring all causes of loss, except for certain specifically excluded events and other specific exclusions. *Most credit property policies are named peril.*

The Underlying Credit

Credit property insurance is offered with credit where:

- The property being purchased is used as collateral to secure the credit, *or*
- The borrower pledges some set of personal assets as collateral in order to obtain the credit. The credit proceeds may then be used for anything, such as a vacation or education costs.

Technically, the creditor need only believe that the assets have a market value equal to some amount proportionate to the amount borrowed. The creditor has a vested interest in the condition of the assets securing the credit and will normally require insurance protection against events such as fire or burglary, at least to the extent of its interest. These credit obligations are generally for small amounts (under $5,000), and short terms (under 60 months), and are provided by banks or consumer finance companies who specialize in this type of credit. Consumer products in this category of installment credit include jewelry, furniture, VCRs, personal computers, televisions, and household appliances.

Another category of credit involves leases. Consumer products, such as fax machines, personal computers, and copiers are examples in this category. These products, with respect to their value and use, tend to fit into the consumer product category. For example, the cost of a 29" TV and a small copier are about the same. They are often leased, instead of being purchased with the proceeds of installment credit. Lease agreements applicable to such items operate similarly to installment credit. The lessee (analogous to borrower) and the lessor (analogous to creditor) have substantially the same interests in the leased property as their counterparts have in an installment credit purchase.

Markets and Marketing

The market for credit property insurance includes any situation in which property is used as collateral for credit. The use of property as collateral creates a need for insurance that protects the creditor's interest. The creditor must be assured that the collateral maintains its presumed value in the event of a loss. Credit property insurance assures that the collateral is replaced or repaired.

A representative list of the entities that market credit property insurance includes:

- Consumer finance companies
- Lessors specializing in certain items, such as office equipment
- Manufacturers' financing and leasing companies

- Retailers providing installment sale contracts or installment credit used in the purchase of:
  - Automobile parts
  - Consumer electronics
  - Furniture
  - Household appliances
  - Jewelry
  - Office equipment
- Specialized creditors, such as those dealing in office equipment or appliances only

The Insurers

The insurers providing credit property insurance are typically considered specialty lines P&C insurers. Almost all of these insurers offer other credit-related insurance products.

Underwriting Criteria

For Borrowers. Underwriting does not take place at the insured borrower level. Any borrower entering into qualifying credit is accepted if the borrower elects insurance.

This criteria contrast sharply with the underwriting process associated with homeowners insurance, but the fact that the insurance is offered in conjunction with approved credit portends that some underwriting has already occurred. Obtaining approval for credit suggests certain favorable characteristics about the prospective insured. Credit worthiness is considered a strong predictor of insurability for certain property insurance products.

For Creditors. Underwriting criteria vary among insurers and among policies due to the circumstances of the underlying credit, such as whether or not the credit proceeds are used to purchase the property. Insurers may have several programs, each with different underwriting considerations.

Underwriting involves evaluating the creditor as a group of insureds (borrowers) that indicate a certain level of claim activity. This underwriting includes information that allows the insurer to determine, at a contract pricing level, the expected claim experience. The most valuable quantitative information is the previous claim experience of the creditor. Other required qualitative information varies; it is based on the judgment of the insurer and is used as a supplement to the claim experience of the creditor and the insurer’s experience with comparable creditors. It may include an evaluation of the creditor’s:

- General credit practices
- Demographics of borrowers/customers
- Processes/procedures, including due diligence methods
- Geographical span of operation

Term of Insurance

For Borrowers. The inception of the insurance and the credit typically coincide, because this insurance is customarily offered at credit application or closing. The term is equal to the term of the credit. Insurance terminates when the credit is repaid or voluntarily terminated. If termination is prior to the scheduled maturity date, unearned premiums are refunded.

For Creditors. The insurer or the policyholder can terminate the policy, normally with 30 days written notice, by following the termination procedures in the policy. The insurer remains responsible for the remaining term of insurance on each in force policy and for all claim payments on claims that occur prior to the date of termination, unless it makes an arrangement for the new insurer to assume the liability through assumption reinsurance or some other transfer of risk agreement.

Benefit Conditions

When a covered loss event occurs, benefits are paid pursuant to the provisions of the particular credit property insurance policy. The general structure of the benefits provided and the policy maximums are described below.

Benefit Provided. Specific policy provisions vary from policy to policy and insurer to insurer. Typical benefit provisions are:

Single interest coverage. The benefit payable in the event of a covered loss event will not exceed the least of the:

- Cost to repair or replace the property with like kind and quality;
- Actual cash value (ACV) of the property at time of loss;
- Amount of impairment of creditor's interest, as represented by the unpaid balance of the credit; *or*
- Maximum amount of insurance as shown in the policy.

Dual interest coverage. The benefit payable in the event of a covered loss event will not exceed the lesser of the:

- Cost to repair or replace the property with like kind and quality; *or*
- Maximum amount of insurance as shown in the policy.

Coverage. Coverage can be *all risk* or *named peril*. Both of these coverages can be provided using either single interest or dual interest protection. Coverage is primary protection—the benefits are payable regardless of any other insurance proceeds. Coverage is often first dollar protection. Even where a deductible is imposed, it is generally small, such as $25 per occurrence.

Maximum Benefit. Most policies contain some limitation on the insurer's liability. Such limits are typically broken into two categories, *per occurrence* and *aggregate* limits. Both the "per occurrence" and the aggregate limits are typically set as a stated dollar amount, such as $10,000 and $1,000,000, respectively.

Per occurrence refers to the individual policies/certificates corresponding to individual credit. The insurer's liability, as defined in the coverage provision, is subject to a maximum limit for any one occurrence.

Aggregate limit applies at the policyholder level, where the policyholder is the creditor or retailer. The policyholder is treated as a group, and the insurer limits its aggregate claims exposure corresponding to that group. The limit can vary, depending upon the size of the creditor, the type of creditor, the average balance of the insured credit, geography, the catastrophe exposure, the type of credit, the type of collateral, and the average credit maturity.

The aggregate limit varies by situation, based upon type of credit, as well as by creditor within type of credit. For example, the credit type may be categorized as retail. Within this category, the size of creditor, the average balance of the credit, and the type of collateral can affect the aggregate limit of liability.

Exclusions. Coverage exclusions vary from policy to policy, however, the following are found in most credit property insurance policies:

- Loss or damage due to wetness or dampness, scratching, molding, freezing, rotting, or general decaying, unless the same is a direct result of an insured peril
- Mechanical breakdown, short circuit, power surge, or some other electrical disturbance, except lightning
- Loss or damage caused by neglect to use all reasonable means to save and preserve the property during and subsequent to any insured event
- Normal wear and tear
- Damage caused by blatant neglect or misuse
- Loss or damage caused by or resulting from:
  - War or warlike action during peacetime or war
  - Any weapon of war used during peacetime or war
  - Insurrection, rebellion, revolution, or civil war
  - Seizure or confiscation by a governmental or public authority
  - Any illegal activity
- Loss or damage under any coverage due to radioactive contamination
- Loss or damage to radio or television antennae or outside/lead in wiring
- Loss or damage resulting from use during a criminal act

Loss Reporting Procedures and Requirements. The insured borrower must report losses to the insurer as soon as it is practical. Credit property insurance policies contain provisions clearly setting forth the insured borrower's responsibility with respect to timely reporting of losses. This procedure will state that the insured borrower must report losses within a reasonable time period after a loss occurs, such as 90 days. Insurers consider the circumstances of the loss in deciding whether to enforce the time limit.

Additionally, the policy generally contains language referring to evidence of loss or sworn proof of loss. It is the insured borrower's responsibility to provide adequate proof to the insurer that an insured loss event has caused damage to the insured property. First, proof of purchase must be presented. A sales receipt will normally suffice. Then, depending on the insured event, some form of evidence of the loss is needed. For example, a police report will usually be sufficient for burglary or vandalism claims.

Settlement Options. Benefits can be paid in the form of cash, repair of the property, or replacement of the property, depending upon the policy and the claim. Suppose the property is purchased from a retailer with the proceeds of credit provided by an affiliated finance company. In such a case, a separate but affiliated insurance company may offer the insurance to the buyer/borrower. If a covered loss occurs, the claim might be handled jointly by the insurer and the retailer. In the event of a damage claim for a partial loss, the retailer where the item was purchased can repair the property. In the event of a total loss, the item can be replaced by an equivalent item from the same retailer. Both of these options might be more cost effective for both the insurer and the retailer, if the retailer has the necessary resources. In this situation, credit property insurance serves to promote goodwill and customer retention.

In the event of a total loss other than burglary and depending upon the policy, the insurer may take possession of the damaged property. A total loss occurs when it is decided that the cost to repair the damaged property exceeds its *actual cash value (ACV)*. If the insurer has this right, it will attempt to mitigate its loss by selling what is left of the damaged property to entities specializing in such matters. Whether this right is exercised also depends upon the condition of the property. For example, a collision loss may result in a different disposition procedure than a fire loss. The insurer's right under the policy to take ownership rights to any remaining value of the property is called *salvage or salvage rights*. The remaining value is *salvage value*; salvage value can equal zero.

Many traditional property insurance policies contain deductibles, disappearing deductibles, and provisions for depreciation. Under such policies, benefits are paid after any negative adjustments—negative in the sense that they reduce benefits payable. Credit property insurance policies do not typically contain depreciation adjustments or deductibles. The premium amounts and coverage amounts are such that the (premium) effects of deductibles would be barely noticeable. Additionally, the presence of deductibles and depreciation creates administrative burdens on both insurers and producers that, given the size of claims and premiums, are not justified. From the perspective of the insured borrower, credit property insurance represents more than just convenience value, since the damaged property can be fully repaired or replaced with no out-of-pocket expenses borne by the insured borrower.

Appraisal Process. In some cases, the insured borrower and the insurer fail to agree as to the covered amount of a loss. A policy provision allows for such cases by setting forth procedures to which all parties are bound. A common procedure is for the insured borrower and the insurer each to select a competent and impartial appraiser, and the selected appraisers will select a third. Within a predetermined amount of time, such as 15 days, an appraisal will be finalized. Situations such as disagreement among the appraisers, who bears the costs of the appraisers, and other conditions, are covered by this provision.

Premium Rates

A single premium is charged at the inception of the insurance term and provides insurance for the entire term. Single premium credit property rates are typically expressed in terms of a rate per $100 of initial gross indebtedness per year of insurance term. Rates for single interest coverage range from $1.00 to $2.50 per $100 per year, while the rates for dual interest coverage generally range from $2.00 to $4.50 per $100 per year.

For example, a single premium for a credit property policy with an initial gross indebtedness of $2,400, an insurance term of 24 months, and a single premium rate of $3.00 per $100 per year equals:

$3.00 x ($2,400 / 100) x (24 months / 12) = $144.00

Premium Refunds

When a policy is terminated before its expiration date, a refund is made in an amount equal to the unearned portion of the original single premium as of the cancellation date. The premium refunding methods and policy cancellation provisions vary by state and by type of policy.

Agent Licensing

Property and casualty insurance licensing requirements must be met, but the regulatory trend is for credit property to be viewed in the same light as credit life and disability insurance. Licensing regulations are being changed to match the requirements for credit life and credit disability insurance. A few states have already enacted regulations permitting credit property to be offered using a limited credit insurance license, while other states have expanded the group enrollment exemption that applies if the product is structured as a group policy.

Typically, one person at the location of solicitation holds a full P&C license in accordance with the laws and regulations of that state, such as a branch of the finance company where credit is originated and credit property insurance is offered in conjunction with the extension of credit. The branch manager, for example, will be fully licensed.

When a group policy is issued, individual credit officers who present the insurance may not be required to be licensed. Instead, they rely on the group enrollment exemption available in most states or they are licensed under a limited credit insurance license available in a few states. For finance companies, these requirements can be a substantial obstacle.

Available States

Credit property insurance, in one form or another, is available in all states.

Advantages to the Producer

The product provides an additional service to the borrower. Credit property insurance allows creditors to provide adequate and valuable protection to their customers. This promotes customer goodwill, especially in the case of property offered by a retailer that is financed by its creditor affiliate. Claimants quite often return to the same store to obtain repairs or to replace property damaged or totaled due to a loss. Customers in such a situation are most likely to perceive the retailer in a favorable light for having provided the opportunity to purchase full coverage.

Offering credit property insurance allows creditors to help customers protect their assets. It also benefits the creditor, since the insured borrower is a future source of business.

The product secures the creditor's interest. The creditor is dependent upon the property in question as collateral to secure the installment credit. The creditor (and perhaps the borrower, depending upon the situation) has an interest in the collateral asset being protected.

Relative to other lines of insurance, credit property insurance is inexpensive in total dollar outlay. Because of its broad coverage, credit property insurance is often more expensive on a "per $100 of insurance" basis than homeowners insurance, but the total dollar outlay is modest. The ease of purchase and breadth of coverage make the insurance an attractive alternative to the borrower in these credit categories.

P**urchase of credit property insurance is convenient.** In the retail situation, the credit application, approval, and purchase of the property are all done at the same location. Credit property insurance is made available to the borrower at that time. The financed single premium payment mechanism makes the payment of the cost of the insurance convenient for the borrower.

Credit property insurance is easy to administer. Since insurance is not the producer's main business, an insurer typically takes responsibility to keep the program current in terms of processes and technology, so that a minimal administrative burden on the producer is maintained. Initiatives in the areas of administrative processes and technology are often shared jointly by producers and insurers in partnership fashion.

Sale of the product provides an additional source of fee income. From a return on investment standpoint, fee income is an attractive proposition to creditors. However, the return is only available because of the initial capital investment made by the creditor to build the installment credit base. Marketing of IUI in conjunction with the credit requires minimum additional capital investment by the creditor. Since IUI produces a good return in dollars on a small capital investment, its return is attractive.

The availability of credit is expanded. A somewhat deeper analysis suggests that the availability of credit property insurance allows for a strata of credit that otherwise would be restricted or would not be available. In the small cash credit business, borrowers often do not own homes, and, therefore, do not have homeowners insurance. Many renters do not have tenants insurance. Even borrowers that do have homeowners or tenants insurance may have insufficient coverage due to policy deductibles and adjustments for depreciation. Finally, homeowners and tenants insurance may limit or specifically exclude coverage on items typically used as collateral for such credit. Even when homeowners or tenants insurance exists, the collateral necessary for such credit cannot be protected to the extent necessary.

Without credit property insurance, demand could only be satisfied if the creditors were willing to extend credit on a less-secure basis, since the collateral may not be insured. This increases the creditor's risk; hence, the creditor will require a higher return through a higher interest rate. When the return is subject to maximum interest rate limits, the creditor cannot earn a risk-adjusted return on capital sufficient to stay in business. The elimination of credit property insurance would change the economics of the small credit business. One possible consequence of such a change is that it would be impossible to earn a fair (risk-adjusted) rate of return. Capital would exit the small credit business, and the availability of this credit would be restricted.

Reserves

Policy Reserves. Typically, the policy reserves at any point in time during the life of the credit equal the unearned premiums. The rate at which premiums are earned is based upon the claims exposure over time. In credit property insurance, this exposure depends upon the policy coverages.

Single Interest Coverage. Under single interest coverage, the coverage is limited to the outstanding balance at time of loss. The outstanding balance under installment credit declines at a rate that is dependent on the rate of interest earned by the creditor pursuant to the credit provisions. The Rule of 78 earnings method may be the most appropriate premium earning method in this case.

Dual Interest Coverage. In dual interest coverage, Rule of 78 and pro rata are the most common methods of earning single premium credit property insurance premium, although other methods are used.

Loss Reserves. Loss reserves for unreported losses, *IBNR (Incurred But Not Reported)*, are an estimate usually based on factors that are developed as a function of written premiums, such as the last *n* months of written premiums, or a function of paid claims. Reserves for reported claims are *case reserves* that are estimated from an inventory of losses that have been reported but not yet paid.

Losses are typically reported, adjudicated, and paid quickly. IBNR and pending claim levels are low. Since the claim typically involves a single payment, there are no continuing claim reserves. Loss adjustment expenses are low, generally under 5% of premium.

Chapter Ten

Non-Filing Insurance

Definition

Non-filing insurance (NFI) protects a creditor in the event that the creditor suffers a loss as a result of its failure to perfect its security interest in the collateral by not filing a lien against the collateral with government authorities. The cost of the insurance, which is less than or equal to the government filing fee, is passed on to the borrower.

Overview

Asset-backed credit, or secured credit, is credit that is secured by something of value. The asset is the collateral securing the credit. In this chapter, the securing asset is typically a household product. If a borrower wants to borrow $100 from a creditor, the borrower must have an asset with a market value of $100 to protect the interest of the creditor. The borrower and creditor agree that if the borrower cannot meet the repayment obligations, the borrower will transfer ownership and possession of the asset to the creditor. The creditor will sell the asset and use the proceeds to repay the credit. The document stating that the creditor can take possession of the collateral under certain circumstances is called the *security agreement.* There are many types of security agreements, such as chattel mortgage, conditional bill of sale, conditional sales contract, chattel trust deed, trust receipt, deed of trust, and bill of sale.

The creditor has a security interest in the collateral. To fully protect its rights, the creditor must file public notice of the security agreement with the government to document its security interest in the collateral. Filing, or recording, the security agreement makes it part of the public record.

The filing process is time consuming and costly. Many creditors, especially small credit specialists, do not record liens. By not filing, the creditor may have difficulty taking possession or receiving payment in a default situation. In other situations, a third party may assert a conflicting claim on the collateral that has a higher legal priority because of the creditor's failure to file.

Without filing, the creditor is exposed, and there is a need for insurance. The insurance most commonly used in these cases is *non-filing insurance* (NFI), also referred to as non-file insurance, or non-recording insurance. Creditors often prefer NFI because it:

- Saves time
- Reduces costs
- Eliminates the administrative overhead needed to file and release a notice of the security agreement with public authorities

The premium charged for this coverage is always less than or equal to the government filing fee that could otherwise be passed on to the borrower. Premiums range from $5 to $30, depending on the state. The borrower is indifferent between paying the fee to have the lien filed or paying the NFI premium.

The benefit is equal to the creditor's monetary loss, up to the least of: *the actual cash value of the collateral, the outstanding principal balance of the credit,* or *the policy limits*.

Policy Structure

The insured under NFI is the creditor. The only policy form is the NFI policy that is issued by the insurer directly to the insured creditor. The borrower is not a party to the contractual arrangement between the insured creditor and the insurer. No document is issued to the borrower indicating the existence of the insurance. Even though the creditor legally passes the cost of the insurance to the borrower (not exceeding the government filing fee), neither a policy nor a certificate is issued to the borrower.

The Insured Event

In general, NFI pays a benefit to the creditor in the event of a default where:

- The creditor is unable to repossess the property, or
- The creditor is unable to obtain the proceeds from the sale or other disposition of the collateral, or
- The creditor cannot enforce its rights for other reasons.

In all situations, the loss must be solely as a result of the creditor's failure to file its security interest.

Eligibility for Insurance

Eligibility is determined at the creditor level. The insurer determines the creditors who are acceptable, the security agreements that are acceptable, and the type of collateral that can be insured. Every extension of acceptable credit having acceptable collateral is automatically insured by the payment of the necessary premium.

The Underlying Credit

Asset-backed credit, particularly where the proceeds are not used to buy the asset, represent the primary credit obligations where non-filing insurance is placed. Typical assets include appliances, electronic equipment, office equipment, and machinery.

Markets and Marketing

NFI is marketed where creditors are exposed due to non-filing and where the cost of insurance is less than or equal to the cost of filing. This includes, in theory, all asset-backed creditors. The biggest markets are small credit specialists and creditors that secure credit with household products, such as consumer finance companies. This insurance may also be an endorsement in a collateral protection insurance policy.

The Insurers

The insurers providing NFI must be property and casualty insurers and usually offer other credit-related insurance products. Less than 25 insurers offer this product through a variety of financial institutions.

The insurer must be authorized to provide NFI. In some states, NFI is written as surety insurance. This may require specific or separate authorization on the part of the P&C insurer providing the NFI. Depending upon the state and the structure of the NFI contract, this classification may affect agent licensing. In most states, it is considered inland marine insurance.

Underwriting Criteria

Several conditions are placed on the conduct of the creditors:

- There must be a valid security agreement associated with the collateral.
- There must be legitimate collateral with an actual cash value similar to the amount of credit extended.
- The underwriting criteria used to evaluate the credit worthiness of prospective borrowers must be the same, regardless of whether or not the security agreement will be covered under NFI.
- Creditors must do everything in their power, to the extent practical, to avoid or at least diminish losses under the NFI policy.
- Creditors must exercise reasonable due diligence with regard to credit underwriting, collateral evaluation, inspection, and appraisal.
- Creditors must maintain reasonable standards with respect to risks taken in providing collateral-backed financing or credit.
- Creditors must maintain reasonable risk management practices, standards, and procedures.

- Creditors must make reasonable efforts to exercise their rights in recovering collateral in default situations.
- There are typically underwriting limits that apply on a "per policy" or "per security agreement" basis, such as $10,000.

Term of Insurance

An important feature of many NFI programs is that insurance of individual security agreements never lapses. In other words, security agreements are insured until expiry even if the NFI policy is canceled for new business. In the case of termination, the insurance continues on the security agreements that are in the creditor's portfolio at the time the NFI policy is canceled. In such a policy, the termination provision contains language that denotes the continuing insurance aspect, such as:

> *"...All further liability on behalf of the Company [insurer] hereunder shall immediately cease except with respect to credit secured by security agreements heretofore concluded by the assured and then only up to the date of maturity of such security agreements but not to exceed in any event a period of thirty-six (36) calendar months from the effective date of such cancellation."*

Benefit Conditions

Benefit Provided. The benefits equal the monetary loss of the creditor up to the least of: the actual cash value, the outstanding principal balance, or the policy limits on a per security agreement basis. Benefits or coverages may be limited on a per security agreement basis to some amount, usually $10,000.

This insurance is typically excess coverage—excess of all losses covered by other insurance. Benefits are paid to the insured creditor. Total benefits may be limited to a percentage of inception-to-date earned premium or a stated dollar amount.

Exclusions. Coverage exclusions vary, depending upon the particular NFI policy.

The following list describes situations where NFI generally does not apply:

- Losses resulting from security agreements made prior to the effective date of the policy
- Losses in excess of the per security agreement limit of liability
- Losses in excess of the aggregate limit of liability
- Losses resulting from the insured's negligence or willful misconduct regarding the terms and conditions of the policy
- Losses resulting from the insured's lack of policy-mandated due diligence, loss containment, or risk management requirements
- Losses resulting from misrepresentation or fraud, or what is deemed to be criminal behavior or actions
- Losses resulting from the insured creditor not maintaining substantially the same credit underwriting standards as was the case without NFI
- Losses for which the insured cannot or will not provide sufficient proof of loss

In general, it is assumed that the creditor will not alter its principles and procedures as they relate to assessing credit-worthiness, appraisals of collateral, and collections as a result of the NFI policy.

Premium Rates

Premium rates depend upon many factors including:

- Coverage provisions of the policy
- Claim payment options
- Deductibles
- Stop loss features

The fundamental question is: *Can an adequate premium be charged that will cover the insurer's claim costs, administrative expenses, and risk margin, and that is simultaneously equal to or less than what the prospective insureds are willing to pay for such insurance?* As a practical matter, the insureds are unwilling to pay more than the government filing fee.

NFI is unique in that the premium rate is constrained by the amount of a fee governed by credit laws and regulations. If the creditor were to file the security agreement, then it would have the right to repossess the collateral in a default situation and would (in theory) not lose any money. The outstanding balance of the credit would be covered with the proceeds from the sale of the repossessed collateral. The cost of filing the security agreement is called the *security agreement filing fee*. These fees are regulated, and the creditor has a legal right to pass them on to the borrower.

In the NFI case, the borrower is indifferent between paying the government filing fee or paying a premium equal to the fee. Since the premium is capped at the government filing fee, it is possible that the allowable premium will be less than adequate to cover the insurer's costs. In such situations, the only NFI available may include a partial coverage limitation.

Creditors are willing to purchase complete or partial NFI because filing security agreements is costly. Filing causes an administrative burden on the creditors, especially small credit specialists who use household products as collateral, since the security agreements are often unenforceable in court. Small creditors cannot generate sufficient interest income from the credit they originate to cover the fixed administrative costs associated with filing security agreements. The administrative filing procedures require a certain number of people, materials, and equipment devoted to this activity. The administrative cost is relatively fixed; it is not related to the dollar amount of the credit being secured.

A creditor making ten $1,000 credit extensions per week must do the same filing work as a creditor making ten $10,000 credit extensions per week. The interest income associated with a small credit extension is substantially less than the interest income from a large credit extension, although interest income must cover the same fixed costs associated with the filing work. The small creditor has the following choices:

- Record the security agreements and attempt to pay the fixed costs by increasing prices (interest rates),

- Bear the risk alone—do not record the security agreements and do not purchase insurance—thereby increasing the costs and risks of credit that will increase prices (interest rates), *or*
- Purchase insurance to eliminate some or all of the risk.

With the first two options, the consumer loses. The cost of credit goes up. If regulators limit interest rates to a point where costs cannot be covered, the availability of small credit extensions may be restricted. The growth in the number of pawnbrokers and other non-traditional small dollar financing alternatives in the 1990s is evidence of this phenomenon. The availability of NFI has a direct, positive impact on the availability of small dollar credit extensions.

Policy Forms

The structure of NFI policies varies from insurer to insurer, but some clauses are common.

Name and address of the insured creditor.

Effective date of insurance. This is usually stated in terms of a date and time, such as "insurance is effective January 1, 1998, at 12:01 a.m. Eastern Standard Time." Sometimes the term of the policy is stated in conjunction with the effective date. Some policies have stated terms, such as one year, but they automatically renew at the end of each term unless otherwise terminated. Some policies are in continuous effect until one party cancels the contract.

Coverage. The coverage provision sets forth the precise insurance. In general, NFI protects the insured against loss or damage as a result of the insured's inability to take possession of collateral represented by the security agreement, *or* enforce its rights under the security agreement solely because the insured did not file the security agreement. Other scenarios may also be covered by the NFI, depending upon the policy.

Definitions. Many terms used in the NFI policy are specified in the definitions section. The most important definition is the description of a *valid security agreement* for the purposes of the NFI policy. A security agreement can be defined to include:

- Chattel mortgage
- Conditional bill of sale
- Chattel trust deed
- Trust receipt
- Deeds of trust
- Conditional sales contracts
- Bill of sale used to secure a credit
- Documents that may be used to create or reserve a lien or security interest in household products, appliances, equipment, or other machinery

All of these security agreements can be filed with an appropriate public official or officer to *perfect* a security agreement.

Premiums. The premium is computed on a per security agreement basis and is less than or equal to the maximum filing fee allowed by the state in which the security agreement originates. In some states, the creditor is also permitted to charge a release fee for releasing the lien when the credit is repaid. This fee may be included in the determination of the maximum NFI fee.

This section of the policy usually describes how frequently premiums are to be paid by the insured. For example, premiums are to be computed each month and are to be paid by the *nth* day of the following month. There may be more detail concerning the specific procedures followed in computing, reporting, and remitting premiums, which may include forms to be completed by the insured, wire transfer instructions, and currency requirements.

In particular, there will be guidance as to when a new premium is to be charged to the borrower. For a particular security agreement, the fee cannot be charged more often than the government filing fee can be charged, generally once every five years. In a refinancing situation, a new fee can be charged only if:

1. The principal balance increases beyond a specified limit,
2. There is a significant substitution of the collateral securing the credit, or
3. There is a significant increase or decrease in the value of the collateral.

Finally, the insurer may require additional premiums or deposit premiums over and above the “per security agreement” premium.

Limits of Liability. This section of the policy defines per security agreement limits and aggregate limits. The “per security agreement” limit is a stated dollar amount, usually from $5,000 to $15,000. The aggregate limit can be stated as a dollar amount or can be a function of some other variable, such as earned premiums.

Termination. The policy commonly contains a termination or cancellation provision that allows for cancellation of the contract by either party (insured or insurer) following a specified procedure. Typically, either party can cancel a policy without cause, subject to 30 days written notice.

Benefit Payable. The policy usually contains a section describing the amount of benefit payable in the event of a loss. For example, the benefit payable might be the lesser of the asset’s actual cash value or the outstanding balance at the time of loss.

Claim Reporting Procedures/Proof of Loss. This policy provision describes the procedures the insured must follow to file a claim. For example, claim forms need to be completed, and a proof of loss document must be filed with the insurer within a certain time frame. The definition of proof of loss is stated in the policy.

Other. Depending upon the particular NFI policy, there may be other provisions or conditions. Examples include:

- Conditions precedent to insurer liability, including risk management and loss containment
- Requirements of the insured precedent to coverage, including bookkeeping requirements and due diligence requirements associated with the appraisal of collateral

- A requirement that the insured adhere to reasonably accepted standards of practice that would be followed in the absence of NFI
- Appraisal procedures to be followed in the event that the insured and insurer cannot agree to the value of the collateral, or to the extent of the damage to the collateral subsequent to the filing and adjustment of a valid claim
- A substitution provision

Premium Refunds

One of the important features of many NFI policies is that insurance is continuous and will not lapse. In other words, the security agreements covered at any point in time will be insured until expiry, even if the insured or the insurer terminates the NFI policy. Since insurance does not lapse upon termination or cancellation, there are no premium refunds due to the creditor.

Some policies require the insured creditor to pay a deposit premium when the policy is initially effected. The NFI policy contains provisions associated with the return of the deposit premium. The deposit premium is returned after all of the individual risks have matured or the stated term period has expired.

Premium refunds vary from state to state. For example, an NFI policy can be filed and regulated as a policy requiring a provision giving the insured creditor the option of terminating insurance on the security agreements in an insured portfolio. Regulations may also allow the insurer to terminate the policy if the security agreements in an insured's portfolio are sold or transferred to a transferee that is not insured by a similar policy. In these scenarios, the premiums refunded should theoretically equal the unearned portion of the original premium.

In some states, when certain insurance policies are terminated by the insured (in accordance with the policy's termination provision), the insurer must refund the unearned premium. State regulations may also clearly define the unearned premium calculation. In NFI, the unearned portion is based upon the pattern by which the premiums are earned. The earned premium pattern is based upon the claim payout pattern. If, for example, benefits are limited to the lesser of the outstanding balance of the credit or the actual cash value of the collateral at the time of loss, the most conservative earning method would be to earn premiums at the same rate that the underlying balance is repaid. The earning pattern depends upon the security agreement itself, which defines the outstanding balance of the borrower's credit at any point in time. A common method is the Rule of 78. The premium refunded at termination equals the unearned premium for each security agreement in the creditor's portfolio at the time of termination.

Premium refunds are not paid to borrowers. This practice is consistent with the alternative to file the notice of the security interest and to charge a filing fee that is non-refundable. No state returns a portion of the filing fee if a security agreement is terminated prior to the original maturity date. Indeed, several states charge an additional fee, the release fee, to remove the lien.

Agent Licensing

In NFI, the creditor pays the insurance premium, but then passes the cost on to the borrower. Although the borrower ultimately bears the cost for the NFI, the borrower is not the insured—the creditor is the insured. The creditor is neither soliciting nor selling the insurance. It simply passes the cost of the insurance on to the borrower in lieu of a filing fee, pursuant to state law. The creditor is not required to be licensed as an insurance agent.

Agents offering NFI to creditors must be properly licensed in accordance with the laws of the state in which the policy is issued.

Available States

NFI is available throughout the United States.

Advantages to the Borrower

In general, the borrower's financial position is the same whether the creditor purchases NFI or pays the government filing fee for filing notice of the security agreement. The product results in administrative efficiency, so it reduces the cost of credit. Such reduction may be passed on to the borrower in the form of lower interest rates. A significant advantage to the borrower is that the collateral remains unencumbered.

Advantages to the Creditor

Non-filing insurance provides a number of advantages to the creditor, including:

- Elimination of the time consuming and expensive process to record security agreements
- Reduction of the creditor's expenses, since the cost of NFI is usually less than the expense of security agreement filing
- Elimination of the need for infrastructure and overhead associated with the security agreement filing process
- Elimination of the expenses associated with foreclosure, repossession, and liquidation of collateral that occurs in default situations

Reserves

Policy Reserves. The NFI exposure is the outstanding indebted-ness at each point in time over the term of the credit. One method is to set unearned premium reserves based on the Rule of 78. In a refinancing situation, a Rule of 78 unearned premium may not be appropriate if it is based on the credit's original effective date.

Loss Reserves. Loss reserves for unreported losses, *IBNR (Incurred But Not Reported),* are an estimate usually based on factors that are developed as a function of written premiums, such as the last *n* months of written premiums, or a function of paid claims. Reserves for reported claims are *case reserves* that are estimated from an inventory of losses that have been reported but not yet paid.

Losses are typically reported, adjudicated, and paid quickly. IBNR and pending claim levels are low. Since the claim typically involves a single payment, there are no continuing claim reserves. Loss adjustment expenses are low, generally under 5% of premium.

Chapter Eleven

Collateral Protection Insurance on Titled Property

Introduction

Overview

Most closed-end installment credit is secured by collateral. If the borrower defaults on the credit, the creditor has the right, via the credit obligation, to seize the collateral and sell it on the open market. The proceeds of the sale are applied to reduce the balance of the defaulted credit.

Creditors extending installment credit have an economic interest in protecting the collateral so that it retains its market value. Credit obligations generally require the borrower to insure the collateral against physical damage caused by an accident, fire, natural disaster, and other events, such as burglary. This requirement ensures that if the collateral becomes impaired, there will be sufficient insurance proceeds to repair or replace it. Proof of insurance must be presented for the credit to be consummated.

The generic name is collateral protection insurance (CPI). There are five primary categories of CPI:

1. Credit property insurance is offered where non-titled property is the collateral. It is a voluntary purchase by the borrower.

2. Creditor-placed CPI (CP-CPI) is placed where titled property, except real estate, is the collateral. The creditor places the insurance. Many people mean this specific category when using the abbreviation "CPI."

3. Creditor-placed CPI on real estate (RE-CPI) is placed where real estate is the collateral. The creditor places the insurance.

4. Blanket CPI (B-CPI) insures titled property, except real estate, pledged as collateral. It is a form of "creditor-placed" CPI, since the creditor requires each borrower to pay a fee for the coverage or provides it on a non-contributory basis to each borrower, but the policy conditions are different enough that is it is considered a separate category.

5. Voluntary CPI (V-CPI) is offered where titled property is the collateral. It is a voluntary purchase by the borrower.

CPI plays an important role in the economy. Without it, creditors would not accept the collateral that secures most of their credit, such as automobiles, boats, or homes. Without this security, many credit extensions would not be made, and economic activity could be reduced.

For non-titled consumer products pledged as collateral, such as a television or a VCR, the insurance requirement can be fulfilled by a loss payee endorsement to an existing homeowners policy or a tenants policy. The retailer or creditor may offer credit property insurance as one convenient alternative to fulfill the insurance requirement.

For automobile credit, the borrower must provide proof of collision and comprehensive insurance. Standard liability insurance is not acceptable, since it only protects against physical damage to the property of others and against bodily injury to others. For real estate secured credit, the borrower must present proof of homeowners insurance. For titled property, such as an automobile or a home, the amount and term of the credit results in a cost for credit property insurance that may overcome the convenience of the product.

Sometimes borrowers fail to purchase or to maintain the insurance on the titled collateral securing their credit. Creditors have four options relating to this contingency:

1. The creditor can absorb the risk and reflect the loss cost in higher interest rates.
2. The creditor can canvass its credit portfolio and place relatively expensive insurance, generally called *creditor-placed insurance (CP-CPI or RE-CPI)*, on the few borrowers who allow their insurance to lapse. The cost is passed on to the few who fail to maintain the required insurance.
3. The creditor can purchase insurance covering borrowers who fail to maintain adequate insurance (generally called *blanket insurance*) and pass a relatively small charge on to all borrowers *(B-CPI).* Some states require the charge to be included in the calculation of the APR.
4. The creditor can offer a voluntary insurance program at the time the credit is extended that will fulfill the borrower's obligation *(V-CPI).*

The insurance options mentioned above are further divided into two segments—personal property (automobiles, motorcycles, boats) and real property (homes, mobile homes). The following sections provide information on creditor-placed CPI on personal property, blanket CPI on personal property, voluntary CPI on personal property, and creditor-placed CPI on real property. A workable form of blanket CPI on real property has not been discovered, and voluntary CPI on real property is not practical.

A recent NAIC Model Act was adopted for collateral protection insurance on personal property. It was titled, *creditor-placed insurance*, but this book uses the longer title *creditor-placed collateral protection insurance on personal property*. That Model Act excludes real property from its scope, so by implication, *creditor-placed insurance* (as used in the Act) does not apply to CPI on real property. This book refers to CPI on real property and uses "creditor-placed" as an adjective in describing some of the process.

Types of Programs

Creditor-Placed CPI Programs. Creditors use computerized tracking systems to verify the continued existence of appropriate insurance on the collateral that secures the credit in each credit portfolio. Automated tracking systems are essential for a creditor-placed CPI program to be successful. Over the years, the software and hardware that comprise these systems have become more user friendly and more accurate.

Financial institutions may have their own tracking software systems, or these services can be provided through a contract with an outside vendor. The outside vendor may be a stand-alone company specializing in tracking services or systems, or the collateral protection insurance underwriter. The third-party services typically include software support, technical support, and ancillary services, such as customer service, data entry of policy information, system updating, letter cycle printing, and interface with the collateral protection insurance underwriter. These systems are integrated with the other software and operating systems in the financial institution's existing computer system.

The tracking system is coded with the details of the insurance that a borrower initially provides at credit closing and is updated for subsequent changes and renewals to the insurance on the item that serves as collateral. If the initial insurance is not acceptable, or if it lapses, the tracking system produces a *deficiency letter* that is sent to the borrower. The borrower must obtain the required insurance and provide the creditor with acceptable proof of insurance. If a borrower does not comply, the creditor has the right to protect its interest in the collateral by obtaining acceptable insurance for the borrower. This insurance typically names the creditor as the insured. The creditor initially pays the premium, but the cost is passed on to the borrower under the terms of the borrower's credit.

These programs are used to protect personal property, such as automobiles, pledged as collateral on installment consumer credit and the real property collateralizing first and second mortgages.

Blanket Programs. Blanket programs are analogous to employee group health insurance. The insurer charges a uniform premium rate for everyone in a certain subgroup, such as automobile credit extensions. On a periodic basis, the claim costs for the preceding period are examined, and the premium rates are either changed or left alone.

The programs are either non-contributory (the cost of the insurance is paid by the creditor) or contributory (the cost is passed on to the borrowers). Blanket insurance protects only the creditor's interest and only provides benefits for the excess of the creditor's loss over the benefits from all other insurance on the property. For non-contributory programs, a monthly premium basis is common. Each month, the creditor remits the required premium for each credit obligation. Contributory programs are often single premium products.

Personal Property. Blanket programs covering this type of credit are common. The average term of such credit extensions is relatively short, approximately 24 months to 60 months. The average amount of such credit is low enough that the fee paid at the credit closing is acceptable to borrowers.

Real Property. The large average amounts and long average terms of mortgages make a blanket program difficult to implement. A single premium is simply too high. In addition, the proportion of borrowers failing to maintain insurance is much lower in this category of credit.

Voluntary Programs. Voluntary programs follow the coverage provided by CP-CPI, but the borrower has the option to buy the insurance. The alternative is to place insurance in the open market. The cost is substantial, so a low-risk borrower can likely buy lower-priced insurance. Often, these programs are used for consumer borrowing where a used car is pledged as collateral.

Comparison of Programs

Relatively few borrowers, certainly fewer than 10%, fail to comply with the terms of the credit obligation by permitting their insurance to lapse. Unfortunately, this group tends to be a high-risk group for the insured events. The result is that uninsured losses add a substantial amount to the cost of credit unless creditors have programs to provide continuous insurance protection.

Creditors are not pleased with their alternatives. The most palatable alternative from a consumer standpoint is for the institution to absorb the cost directly by failing to enforce the contractual requirement or by purchasing a non-contributory blanket program. In either case, the cost must be reflected in the creditor's interest rates and will ultimately make the creditor less competitive. Implicit in this choice is the decision to spread the cost over all borrowers.

Another way to spread the cost over all borrowers is to use a contributory blanket program. Under this option, the charge is not included in the APR if the insurer waives the right of subrogation. This is a direct and disclosed cost that is clearly stated in the credit obligation, but disclosure rules vary by state.

A blanket program has the advantage of administrative simplicity over creditor-placed programs. For personal property credit, the premium dollar outlay is modest—under $20 per credit obligation. The amount is small enough that most borrowers will not object. Still, borrowers who maintain the required insurance find it objectionable to fund the cost of those who shirk their responsibility. Users of blanket programs verify compliance at credit inception, but most do not track continued compliance. If the creditor receives a cancellation notice, it may send a form letter reminding the borrower of the requirement to maintain insurance.

The objectionable aspects of these alternatives led to the development of creditor-placed programs—another equitable solution that places the entire cost on those borrowers that create the problem in the first place. These costs include identifying the uninsured borrowers and placing insurance with premium rates reflecting the claim costs of the group. The tracking system and letter cycle are expensive, but the process is necessary to determine where the exposure lies. Once identified, the borrower without insurance joins a high-risk group. In automobile credit, many of the borrowers who let insurance lapse do so because of poor driving records and the high cost of assigned risk insurance. Given the administrative costs and the risk pool, the relatively high premium cost is not a surprise.

With the blanket approach, it is a simple task to match the collateral type with the necessary policy. Under creditor-placed programs, however, this is difficult, as there are different policies corresponding to each type of collateral. Still, no one solution is clearly more equitable to the borrowers than the others.

The choice between a creditor-placed program and a blanket program must be analyzed on a case-by-case basis. Either alternative can provide a customized, effective risk management program designed to allow the creditor to remain competitive and focus on its core business.

Creditors opting for blanket insurance include:

- Creditors lacking the infrastructure necessary to administer a creditor-placed program
- Creditors with insufficient computer hardware to run tracking software
- Creditors concerned about the possibility of litigation who cover the cost through higher fees
- Creditors accepting many forms of collateral
- Creditors extending predominately short-term credit with a high percentage of terminations prior to expiry

In the last ten years, there have been a few class action lawsuits concerning the practices in the creditor-placed approach. Some creditors are not willing to accept the litigation risk associated with a creditor-placed program.

The types of collateral being pledged are also an important consideration. If a creditor provides short-term credit or credit secured by many different types of collateral, a blanket program is less complicated than a creditor-placed program, especially if the creditor also falls into one or more of the other categories favoring blanket programs. In most creditor-placed programs, the collateral can be repaired (if not totaled), and the credit can continue. With a blanket plan, repossession is required.

Creditor-Placed Collateral Protection Insurance on Titled Personal Property

Definition

Creditor-placed collateral protection insurance (CP-CPI) on titled personal property is property insurance purchased unilaterally by the creditor, who is named as the insured, subsequent to the date of the credit.

Overview

CP-CPI provides insurance against loss, expense to recover, or damage to personal property pledged as collateral resulting from fire, burglary, collision or other loss occurrence that would either impair a creditor's interest or adversely affect the value of the collateral. CP-CPI is purchased according to the terms of the credit obligation when the borrower fails to provide the required insurance. Cost of the insurance is charged to the borrower.

The most common installment credit secured by personal property is automobile financing. Boats, major appliances, and furniture are also used as collateral to secure credit. Each category of personal property has a corresponding insurance product. For example, automobile insurance protects credit on automobiles, smaller boats, and recreational vehicles, while pleasure boat insurance protects credit on larger boats. CP-CPI is offered on items with ownership titles, while credit property insurance is generally offered on non-titled products, such as appliances.

Generally, the collateral securing the installment credit is the item purchased with the credit proceeds. Even when the credit is used for some other purpose, the creditor maintains an economic interest in the actual cash value of the collateral, since the collateral offsets any loss if the borrower defaults.

The credit obligation requires that the collateral be continuously covered by adequate insurance. If the borrower does not comply with this obligation, the creditor has the right to obtain adequate insurance at the borrower's expense. Without this right, creditors could not lend at the current interest rates. CP-CPI allows creditors to maintain continuous insurance and protect their interest even when a borrower's original insurance has lapsed.

The process involves either manual or automated credit and insurance tracking, a sequence of reminders or notification letters (*the letter cycle*), and insurance placement corresponding to the type of collateral in question. The following example of a creditor-placed process is based on an automobile used as collateral.

The typical automobile insurance policy has a one-page summary of information specific to the covered automobile called a *declarations page* (*dec page*). This summary includes the name and address of the *lienholder* (the creditor). Automobile insurance policy terms are usually six or twelve months. When a policy is originally issued, a copy of the dec page is sent to the creditor by the insurer.

At renewal, the insurer usually sends the new dec page to the creditor. In other cases, the creditor receives only the original dec page—additional information is provided to the creditor on request; or the creditor only receives information if a policy change is made—insurance is assumed to be in force until the creditor receives a notice of cancellation of insurance.

In most cases, the insurer sends a notice to the creditor if the policy lapses or is canceled for any reason. Sometimes the only notice the creditor "receives" is the failure to receive a new dec page when renewal should occur. In other cases, the notice may go to an independent agent or broker who has the responsibility to notify the creditor. A considerable delay may occur before the creditor is notified.

Each creditor has procedures for creating, updating, and maintaining the insurance information section of a borrower's credit file. By maintaining insurance information on each borrower, a creditor can ensure that the collateral is protected with adequate insurance. When the creditor receives the policy information outlined on the dec page, the information is reviewed to confirm that adequate insurance is provided. If the insurance is in order, the insurance information is added to the borrower's file.

When it is discovered that insurance has lapsed or has been canceled, the borrower or last insurer is contacted. For example, if the creditor receives a lapse or cancellation notice from the insurer, the insurer is initially contacted to investigate the situation. Next, the creditor may call the borrower and explain the obligation to replace the insurance within a stated number of days. If no proof of insurance is received within the stated period, the creditor sends a letter to the borrower providing an additional stated number of days to obtain acceptable insurance and to provide proof of insurance. The letter references the provisions of the credit that require the borrower to maintain continuous adequate insurance on the collateral. It notifies the borrower that the creditor will purchase insurance for the borrower and pass the cost on to the borrower. After a second reminder letter, the insurance is placed.

Creditors do not wish to "force place" insurance unless it is absolutely necessary. In addition to the cost of the transaction, creditors can lose customer goodwill if they do not provide enough time for the borrower to fulfill the insurance obligation or if the creditor erroneously places insurance. Errors in placing insurance can be costly if, later in the credit term, the borrower provides evidence that insurance was always in force. This means the CP-CPI policy must be *flat canceled*—cancellation is retroactive to the inception of the CP-CPI. All premiums are returned to the insured borrower, and any finance charges are eliminated.

When a policy is flat canceled, the creditor must:

- Absorb the administrative expense of removing the insurance charges
- Lose interest on the premiums paid to the CP-CPI insurer
- Incur the intangible costs associated with harming the customer/borrower relationship

CP-CPI procedures must be carefully structured to ensure accurate credit monitoring and adequate time for borrower contacts. A well-structured program protects the collateral without costing the creditor money or damaging customer goodwill.

The tracking process can be manual or automated. The computer technology available for credit monitoring and insurance tracking, letter generation, insurance placement, premium billing, and management reporting is highly sophisticated. Tracking software can be fully integrated into the creditor's overall data processing system and can work in conjunction with any insurer's program. Gathering insurance documents, reviewing insurance, and oral interaction with customers and insurers, however, is time consuming and labor intensive.

A properly structured CP-CPI program is an important risk management tool and is critical to the success of creditors in the modern, competitive, secured-credit marketplace.

Policy Structure

In the typical case, the CP-CPI insurer issues a master policy to the creditor. When insurance is placed for individual borrowers, the borrower receives a *dec page* and a *certificate* *of insurance* outlining the general coverages. In a few situations, a group policy may be issued, with the creditor named as the group policyholder.

Creditor's Policy. The creditor's policy, which is also the master policy, is the insurance contract between the creditor and the CP-CPI insurer. The contract is a dec page and an insuring agreement.

The dec page contains specific information pertaining to the particular insured creditor, such as:

- Insured's name and address
- Policy period (for example, *n* years with beginning and ending dates *or* a beginning date and language stating that the policy is continuously in effect until canceled)
- Coverages
- Deductibles by coverage
- Limits of the CP-CPI insurer's liability by coverage
- Applicable endorsements
- Issue date

The insuring agreement is the actual insurance contract between the CP-CPI insurer and the creditor that:

- Defines key terms
- Describes each coverage in detail
- Describes the conditions necessary for the insurer to have liability (a loss must occur during the policy period; the loss must result from a covered occurrence)
- Describes policy exclusions, such as excluding a loss that occurs while using the property during a criminal act
- Describes what constitutes valid proof of loss and claim settlement options

Borrower's Certificate of Insurance. In addition to the preceding set of documents pertaining to the creditor, the borrower is notified when CP-CPI is placed. The borrower receives a dec page and a certificate of insurance. The dec page includes:

- Insured creditor's name and address
- Borrower's name and address
- Borrower's account number or credit number
- Description of the property (collateral)
- Coverage effective date
- Amount of insurance
- Premium cost
- Insurance term
- Credit information, including the outstanding balance

The certificate of insurance includes:

- A description of the coverages, the CP-CPI insurer's maximum liability, the deductible amounts, any exclusions, and cancellation provisions
- An explanation of the policy's purpose and reason for placement by the creditor
- An explanation of the borrower's obligation regarding continuous insurance of the collateral
- A notification that informs the borrower that this insurance covers only physical damage to the property up to specified limits—either the actual cash value or, in some cases, the outstanding balance of the credit. In the latter case, it will also describe or state that only the creditor's interest is being protected. It does not provide bodily injury liability nor property damage liability coverage (damage to other's property). It does not fulfill the requirements of any financial responsibility laws nor the no-fault insurance laws of any state.

Eligibility for Insurance

The fundamental principle behind these programs is that the CP-CPI insurer provides insurance when no other course of action is available to the creditor. It is critical that the creditor can depend on the CP-CPI insurer to accept all risks. The premium rates and underwriting criteria are developed with this principle in mind. All borrowers with credit secured by eligible collateral are accepted. The program usually lists eligible and non-eligible property. There is a maximum dollar limit on all property eligible for insurance. Typical items in these categories are:

Eligible Property

- Automobiles
- Boats
- Farm equipment
- Motor homes
- Motorcycles
- Office equipment

Non-Eligible Property

- Commercial vehicles (taxis, ambulances)
- Jewelry
- Furs

The Insured Event

The insurance protects against direct or accidental loss caused by physical damage or theft. A CP-CPI policy covering automobiles provides the same protection as standard collision and comprehensive coverages only. CP-CPI policies do not provide any property damage liability insurance, bodily injury liability insurance, or uninsured motorist coverage.

The insurance can be *all risk* or *named peril*. *All risk* policies provide coverage against all causes of loss, *except* for certain excluded events, and subject to specific exclusions. *Named peril* coverage insures against specific perils that are itemized in the policy.

In addition to the basic comprehensive and collision coverages, other coverages are often available. These include:

Skip and confiscation coverage. This coverage insures the creditor against a direct loss as a result of:

- The borrower disappearing (skipping) with the collateral and defaulting
- The collateral being confiscated by a public authority and the borrower defaulting

Repossessed vehicles coverage. This coverage insures the creditor against all physical losses or damage from external causes to repossessed vehicles while in the process of being repossessed, or while being held by the creditor subsequent to the repossession. A typical time limit on such coverages is 60 days, starting with the date of repossession. Benefits include the cost to recover the property.

GAP coverage. Some states permit GAP coverage to be included. As described in Chapter Thirteen, the coverage provides a benefit when the indebtedness exceeds the primary property insurance benefits at the time of a total loss to the insured vehicle.

The Underlying Credit

The related credit is installment credit collateralized by personal property. Most CP-CPI insured personal property is titled property. It does not include real property, such as land or buildings. Additionally, the underlying asset is typically purchased with the proceeds of the credit.

Credit secured with collateral where the proceeds are *not* used to purchase the collateral asset still requires that insurance covering the collateral be maintained continuously. There is no difference between the two, but the former is more common.

This credit differs from credit secured by real property in two principal ways that affect the insurance:

1. The term of credit is substantially shorter, and the amounts are much smaller.
2. The credit can be used for a variety of purposes, so the type of collateral can vary.

The CP-CPI policy must cover many forms of collateral, or there must be a CP-CPI policy for each form of collateral, such as automobiles or pleasure boats.

Markets and Marketing

All financial institutions involved in extending asset-based credit of the type described in the previous section have potential CP-CPI exposures. These institutions include banks, consumer finance companies, and credit unions.

Since the creditor chooses the insurer to provide the product for its credit portfolio, or some subgrouping, all marketing by the insurer is directed at the creditor. Some insurers market through a home office sales staff, generally those insurers who have developed in-house tracking systems. A significant portion of the business is marketed and administrated by general agents who also serve as third-party administrators. The general agents contract with the insurer to market the product to the creditors and to provide complete administrative services, including tracking, letter cycle generation, and claim adjudication.

The Insurers

The insurers must be property and casualty insurers and are typically considered specialty lines insurers. Almost all of these P&C insurers offer other credit-related insurance products. Less than 25 insurers offer this product through a variety of financial institutions.

Underwriting Criteria

Little underwriting in the traditional sense is done. In the traditional marketplace, individual policies are offered after a careful review of the individual's pertinent risk characteristics, such as driving record, demographic factors, or other appropriate underwriting criteria. Under CP-CPI, the creditor is the policyholder, and underwriting criteria are based on the credit portfolio's characteristics. Certain group characteristics are considered pertinent underwriting criteria. Discounts and surcharges equal to percentages of base rates may be applied to the particular group depending upon relevant risk factors, such as:

- Mix of direct and indirect credit
- Mix of new and used vehicles
- Mix of collateral securing the credit
- Historical repossession and past due percentages
- Average credit balance in the portfolio versus some national average balance for the same type of credit
- Average credit term in the portfolio as compared to national average terms for the same type of credit

The collateral is identified and categorized as eligible or non-eligible. Then a base rate corresponding to the eligible property is established; it will vary by state and can vary by type of creditor. Group characteristics mentioned above may be considered and appropriate rate adjustments may be made. The final result is a set of base rates by state for each type of eligible collateral that is accepted by the particular creditor.

Sub-categories of collateral are considered. The rate for certain vehicles may be surcharged. For example, an exotic sports car, such as a Porsche, may carry a 100% surcharge in some CP-CPI programs. Other appropriate surcharges may be applied. The cost for supplementary coverages may be added where permitted, such as repossessed collateral coverage.

The final rate is then expressed as a function of the remaining credit balance. Factors are developed for annual premium plans or for plans insuring the remaining term of credit. For automobile credit, annual premium plans are common if the remaining credit term is more than 18 months.

Term of Insurance

The most common insurance terms are one year and the remaining term of the credit. When CP-CPI is placed, it remains in effect until the end of the policy term or until:

- The credit is paid off or the creditor's security interest ends through a release
- The collateral is repossessed or declared a total loss by the primary insurer
- The borrower replaces it with acceptable insurance
- The borrower provides evidence that acceptable insurance has been in force

Annual premium policies are automatically renewed. A renewal notification is sent to the borrower along with information that the creditor-placed insurance continues. For years, many programs were single premium insurance for the remaining term. This approach is less common as a result of the problems created by flat cancels. Most coverage insuring the remaining term does not exceed 18-24 months.

Benefit Conditions

Benefit Provided. The protection insures physical damage or theft to the property. The named insured is the creditor and only the creditor's interest is protected; the entire benefit is payable to the creditor. The maximum benefits that are payable are limited to the creditor's interest in the collateral, as evidenced by the credit obligation. The insurer pays the insured creditor the *least of*:

- The cost to repair the collateral and bring it to pre-loss form (value)
- Actual cash value of the collateral
- Outstanding principal balance of the credit

The benefit is subject to deductibles and limits noted in the insurance policy. If the collateral is a total loss, any salvage of the property may be deducted from the benefits payable. Repossession is not required for benefits to be payable. In the NAIC Model Act, this coverage is named *limited dual interest insurance*. There are two other forms that are much less common.

- *Dual interest insurance* is permitted in some states, but not by the NAIC Model Act. It provides the same benefits, but the outstanding principal balance of the credit does not limit the maximum benefit.
- *Single interest insurance* is more common in blanket programs. The benefit is the same as limited dual interest insurance, but benefits are only payable if three conditions are met:
  1. The borrower is in default under the obligation,
  2. The creditor has legally repossessed the collateral, unless the collateral has been stolen, and
  3. The creditor's interest is impaired, i.e., the value of the property, before repair, is less than the balance of the credit.

In other words, under dual interest, a benefit can be paid even though the borrower is not in default (damage to the property while the credit is in good standing). The benefit can exceed the creditor's interest (when the damage and the ACV both exceed the outstanding balance of the credit).

Under limited dual interest, a benefit can be paid even though the borrower is not in default (damage to the property while the credit is in good standing), but the benefit cannot exceed the creditor's interest.

Under single interest, a benefit is paid only when default and repossession have occurred and the creditor's interest is impaired. The benefit cannot exceed the creditor's interest.

	Dual Interest	**Limited Dual Interest**	**Single Interest**
Maximum Benefit Payable	ACV	Outstanding Balance, or ACV if less	Outstanding Balance, or ACV if less
Must the Creditor's Interest Be Impaired?	No	No	Yes

Additional coverages are available in some policies. Skip coverage insures the contingency that the borrower disappears with the collateral. The benefit under *skip and confiscation coverage* is payment in cash to the insured creditor of the actual cash value at the time of loss, up to the outstanding balance of the credit.

Creditor's repossession and storage expense insures the repossession and storage expenses of the creditor up to some pre-determined limit, regardless of whether the property is damaged. The *repossessed vehicles coverage* benefit is the *least of*:

- Cost to recover and repair the vehicle
- Actual cash value of the collateral
- Outstanding principal balance of the credit

Exclusions. Exclusions vary from policy to policy according to the type of collateral asset covered. In general, the typical policy excludes the following perils from coverage:

- Losses due to normal wear and tear
- Losses due to confiscation by a governmental authority
- Losses as a result of use during an illegal act
- Losses due to war (declared or non-declared), invasion, civil war, or revolution

Premium Rates

Premium rates are determined by considering many variables. Characteristics such as the physical location of the collateral asset, how it is used (personal versus commercial), how frequently it is used, and the characteristics of the person principally using the item are all related to loss frequency and severity. Rates are a function of all of these variables.

Since this credit is collateralized by a variety of items, each with its own unique characteristics which affect rates, a thorough discussion of this topic is beyond the limits of this book. Some insight into this complicated subject can be gained by examining how general principles apply to the automobile physical damage risk.

The typical automobile physical damage policy insures against direct and accidental loss to the collateral as a result of a collision or other occurrence, such as theft or storm damage. Accordingly, the following factors are considered in rating:

- **Geography.** Physical damage loss frequencies associated with collisions vary substantially by state, as do the losses caused by other perils, such as theft and storm damage. Loss frequencies vary by territories within states as well. For example, theft frequency in an inner city may be higher than in a rural area.
- **The Collateral.** Loss experience is substantially worse for expensive automobiles and sport cars, due to higher theft frequency and severity of loss. Rate surcharges are common for vehicles such as a Mercedes Benz.
- **The Individual User.** One would expect that the characteristics of the individual using the property would be considered. In the case of automobiles, extensive systems exist to incorporate the individual's age, sex, marital status, and driving record into the rating process. However, it is rare for these factors to be applied to individual credit in a CP-CPI program. Ratemakers develop a general profile of the typical CP-CPI insured and determine an average rate.
- **"Group-type" Conventions.** The creditor's borrowers are a group. Certain favorable and unfavorable group characteristics are identified and are reflected in discount or surcharge factors that are applied to base rates. These discounts or surcharges are developed based on research showing that certain characteristics imply lower or higher aggregate claims. One such characteristic is the mix of direct and indirect credit in the creditor's portfolio.

Rates are developed for each of the coverages and are filed with the appropriate state insurance departments.

Once corresponding rates are developed, they must be used to compute premiums. The actual premium is typically based on a combination of the following factors:

- Borrower's state of residency
- Discounts or surcharges applicable at the borrower and creditor levels
- Remaining term of insurance
- Initial amount of insurance in force (current balance)

The terms are typically one year or the remaining term of the credit. Rates for all coverages corresponding to an annual term and a range of terms are entered into a computer or printed on a rate chart for use in developing premiums. If a borrower without insurance is identified and insurance is creditor-placed, a one-year premium or a remaining-term premium (depending upon the creditor and its agreement) is calculated based upon coverages and rates using a computer or a rate chart. Once the premium is computed, the insurance is placed, and the premium is paid to the CP-CPI insurer by the creditor. In accordance with the credit terms, the creditor passes the premium charge on to the borrower.

The methods of collecting premiums from the borrowers vary by creditor and by state. Much depends upon the creditor's operating procedures, technological capabilities, and credit practices, not to mention the creditor's regulators and the CP-CPI insurer's regulators. Three common methods of collecting CP-CPI premiums from the borrower are:

1. If the borrower receives a monthly statement showing the amount due, including principal, interest and any other charges, the creditor usually adds a monthly CP-CPI charge to the statement.
2. If the borrower remits a coupon from a coupon booklet with the monthly installment payment either:
   (a) A new coupon booklet with revised monthly payments is sent to the borrower, *or*
   (b) The total CP-CPI premium is added to the "back end" of the credit. In this case, the creditor notifies the borrower that an additional amount is due (the CP-CPI premium) after the last installment payment is made. This amount must be paid before the creditor releases the title.
3. If the credit and the pertinent laws allow, the creditor can refinance the credit. The proceeds from the new credit pay off the original credit and pay the CP-CPI premium. In this case, it makes more sense to issue a CP-CPI policy for the remaining term of the original credit.

If a change is made in the monthly payment, the creditor must determine the time period over which to pass the cost on to the borrower. If the CP-CPI premium insures the remaining balance and remaining term of the credit, the monthly charge equals one *nth* of the total CP-CPI premium (where *n* equals the number of months remaining in the credit term). If the term of insurance is one year, the monthly premium may be calculated as:

1. The annual premium divided by the remaining term of the credit
2. The annual premium divided by twelve
3. The annual premium divided by the months remaining in the insurance term, which is normally less than twelve by the time the premium charge is assessed

The time value of money may be considered in any of these calculations, depending on the length of the insurance term and the assumptions used in developing the premium rates.

Premium Refunds

Premiums are refunded when a policy is canceled. Cancellations can result in full or partial premium refunds.

If the borrower provides sufficient evidence that acceptable insurance was in force at the time the CP-CPI policy was placed, the CP-CPI policy is flat canceled, and all premiums are returned.

If the CP-CPI was in force for a period of time before the borrower obtained insurance, a partial premium refund is made when sufficient proof of insurance is provided to the creditor. In this case, the amount of premium refunded is equal to the unearned premium. A number of methods are used to calculate the appropriate unearned premium for refunds.

Determining the earned premium at the time a policy is canceled depends upon the specific policy coverages, the type of credit, and state regulations. For example, if the creditor's interest is defined as the outstanding principal balance of the credit and the policy covers the creditor's interest only for the remaining term of the credit, one could argue that the premium should be earned at the same rate as the outstanding principal declines. This rate depends upon the credit obligation and how interest and principal are treated. It is most common (and states typically allow) for insurers to use the Rule of 78 method to calculate unearned premiums.

Alternatively, a physical damage policy for the actual cash value of the collateral asset may be earned using the pro rata method. Although the value of the asset is likely to decline somewhat over the policy term, the protection is assumed to be level. Methods other than pro rata may result in a modest surrender charge on refunds (short rate cancellations).

Agent Licensing

In the case of CP-CPI, the creditor is the insured and does not receive a commission. No licensing is required except for the insurer's agent that offers the policy to the creditor. A creditor may receive an expense reimbursement for services provided, but this revenue is different from a commission.

Available States

CP-CPI is available to creditors in all states, but some supplementary coverages may not be permitted.

Advantages to the Borrower

At first glance, CP-CPI appears to solely benefit the creditor, since the main benefit is the protection of the creditor's interest in the collateral. When one views the full economic picture, CP-CPI benefits all borrowers. Without CP-CPI, the creditor bears the full risk, thereby reducing profits and causing interest rates to rise to offset losses. With higher interest rates, automobile credit is harder to obtain, adversely affecting both consumers and the automobile industry. Higher interest rates affect all borrowers, not just the borrowers who give rise to the increased costs.

Any policy benefits are paid to the creditor and reduce the obligation of the borrower, but the benefits may not extinguish the balance of the credit. Some borrowers can then afford to repay the new (lower) balance and preserve the relationship with the creditor.

CP-CPI ignores driving records and other rating factors. In spite of its dollar cost, there are some borrowers for whom CP-CPI is the less expensive option. Young drivers, sports car owners, and drivers with poor driving records may not have less expensive options for comparable insurance.

Advantages to the Creditor

Tracking software is an effective risk management tool when used with CP-CPI. Additionally, this software can perform ancillary management information functions, such as acting as an early warning system on credit problems and providing effective management reporting.

Finally, CP-CPI allows the creditor to insure only collateral that needs to be covered. This is very important to many creditors, but there are also cost considerations associated with such a program.

Reserves

Policy Reserves. Policy reserves are an estimate of future losses. In general terms, policy reserves equal the unearned premiums. The central idea is to match the premium-earning pattern with the loss incurral pattern. Premiums are typically earned on a pro rata basis. A particular problem is flat cancels; borrowers present evidence that the CP-CPI was redundant, since other insurance was in force. The refund must include amounts for a prior time period and may result in a refund that is in excess of the existing unearned premium. CP-CPI may be unique in that the standard calculation for earned premiums may result in negative earned premiums for an accounting period unless a specific adjustment is made in the reserving system for the cost of flat cancels. Some type of premium deficiency reserve or a reserve for "unearned earned premiums" may be necessary.

Loss Reserves. Loss reserves for unreported losses, *IBNR (Incurred But Not Reported),* are an estimate usually based on factors that are developed as a function of written premiums, such as the last *n* months of written premiums, or a function of paid claims. Special provision must be made for coverages that have a modest "tail." Skip and repossession losses have a longer lag than physical damage losses.

Reserves for reported claims are *case reserves* that are estimated using 1) an individual analysis of each claim, or 2) the number of pending claims times an average amount per claim.

Losses are typically reported and paid quickly. IBNR and pending claim levels are low. Since the claim typically involves a single claim payment, there are no continuing claim reserves. Loss adjustment expenses are low, generally under 5% of premium.

Blanket Collateral Protection Insurance on Titled Personal Property

Definition

Blanket collateral protection insurance (B-CPI) on titled personal property insures every extension of credit in the creditor's portfolio that is collateralized with eligible personal, titled property against physical loss or damage from any external source.

Overview

The key features of this insurance are:

- Every credit extension is insured. This differs from CP-CPI where only uninsured credit is covered.
- The same premium rate is paid for every credit extension in the creditor's portfolio. A single premium for the entire insurance term can be paid at each credit closing, or a monthly outstanding balance (MOB) premium can be paid monthly based on the total outstanding principal balance of the covered portfolio.
- Programs are often experience rated. Premium rates for a particular creditor are based partially or entirely upon that creditor's claim history.
- No tracking is required relative to the insurance being maintained by the individual borrower. There is no requirement for the tracking software, the hardware, the administrative processes, and the associated infra-structure (and cost). A prudent creditor may still use a tracking program to identify and contact borrowers that let their individual insurance lapse.
- There are few policy form variations. One policy form can cover a wide range of credit categories and various types of collateral.
- The collateral must be repossessed before benefits are paid, except in case of confiscation, skip, or theft.
- Blanket programs are often non-contributory. Under a non-contributory plan, the creditor pays 100% of the premium and does not pass any identifiable charge to the borrower.

Policy Structure

All blanket insurance is a master policy or group insurance with certificates of insurance. In many respects, blanket insurance is more like traditional group insurance than many of the so-called group insurance plans on the market today. The theory is that a group, formed for some reason other than obtaining insurance, purchases a policy. Every risk in the group is covered and receives the same set of coverages. The *group* is underwritten, not the individuals comprising the group. The line between group and individual insurance has blurred through the years, particularly for credit-related insurances. Credit-related coverages issued under a group policy or a master policy often have individual underwriting criteria and other individual insurance characteristics. Blanket insurance still follows the basic group concept.

The primary policy documents consist of a *declarations* (*dec*) *page* and an *insuring agreement*. The dec page contains information specific to the insured creditor, such as:

- Name and address of the insured creditor
- Effective date of the policy
- Coverage extended by type of collateral, and the limits, deductibles, rates, and other conditions of each coverage
- List of attached endorsements and applicable rates

- Premium payment terms
- Premium computation method

The insuring agreement is the policy itself—the insurance contract between the insured creditor and the insurer. It:

- Outlines coverages
- Contains definitions of key terms
- Outlines exclusions, limits of liability, and termination and cancellation procedures
- Outlines the responsibilities of the insurer and the insured with respect to premium payments and claims reporting
- Outlines other applicable terms and conditions, such as settlement options, and defines a valid claim

Endorsements may be added to the insuring agreement 1) for optional coverages, or 2) for state-specific modifications that are made to the base policy language or conditions. Typically, no notification of insurance, dec page, certificate of insurance, or policy is sent to individual borrowers.

Eligibility for Insurance

Eligibility is determined at the creditor level. The insurer determines the creditors who are acceptable, the forms of credit extensions that are acceptable, and the type of collateral that can be insured. Every extension of acceptable credit having acceptable collateral is automatically insured with the payment of the required premium.

The Insured Event

The most common blanket policies protect the asset against physical loss or damage from any external source. Typical causes can be collision (in case of an automobile), fire, and theft, subject to certain specific, excluded occurrences.

The Underlying Credit

In principle, any credit secured with an asset that a creditor accepts as collateral can be required to carry sufficient insurance to protect the creditor's interest in the collateral. Typical collateral includes:

- Automobiles and pickup trucks
- Motorcycles
- Pleasure boats
- Motor homes and house trailers
- Garden tractors
- Office equipment

Markets and Marketing

All financial institutions extending asset-backed credit have potential exposures, including banks, consumer finance companies, credit unions, and captive finance companies, such as creditors owned by manufacturers.

Most insurers market the products directly through home office or branch sales personnel. General agents that market other credit-related products also offer it.

The Insurers

The insurers providing blanket insurance must be property and casualty insurers and are typically considered specialty lines insurers. Almost all of these P&C insurers offer other credit-related insurance products.

Underwriting Criteria

Underwriting occurs at the creditor level where each creditor is considered a group. Loss frequency and loss severity for many types of collateral vary by geographical location, so geographical location is usually one critical underwriting factor. Other underwriting criteria are used at the creditor level. These criteria recognize various group characteristics and may include:

- Mix of direct versus indirect credit
- Mix of new versus used merchandise (cars)
- Age distribution of borrowers
- Term distribution of credit extensions
- Average credit amounts and distribution by size bands
- Average outstanding balance

The observed levels of the group characteristics are used in determining the premium rate. In addition, on the policy anniversary, or intermittently if allowed, the loss experience of the creditor will be reviewed and evaluated. If loss experience is poor, the case will be rerated, and the contract will be amended with higher blanket rates. This, of course, may result in changes in the other direction—lower rates resulting from favorable experience. Rates are not the only corrective tool; coverages may be restricted or expanded as appropriate.

Premium rates may vary by risk class of borrower; every borrower in each risk class pays the same premium rate.

Term of Insurance

The most common term of a B-CPI policy is defined as *continuous until canceled*. In other words, as of 12:01 a.m. on the effective date, the policy is in effect and newly accepted collateral is covered until the insurer or the insured creditor cancels the policy. The policy's cancellation provision typically states that either party can cancel the policy with *n* days written notice. The notice period is typically 30 days. Some creditors seek a more defined policy term for planning reasons. In these cases, the typical policy term is one year.

Benefit Conditions

Benefit Prerequisites. Before benefits are paid, certain conditions must be met. Common conditions are:

- The creditor's interest has become impaired as a result of a covered loss;
- The borrower has defaulted in payment;
- The collateral is not covered by acceptable insurance; and
- No funds are available from another obligor, such as a co-maker on the credit obligation.

Benefit Provided. *Blanket programs are typically single interest coverage*—the named insured is the creditor and only the creditor's interest is protected; the entire benefit is payable to the creditor. The maximum benefits that are payable are limited to the creditor's interest in the collateral, as evidenced by the credit obligation. The insurer pays the insured creditor the *least of*:

- The cost to repair the collateral and bring it to pre-loss form (value), *or*
- The outstanding principal balance of the credit, *or*
- The actual cash value of the collateral.

The benefit is subject to deductibles and limits noted in the insurance policy. If the collateral is a total loss, any salvage of the property may be deducted from the benefits payable.

Exclusions. Typically, the blanket policy does not cover losses or damages:

- Occurring prior to the effective date of the policy
- Resulting directly or indirectly from any dishonest, fraudulent, or criminal act of any of the creditor's officers or employees
- From any risk or encumbrance in title that existed at the time the credit extension was made
- From normal wear and tear
- Caused by or resulting from:
  - Any hostile or warlike action during peace or war by any governmental authority or the military
  - Nuclear war
  - Insurrection, rebellion, riot, or civil war
- Caused by or resulting from use during an illegal act

Some policies only cover credit extended after the effective date of the policy, but some policies cover existing credit that is not more than 60 days past due.

Premium Rates

The development of rates for blanket programs starts with the same data used with creditor-placed programs, but the data are evaluated differently. With blanket insurance, the creditor is considered a group. Subgroups can exist within the group, if the subgroups have distinctive risk characteristics and sufficient volume.

In rate development, basic claim frequency and severity data are examined. These data vary based on geographical location, the principal use of the property, and the principal user. The data can be examined based on creditor characteristics, such as mix of indirect versus direct credit, credit terms, credit size, and the demography of the borrowers. For example, loss data can be compared among creditors in different geographical areas and creditors catering to business credit versus personal credit. Loss data can be examined that corresponds to creditors extending large, long-term indirect automobile credit to affluent customers versus short-term direct automobile credit to less affluent customers.

The end result of the data analysis is a rough idea of expected loss costs that may be determined by state (perhaps by territory within state), by group (creditor) based upon easily measurable characteristics, and perhaps by type of credit category.

The expected loss costs can then be expressed as a function of the key risk factors, as a single premium per $1,000 initial credit balance for each credit extension, or as an MOB premium per $1,000 outstanding balance. Since the premium is charged with respect to every borrower, these bases provide a convenient method to determine the premium rates and gross premiums.

Rates are filed for approval with the insurance department in the state where the policy will be issued. The rate filing may include a range within which the base rates can be adjusted based upon loss experience.

Premium Refunds

Upon cancellation of an insurance policy, unearned premiums are refunded to the insured in accordance with the policy provisions. In a monthly premium blanket insurance program, premiums are paid monthly and are fully earned by the time they are remitted to the insurer, so there are no premium refunds on termination. Actual situations and arrangements may vary. For example, if a creditor is required to pay an *up front deposit premium* (similar to a security deposit), it is returned after the policy is canceled.

For policies with a single premium per credit extension, a refund provision may be required for the period after the effective date of the termination. Some policies earn all premiums on the effective date of the termination, so no refund is due.

Agent Licensing

With blanket programs, the creditor is the insured, so no licensing is required except for the insurer's agent who offers the policy to the creditor.

Available States

Blanket programs are available to creditors in all states.

Advantages to the Borrower

The use of a blanket insurance policy is a choice to spread the cost over all borrowers. If the cost is passed to all borrowers with contributory premiums, the insurance results in an administratively simple process that produces lower interest rates. If the creditor absorbs the cost through non-contributory premiums, the cost must ultimately be reflected in the creditor's interest rate. On uninsured credit, individual insurance is not placed. The cost of blanket insurance is dramatically lower than creditor-placed insurance. In some situations, individual insurance may not be available.

Advantages to the Creditor

The principal benefit of B-CPI is the protection of the creditor's interest in the asset pledged as collateral. In general, the blanket programs provide the creditor with:

- Immediate insurance for all credit extensions in the portfolio
- Complete protection for the entire portfolio
- No selective underwriting
- Lower potential for litigation

B-CPI programs have the additional benefit of not requiring the administrative infrastructure, money, or computer capacity necessary for a creditor-placed program. Blanket programs are simpler to administer and cost substantially less than creditor-placed programs resulting in a better fit with some creditors' operating procedures and budgets.

Reserves

Policy Reserves. Blanket insurance that is sold on a monthly premium basis results in premiums that are fully earned by the time the insurer receives them. If the policy is cancelled, the termination date is normally the end of a policy month. No benefits are payable for any losses occurring after the effective date of termination. Therefore, reserves for future losses are typically not maintained.

Where a single premium is charged for each credit extension, an unearned premium reserve may be held. An individual inforce file is not maintained, so broad approximations are used. The premium collected in a given month from a creditor will be earned over an assumed average term of the credit, usually calculated using pro rata unearned premiums.

Loss Reserves. Loss reserves for unreported losses, *IBNR (Incurred But Not Reported)*, are an estimate usually based on factors that are developed as a function of written premiums, such as the last *n* months of written premiums, or a function of paid claims. Reserves for reported claims are *case reserves* that are estimated from an inventory of claims that have been reported but not yet paid.

Losses are typically reported and paid quickly. IBNR and pending claim levels are low. Since the claim typically involves a single claim payment, there are no continuing claim reserves. Loss adjustment expenses are low, generally under 5% of premium.

Creditor-Placed Collateral Protection Insurance on Real Property

Definition

Collateral protection insurance (RE-CPI) on real property is a form of homeowners insurance that is unilaterally placed by the creditor to protect its interest in the collateral of a mortgage when the mortgagor fails to provide proof of homeowners insurance. The creditor usually pays the premium from the borrower's mortgage escrow account.

Overview

Most homebuyers today purchase their home with borrowed money. Credit secured with real property is called a mortgage. The creditor is the *mortgagee,* and the borrower is the *mortgagor.* When the mortgagee has the first lien on the property, the credit is a first mortgage. At any time, the difference between the value of the property and the mortgage is the *equity* in the property. Creditors will extend credit beyond the first mortgage using this equity as collateral by placing a second lien on the property—second mortgage credit or home equity credit.

As a condition of a mortgage, the mortgagor must continuously maintain homeowners insurance on the real property. If the mortgagor does not fulfill this obligation, the mortgage can be called, or the mortgagee can exercise its right to purchase insurance and pass the cost on to the mortgagor.

In principle, there are many ways the mortgagee can protect its interest in the collateral securing the mortgage. One practical method is *creditor-placed collateral protection insurance.*

In today's market, a home mortgage is typically originated by a mortgage affiliate of a large credit institution. Individual mortgages are "pooled" or "packaged" with other mortgages of similar terms and interest rates; the pool is sold to an underwriter, such as Fannie Mae. The pool of mortgages is then securitized, and these securities are sold in the financial markets to investors.

Typically, the purchaser in the secondary market has fixed rules applicable to the insurance provisions contained in the mortgages that it will purchase. Non-conforming mortgages will not be bought. These requirements of the secondary market give little flexibility to mortgage originators to bargain over the insurance requirement provisions.

The mortgage originator is usually the mortgage servicer. The servicer contracts with the mortgage underwriter to service the mortgages. In accordance with this service agreement, the servicer is obligated to perform several functions including:

- Collection of principal and interest
- Administration of escrow accounts

- The collection of funds for, and the payment of, taxes to property tax authorities
- The collection of funds for, and the payment of, insurance premiums for insurance that meets the minimum requirements of the mortgage

One of the key responsibilities of the servicer is to ensure that the mortgagor maintains homeowners or other acceptable insurance. The process typically works in this way:

- The homeowners policy has a one-page summary of key information called a *declarations (dec) page*, that includes the name and address of the *lienholder* (the mortgagee).
- When the homeowners policy is renewed, copies of the dec page and the *premium statement* are sent to the lienholder. The dec page is reviewed to verify that the collateral is insured and that the obligation to the mortgagee is duly recorded.
- The servicer confirms that all information on the dec page is correct—the address of the property/home, the mortgagor's name, and the amount of insurance. Once confirmed, the servicer pays the premium from the mortgagor's escrow account and updates the individual mortgagor's mortgage file in the mortgage database to record proof of insurance.
- The insurance tracking system monitors the database of the mortgage files. If the tracking system finds a file that is not in compliance, the file is flagged. The system automatically generates a letter to the mortgagor, the last insurer named, or both. The letter states that, in accordance with the mortgage, the mortgagor has a stated number of days to obtain acceptable insurance covering the real property or provide evidence that such insurance is in place.
- If the mortgagor does not respond, the mortgagee obtains insurance to protect its interest. The insurance escrow component of the mortgagor's monthly payment is adjusted accordingly in most cases.
- At the end of the policy term, a renewal notice is sent to the mortgagor. If no response is received from the mortgagor, the policy will automatically be renewed.
- If at any time the mortgagor produces evidence of acceptable insurance, the creditor-placed collateral protection insurance premiums are refunded on a pro rata basis. The refund will be paid back to the earliest time the mortgagor produces evidence of insurance, even if this period precedes the last renewal date.

Insurance tracking is a separate industry in and of itself. In the early days, insurance tracking was done manually. The evidence of insurance was confirmed on a manual basis by physically reviewing the mortgage files. Smaller mortgagees still use this method. With the advent of computer technology, most large mortgagees have gone to automated insurance tracking systems. Typically, software is installed on the servicer's computer to continuously monitor each mortgage for compliance with the mortgagor's insurance obligations.

There are numerous software packages available. Third-party administrators specializing in this field have developed software systems, and some insurers have their own software. The tracking software must be integrated with the collateral protection insurance software that issues, maintains, and services the policies and supports the claims paying process.

The servicer typically retains the right to solicit the mortgagor with certain ancillary products, such as mortgage life insurance, mortgage accidental death insurance, and mortgage disability insurance.

Policy Structure

The insurance may be structured as individual insurance, as insurance offered under a master policy, or as group insurance where the policyholder is usually the mortgage servicer. For group insurance, the group may be "all first mortgage credit serviced by ABC mortgage service company." In one form or another the primary documents are the declarations page and the insuring agreement.

Declarations page. The declarations page, commonly referred to as the *dec page*, contains detailed information about the coverage, such as the dwelling coverage limit and the deductibles. Other conditions that apply to the entire policy are listed.

Insuring Agreement. This is the insurance policy itself. It defines and outlines the coverages—the losses insured against, losses not insured, and conditions. The primary insured is the mortgagee. An additional insured is the mortgagor.

The servicer, the mortgagor and the mortgagee all receive a certificate of insurance that contains:

- Insured name; address of the property
- Coverages and corresponding limits and deductibles
- Mortgage amount
- Lienholder information
- Annual premium
- Effective date of the insurance

In the case of a renewal, the servicer/insured typically receives an updated certificate of insurance similar to the practice in the standard homeowners insurance market. Other methods and arrangements are possible.

Eligibility for Insurance

The fundamental principle behind these programs is that the insurer provides insurance when no other course of action is available to the mortgagee/servicer. It is critical that the mortgagee can depend on the RE-CPI insurer to accept all risks. The premium rates and underwriting criteria are developed with this principle in mind.

The Insured Event

Covered perils vary from policy to policy. In general, the policy insures against the same perils as insured against by homeowners insurers—perils that cause physical damage to the property.

The insurance can be *all risk* or *named peril*. *All risk* policies provide coverage against all causes of loss, *except* for certain excluded events, and may be subject to additional specific exclusions. *Named peril* coverage insures against specific perils that are itemized in the policy. *A combination of the two is common—dwelling coverage will be all risk and contents coverage will be named peril.*

The Underlying Credit

The principal credit is first mortgages on residential and commercial properties. Other credit includes second mortgages secured by the mortgagor's equity in real property and properties the mortgagee has acquired through foreclosure or repossession.

Markets and Marketing

All financial institutions involved in servicing first or second mortgages have potential collateral protection risks. These include the mortgage servicing subsidiaries or units of banks, savings institutions, insurance companies, and consumer finance companies. Insurers generally market this product through home office and branch sales personnel.

Underwriting Criteria

Gross premiums are based on the characteristics of the property. The characteristics considered are:

- State
- Territory within the state
- Protection class
- Construction type
- Coverages
- Amounts of coverages

Proper classification of the property based on these characteristics is essential in determining the correct and adequate premium for the specific policy. Once the rating work is completed, the policy is issued subject to limits, deductibles, and exclusions of the various coverages.

The Insurers

The insurers providing RE-CPI on real property must be property and casualty insurers and are typically considered specialty lines insurers. Most of these P&C insurers offer other credit-related insurance products, but some are general lines P&C insurers. Less than 25 insurers offer this product through a variety of financial institutions.

Term of Insurance

Insurance terminates at the end of the policy term (usually one year), or when:

- The mortgage is paid off, or
- The mortgagor provides an acceptable replacement policy or evidence of acceptable insurance already in force.

Benefit Conditions

Benefit Provided. The basic insurance for this plan is on the dwelling. The corresponding benefit is the repair or replacement required to bring the dwelling back to its pre-loss form thereby restoring the collateral to its pre-loss market value. The benefit is limited by some maximum amount, such as the outstanding balance of the mortgage, the market value of the dwelling, or some other stated amount.

These benefits are subject to a deductible, typically in the $100 to $1,000 range, similar to the standard homeowners policy. Additionally, some of the traditional coverages found in standard homeowners policies may be provided, including coverage on additional structures, contents/personal effects, and general liability. Auxiliary coverages are subject to separate deductibles, and limits that are typically 50% of the dwelling's maximum liability. The benefits of these additional coverages are:

- **Additional Structures.** The benefit is repair or replacement as required to bring other structures on the property back to their pre-loss form.
- **Contents/Personal Effects.** Benefits equal the cost of replacing damaged or stolen items, subject to a deductible and a maximum limit. The policy states whether the replacement amount is the full replacement cost or the depreciated value.
- **Liability.** Basic liability insurance protects the insured borrower against damages resulting from 1) a non-resident being injured, or 2) non-resident's property being damaged while on the insured borrower's premises. The collateral protection insurer pays for all damages, subject to deductibles and policy limits, arising from a lawsuit against the insured borrower when the insured borrower is found liable.

  When offered, it is limited to the $100,000 range, but some insurers go as high as $1 million. These higher coverage amounts are being seen more frequently in creditor-placed insurance, because mortgagees have been sued for obtaining insurance on behalf of the mortgagor that was considered inferior to the insurance that was previously in place. As a result of these cases, mortgagees who obtain collateral protection insurance on behalf of mortgagors are obligated to obtain at least a minimum amount of protection for each coverage.

Many collateral protection policies protect the dwelling only. Some limit coverage to the outstanding principal balance of the mortgage at the time the insurance is placed, but comprehensive plans with dwelling limits equal to the market value or replacement value of the property are becoming more common. Collateral protection insurance is often *excess coverage*, that is, benefits are only paid for losses in excess of any benefits paid by any other insurance in place at the time of loss.

Exclusions. Specific exclusions are dependent upon the policy. The most general form of creditor-placed collateral protection insurance covering mortgages is a standard homeowners form. It covers the dwelling and any other additional structures against all perils except:

- Earth movement (sinking or shifting or contracting of the earth, such as a landslide, a sink hole, a mud slide, or an earthquake)
- Water damage as a result of a flood or sewer backup
- Damage to the property as a result of neglect by the homeowner
- Damage as a result of war or nuclear hazard

With respect to personal property insurance, this form lists certain perils that are covered, for example, fire or lightning, windstorm or hail, explosion, smoke, vandalism, and burglary. In a personal property/named peril policy, if the loss is not a result of a listed peril, then the loss is not covered. In addition, the policy lists certain property that is not covered, such as motor vehicles, property of roomers or boarders, and pets.

Premium Rates

Rates are developed based on many variables. In the creditor-placed arena, rating structures vary, but in principle, premium rates are based upon the following factors:

- **Geography.** Some areas are more likely to experience damage from natural disasters, so the location of the property greatly affects the premium rate. In some states, particular sections of the state may be more prone to natural disasters. For example, land facing a large body of water experiences frequent severe storms. A state with this type of geography is commonly divided into multiple territories. Properties in highly-exposed territories will have higher rates reflecting the increased frequency and severity of claims.
- **Protection Class.** The proximity of the property to various public services, such as a fire station, is another factor. Territories are often divided into protection classes that consider these types of characteristics.
- **Construction**. The construction of the dwelling affects the premium rate. In some states, masonry homes have lower rates than frame homes.

In general, insurance companies study loss data and try to measure the characteristics that drive loss frequency and severity. These relevant risk factors are then incorporated into a rating plan or a “rate manual.” All rates must be filed with and approved by the state insurance departments. Rate filings are public record, though, so competitive advantages do not last long.

Once a rate is developed, the premium is charged. Premiums are typically paid from the mortgagor’s escrow account, and adjustments are made to the insurance component of the monthly payment as necessary.

Premium Refunds

The insurer typically earns collateral protection insurance premiums on a pro rata or straight-line basis. In the case of a 12-month policy, one-twelfth of the annual premium is earned each month. Refunds occur when the policy is canceled. The policy is canceled either:

- When the mortgagor provides evidence that acceptable insurance was in force continuously (no lapse in insurance), *or*
- When the mortgagor obtains acceptable insurance during the term of the collateral protection policy, *or*
- When the mortgage is canceled.

In the first case, the collateral protection policy is *flat canceled*, and the entire premium is refunded. In the last two cases, the unearned premium is refunded in accordance with the pro rata earning formula.

Agent Licensing

With creditor-placed collateral protection insurance, either 1) the mortgagee/servicer is the insured, or 2) the servicer is purchasing a policy on behalf of the mortgagor pursuant to an agreement between or among the parties involved. No licensing is required, except for the insurer's agent that offers the policy to the servicer.

Available States

In all states, creditors have the right to protect their interests in collateral that secures credit. Creditor-placed collateral protection insurance, in one form or another, is available in all states.

Advantages to the Mortgagor

Without the knowledge that CPI provides continuous protection, mortgagees would have no choice but to call and foreclose on mortgages much faster than is the practice today. Continuous insurance protection is the responsibility of the mortgagor, and the availability of CPI as a backstop to those who fail to fulfill their responsibility is a service in itself. It avoids foreclosure and helps maintain the mortgagor's credit record.

Advantages to the Mortgagee

Credit Protection. The principal advantage is the continuous protection of the creditor's interests in the collateral. Without insurance, mortgage transactions would be difficult, if possible at all. Collateral protection insurance allows the mortgagee to remain continuously protected and, therefore, concentrate on its core business of extending credit. Blanket programs on mortgaged real property are virtually impossible to buy, since few insurers have ever been willing to accept the risk for a reasonable premium.

Insurance Tracking Software/Systems. Collateral protection insurance tracking software provides large mortgagees with the most efficient and effective means of continuously tracking each mortgage and confirming that adequate insurance protection is maintained on the collateral. Software on the market today is user friendly. It is integrated with the creditor's other systems and the collateral protection insurance program itself. In addition to maintaining state-of-the-art software and systems, the tracking services themselves are customer service sensitive. They also provide the mortgagee with an impressive array of features, such as management reports to assist the mortgagee in managing its portfolio.

The combination of flexible collateral protection products and state-of-the-art insurance tracking software and systems provide mortgagees with an effective risk management tool. These programs allow the mortgagees to maintain an appropriate level of risk in their mortgage portfolios and also remain competitive.

Reserves

Policy Reserves. In general, reserves are set equal to unearned premiums that decline using the pro rata method. If the policy limit is the outstanding balance of a mortgage, the amount of risk or exposure does not decline linearly. However, during a 12-month policy, the effect of the decreasing maximum limit is small, so the premium is still earned using the pro rata method.

Loss Reserves. Loss reserves for unreported losses, *IBNR (Incurred But Not Reported),* are an estimate usually based on factors that are developed as a function of written premiums, such as the last *n* months of written premiums, or a function of paid claims. Reserves for reported claims are *case reserves* that are estimated from an inventory of claims that have been reported but not yet paid.

Losses are typically reported and paid quickly. IBNR and pending claim levels are low. Since the claim typically involves a single claim payment, there are no continuing claim reserves. Loss adjustment expenses are low, generally under 5% of premium.

Chapter Twelve

Auxiliary Products

Mortgage Impairment Insurance

Mortgage impairment insurance (MII) is a form of title insurance on credit secured by real estate, excluding first mortgage credit. It protects the creditor's interest in the event that the creditor forecloses on real property and is unable to collect because of an undisclosed encumbrance or other legal obstruction to the title of the property. The product is also known as *foreclosure impairment insurance* and *lender impairment insurance*.

A master policy is issued to the creditor. No evidence of insurance must be given to the borrower, since all protection is for the benefit of the creditor. The insurer will provide the creditor with a binder or other evidence of the acceptance of each eligible credit obligation. A form is provided to the creditor who completes the form and submits it to the insurer. The insurer countersigns the form and returns a copy to the creditor.

All eligible credit must be insured. The creditor must establish and follow procedures to protect the collateral:

- Appraise the collateral within 50 days of the credit extension
- Limit total encumbrances to less than 95% of the appraised value of the collateral
- Have a title search conducted with 15 days after the credit extension, and the results must be satisfactory.

Automatic insurance is granted for any eligible credit with an initial principal balance of $150,000 or less, and a term of 180 months or less (or similar limits). Insurer approval is required if either limit is exceeded. The term of insurance is the term of the credit. All insurance ceases when the credit is repaid.

Title insurance is a well-established product. Its purpose is to insure against the possibility that a title to real estate property contains an undisclosed encumbrance. Prior to a sale of property financed with a first mortgage, a thorough title search is performed. Even though no liens or encumbrances appear to exist on the title, the potential exists that an unknown encumbrance may exist and may surface at some future date.

Under a title insurance policy, both the borrower and the creditor are protected if an encumbrance becomes known. A claim can be filed without default occurring on the credit. The underwriting requirements are strict and require a substantial amount of paperwork and research. Although the cost of the insurance is passed along to the borrower, the creditor incurs costs and must put forth some effort.

MII protects only the creditor's interest; and that interest is limited to the situations where default on the credit obligation actually occurs. The creditor has the same protection as title insurance.

The product can be used in any credit situation where real estate is taken as collateral. Due to the limited underwriting requirements, first mortgage credit is excluded. Installment credit is the primary market—home improvement or other second mortgage credit. Real estate secured open-end credit, such as a home equity line of credit, can also be insured.

All financial institutions participating in these credit activities are potential customers. Consumer finance companies moved into second mortgage lending in a big way in the early 1980s and remain a primary target market for the product. Banks and credit unions are also potential markets.

At the time of issue, a title search is done and all known encumbrances are disclosed to the insurer. For a valid claim:

- Default on the credit must occur
- Foreclosure must be attempted, and the creditor must be unable to complete foreclosure (or to collect the proceeds of the foreclosure) because of an undisclosed lien or other legal obstruction

Any form of undisclosed lien is valid, including adverse possession liens, mechanic liens, or material man liens. The maximum benefit under the policy is equal to:

- The unpaid principal balance, plus
- Accumulated interest, plus
- Attorney and legal fees, not to exceed 10% of the unpaid principal balance

Any refunds on financed insurance premiums reduce this benefit. Benefits are further reduced for amounts due or collected from other similar insurance.

Alternatively, the insurer may elect to pay the costs of removing the offending encumbrance.

Only a limited set of exclusions apply given the limited situations in which a claim may occur. Common exclusions include:

- War
- Invocation of the Soldiers' and Sailors' Relief Act of 1941 by the borrower
- Expenses to repair damage to the collateral

- Credit not using simple interest to earn interest

The cost of insurance is normally passed along to the borrower. Single premium rates are set per $1,000 of total initial principal balance of the insured credit. Rates vary by state from $2.50 to $5.00 per $1,000. The creditor may pay the premium if it is absorbing the closing costs. The creditor remits premiums to the insurer within 14 to 21 days following the close of the month. No refunds are paid if the credit is repaid early.

The following states have been known to approve the insurance:

AL, CA, CO, GA, IN, IL, LA, MD, MA,

MS, NV, NH, OH, PA, TN, UT, WA, WV

For the creditor, this is a substitute for title insurance, but it is far more convenient. Many of the target credit obligations are currently unprotected from this peril. This product has a cost that is reasonable for second mortgage credit.

An alternative coverage does not require the creditor to perform a title search on the collateral. Under this coverage, the insurance is comparable to non-filing insurance. This alternative is normally used when the amount of credit is relatively low.

Reserves are based on gross unearned premiums. The pro rata method of calculating unearned premiums is considered appropriate. However, this product is fairly new, so there is no proof that unusual claim patterns do not develop.

No refunds are paid on early terminations, so the insurer may not receive notification of credit cancellations. Given the steady level of terminations on second mortgages, the unearned premium may develop a substantial level of conservatism as the credit portfolio builds. This will provide protection in the event the frequency of claim proves to increase with policy term.

Losses are likely to occur infrequently, even for portfolios with substantial premium production. A conservative IBNR method should be adopted. For the first few years of premium production, the loss ratio approach may be the best method to set loss reserves and loss adjustment expense reserves.

Flood Insurance Programs

The Flood Disaster Protection Act of 1973 expanded the national flood insurance program by:

1. Requiring states and local communities to participate in the flood insurance program, and
2. Requiring the purchase of flood insurance as a condition of receiving any form of federal or federally-related financial assistance for acquiring or constructing any building or manufactured home located in an area identified as an area of special flood hazard within a community participating in the National Flood Insurance Plan (NFIP).

Under the regulations of this Act, mortgagors are required to purchase flood insurance covering properties located in communities participating in the NFIP. The Federal Emergency Management Agency (FEMA) believes that if the borrower refuses to purchase flood insurance, the bank is justified in purchasing the insurance for the borrower and charging the borrower for the cost, i.e., force placing the insurance. The intent of this requirement is to protect borrowers and creditors. FEMA has developed standards for creditor-placed flood programs.

Flood is "a general temporary condition of partial or complete inundation of normally dry land areas from inland or tidal areas, mud flows, or the unusual and rapid accumulation of surface waters from any source." **Flood insurance** generally covers all direct physical losses directly caused by a flood of the insured property. National Flood Insurance Plan policies cover only buildings and eligible contents within; policies do not insure land values. To be eligible for federal flood insurance program assistance, communities with flood-prone areas must participate in the program. Once a community is accepted into the program, the properties within the community become eligible for insurance. The NFIP has prepared flood maps for 18,538 communities in which there are Special Flood Hazard Areas (SFHA). Of these communities, about 18,000 are currently participating in the NFIP.

Flood insurance policies can be purchased through property insurance agents and brokers from the NFIP's servicing company. Policies can also be purchased from private insurance companies that have "Write Your Own" arrangements with the Federal Insurance Agency (FIA). Under the Write Your Own arrangements, NFIP policies are written by those companies at the same premium rates.

General agents offer a blanket flood program to financial institutions under the Write Your Own plan. Participants in this program are issued a master policy insuring all of their credit that is in SFHAs. The institution is immediately brought into compliance, and the general agent can analyze individual properties without concern for uninsured properties.

The individual property analysis is accomplished by tracking programs, similar to the tracking programs used for collateral protection insurance. The software assembles data in a specified format from the mortgage files of the financial institution. These data are sent to a specialized service organization for zone determination. A *zone determination* identifies each property that is in a SFHA.

The zone determination results are coded into the mortgage records. The tracking program identifies the properties located in a SFHA that are uninsured. Borrowers with uninsured properties receive a series of letters informing them of the need for flood insurance. Borrowers who respond will be assisted in obtaining the necessary insurance through the NFIP. If they do not respond, a binder is issued through the blanket master policy until insurance can be forced-placed with the NFIP. A final audit of the mortgage portfolio is performed to ensure insurance is necessary before insurance is forced-placed.

Accidental Death and Dismemberment Insurance

Accidental Death (AD) insurance is term insurance that provides a stated benefit if death occurs as a result of accidental means within 90 (or so) days following an accident. **Accidental Death and Dismemberment (AD&D) insurance** is AD insurance that includes a stated benefit if dismemberment occurs. The dismemberment benefit may vary depending on the nature and extent of the dismemberment. Most policies are for level term insurance, but decreasing term insurance is occasionally offered. The acronym *AD&D* is used in this section for convenience, but both forms are common in the marketplace.

Finance companies and other producers of credit-related insurance offer this product as a standalone optional purchase. AD&D insurance is voluntary and is independent of the credit extension. However, the producer may be willing to extend credit to finance the purchase of the insurance. The AD&D policy is a separate contract; its benefits do not vary proportionately with the outstanding credit, as in the case of credit life insurance.

AD&D insurance has commonly been offered as a rider to ordinary life insurance, but legally, it is considered accident and health insurance. Standalone AD&D policies are offered in the mortgage life and disability market and in a few specialty product situations. If sold by a life insurer, AD&D is classified as accident and health insurance, often group A&H insurance. A P&C insurer can also offer it as a P&C product.

Typically, all applicants within an age range, such as 18 to 70 years of age, are eligible for insurance. AD&D is often purchased with a single premium for a one-year term, but single premium, multiple-year term policies are offered.

It is typically offered in benefit units of some fixed amount, such as $1,000. The applicant selects the number of benefit units at time of application. Rates are typically expressed in terms of the benefit unit, such as $3.00 per $1,000 of benefit per year. The cost of AD&D insurance varies widely. Variations in premium rates are mostly due to policy benefit variations. Policies may insure all accidental causes, just common carriers (travel accident), or automobile travel only. Variations in premium rates also result from the interaction of the fixed expenses and the small dollars of premium income. For example, even at $3.00 per $1,000 per year, the single premium for $5,000 of insurance is $15.00.

Extended Service Contracts

Extended Service Contracts (ESCs), or extended warranties, are typically offered by retailers, such as appliance dealers and consumer electronics dealers, to their customers. The ESC usually extends many of the provisions of the manufacturer’s warranty for a period of time beyond the expiration date of the manufacturer’s warranty. ESCs function much like insurance policies; the retailer offers the customer a “policy” (the ESC), collects a “premium” (the selling price of the ESC), and the “insured” (the customer) files a “claim” when a covered item fails as a result of a covered loss event.

The ESC names the *obligor*—the party responsible for performing pursuant to the provisions of the ESC—also referred to as the *named obligor* or the *contractual obligor*. The obligor is typically one of three entities, 1) the selling retailer, 2) the manufacturer, or 3) an ESC administrator. In many states only the manufacturer or the selling retailer can be the obligor. In other states, any one of the three can be the obligor. Often the obligor insures the obligations specified in the ESCs it has issued by purchasing P&C insurance from a P&C insurer.

There are many versions of ESC arrangements in existence, largely dependent upon the status of the obligor of the ESC. Regardless of the structure of the ESC arrangement, the principal features and benefits of ESCs are substantially the same. The obligor will repair or replace a covered item in the event of a covered loss event, or pay for the repair or replacement.

Vehicle Service Contracts

Vehicle Service Contracts (VSCs), are typically offered by automobile dealers to their customers. VSCs work much like insurance policies in that a customer pays a "premium" (the purchase price of the VSC) in return for which the customer receives a "policy" (the VSC) covering the vehicle in the event of mechanical breakdown. The "insured" (the customer) files a "claim" when a covered part fails as a result of a covered loss event. In some states, the protection can only be extended via a filed and approved insurance policy—mechanical breakdown insurance.

The VSC names the *obligor*—the party responsible for performing pursuant to the provisions of the VSC—also referred to as the *named obligor* or *the contractual obligor*. The obligor is typically one of three entities, 1) the selling dealer, 2) the manufacturer, or 3) a VSC administrator. In many states only the manufacturer or the selling dealer can be the obligor. In other states, any one of the three listed above can be the obligor. Often the obligor insures the obligations specified in the VSCs it has issued by purchasing P&C insurance from a P&C insurer.

There are many versions of VSC arrangements in existence, largely dependent upon the status of the obligor of the VSC. Regardless of the structure of the VSC arrangement, the principal features and benefits of VSCs offered in conjunction with new and used vehicles are substantially the same. The obligor will repair or replace a covered item in the event of a covered loss event, or pay for the repair or replacement.

VSCs are offered in conjunction with new and used vehicles. In the case of new vehicles, the VSC will provide coverages that are not provided by the manufacturer's warranty when the manufacturer's warranty is in effect. Examples of such coverages are emergency roadside service and rental car reimbursement while a manufacturer's warranty claim is in process. As the coverages provided by the manufacturer's warranty begin to expire, the VSC will replace some portion of them, depending upon the particular VSC. Common terms of coverage for new vehicle VSCs are *five years or 60,000 miles* (whichever comes first) and *six years or 72,000 miles*.

In the case of used vehicles, the VSC provides protection similar to the provisions of the manufacturer's new car warranty for a period of time after purchase. Used vehicle VSC terms typically range from *3 months or 3,000 miles* to *48 months or 48,000 miles*. Used vehicles eligible for such coverage are typically those up to five years in age or up to 60,000 miles. Other eligibility criteria exist. Some contracts can be written on vehicles up to ten years in age or up to 100,000 miles.

Debt Cancellation Contract

A debt cancellation contract (DCC) or a debt deferment contract (DDC) is an agreement between a creditor and a borrower under which the creditor agrees to modify the credit obligation in the event of the borrower's death, disability, involuntary unemployment, family leave, or other named event. DCCs are virtually identical to the comparable credit life, disability, IUI, and family leave products, but DDCs have significant differences.

In March 1964, the Comptroller of the Currency issued regulation 12 CFR 7.7495 that read:

> "Debt Cancellation Contract. A national bank may provide for losses arising from cancellation of outstanding loans upon the death of borrowers. The imposition of an additional charge and the establishment of necessary reserves in order to enable the bank to enter into such debt cancellation contracts are a lawful exercise of the powers of a national bank and necessary to the business of banking."

This power was granted under federal law and supersedes any state banking or insurance laws or regulations. In 1994, the Comptroller issued Interpretive Letter No. 640 that reaffirmed the 1964 ruling and extended the authorization to the contingencies of disability and unemployment. The wording appears broad enough to include the contingency of family leave.

As a practical matter, no one exercised the original authority until The First National Bank of Eastern Arkansas began issuing contracts on installment credit. Credit insurers objected, saying the contracts were insurance products, and the Arkansas Insurance Department ruled that the product was subject to state credit insurance laws and regulations. The bank sued. The court ruled in the bank's favor, stating that a DCC does not constitute the "business of insurance" when issued by a national bank within the bounds of the National Bank Act. The 8th Circuit U. S. Court of Appeals upheld the original court decision on appeal.

A DCC or a DDC has significant advantages for a bank. Neither contract provisions nor rates are subject to state insurance regulations. Both can provide more liberal benefits by the elimination of age and underwriting restrictions. Most importantly, if the concept is available nationwide, the program can be uniform as to benefits, contract language, and rates in all states. This is of particular benefit to credit card programs. Several banks are offering DCCs or DDCs on a widespread basis.

In return for a fee, the bank issues an addendum to the credit obligation. Under installment credit, if the DCC purchase is optional and the cost is disclosed, the fee can be financed, and the cost can be excluded from the finance charge. Under open-end credit, the fee is not financed, so the issue of including the fee in the finance charge is moot.

The contracts offered so far fall into two primary categories:

Debt Cancellation Contract. At death, the balance of the credit is cancelled, and no further amounts are owed. (Unlike a credit life insurance benefit, this benefit may be taxable to the beneficiary.) On disability, involuntary unemployment, or family leave, any monthly payment due during the period of claim is cancelled; the benefit includes both the principal and the interest that is due.

Debt Deferment Contract. At death, the balance of the credit is waived, and the account is closed. On disability, involuntary unemployment, or family leave, the requirement to make a monthly payment is waived, along with the interest due for the month. (These benefits may not be taxable to the beneficiary.)

The eligibility requirements and contractual language are similar to credit insurance policies but are much simpler documents. Eligibility requirements are often more liberal. The monthly indemnity coverages are similar—a 30-day retroactive plan is common on disability, involuntary unemployment or family leave, but the maximum benefit is usually a stated number of monthly payments, such as twelve.

The bank must also make provisions to handle typical administrative functions associated with recording the sales of the DCCs and administrating claims. The reserving requirements on the bank are unclear, but the need for proper reserving is just as critical as it is for credit insurance products.

Chapter Thirteen

GAP

Definitions

GAP insures the excess of the outstanding indebtedness over the primary property insurance benefits that may occur in the event of a total loss to a collateral asset. *Primary property insurance* refers to the underlying P&C insurance policy insuring the property, such as automobile physical damage insurance. GAP can be written on a variety of assets that are used as collateral to secure credit, however, it is most commonly written for automobiles.

GAP may or may not be insurance depending on the state regulations and the contractual relationships. Since its introduction in the mid-1980s, the products and the applicable regulations have been evolving. That evolution is continuing. Because of variations in state credit and insurance regulations, the evolution is proceeding in a haphazard pattern.

Actual Cash Value (ACV) is the market value of an asset at a particular point in time. *Total Loss* is a loss where the cost to repair the property exceeds the ACV. Unrecovered theft is also an example of a total loss.

GAP is a relatively new product; it first appeared around 1985. Industry-wide terminology has not emerged. For this chapter, the following terminology is used.

- *GAP waiver* refers to the contractual protection purchased by a borrower from the creditor, where the contractual terms of the protection are contained in the credit obligation or in an addendum to the credit obligation.
- *GAP waiver insurance* refers to insurance protection purchased by a borrower from the creditor or from a P&C insurance agent, where the contractual terms of the protection are contained in an insurance policy between the borrower and the P&C insurer.

- *GAP insurance* refers to an insurance policy purchased by the creditor from a P&C insurer that insures the contractual liability assumed by the creditor to its borrowers under GAP waivers.
- *Blanket GAP*. Some leasing companies purchase GAP protection for all of their leases and absorb the cost of the product. The protection generally follows the description of GAP waivers in this chapter, but policies are often tailored to the particular leasing company. This type of GAP is not addressed in the remainder of this chapter.

Overview

The letters, GAP, may stand for Guaranteed Automobile Protection, or possibly Guaranteed Asset Protection, but those words do not have significant meaning. Several of the early developers called the product TLP, for Total Loss Protection. Many people just consider the letters to stand for the *gap* that occurs between the indebtedness and the value of the primary property insurance benefits.

When an insured loss results in a total loss to the property, the primary property insurance policy usually provides a benefit equal to the ACV. In consumer credit, the outstanding indebtedness often exceeds the ACV of the collateral asset at the time of a total loss. Typically, the outstanding indebtedness and collateral's value decline at different rates. Colloquially, the borrower has "negative equity," the borrower is "under water" or "upside down."

The difference between the indebtedness and the collateral's ACV is the borrower's unprotected exposure—the GAP. If a total loss occurs, the borrower has a contractual obligation to pay the creditor the excess of the indebtedness over the actual cash value.

Policy/Contractual Structure

The intent of GAP products is to ensure that the borrower is fully protected in the event of a total loss. This benefits the borrower and the creditor. Borrowers are often unaware of this exposure. Only a few states require creditors to disclose the exposure (New York in particular).

There are a variety of ways to provide protection. The structure of the contractual arrangement between the borrower, creditor, and insurer will vary with the method chosen.

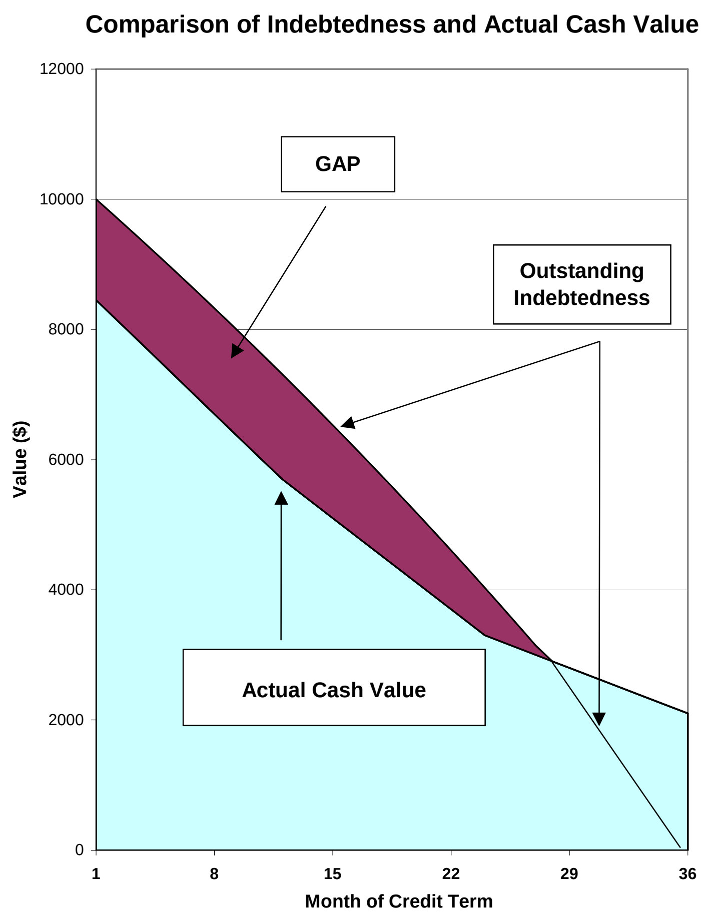
GAP Waiver. One common structure is a provision in the credit obligation stating that, in the event of a total loss, the borrower's obligation to pay the remaining indebtedness will be discharged after the primary property insurance benefits have been collected by the creditor. Alternately, a waiver or addendum to the credit obligation is issued with a similar statement. The creditor collects a fee for providing the waiver. The contingencies that result in the waiver of any remaining indebtedness are specified in the contractual language. GAP waiver is generally not considered insurance under federal law, but it is considered insurance in about one-half of the states. States want to bring the protection under the definition of insurance in part to capture premium taxes.

The primary problem created by an insurance classification is that the product may be subject to general P&C agent licensing laws. In other situations, it may be advantageous for the protection to be considered insurance. Laws governing retail installment sales and small loans often specify in detail the fees and charges that can be imposed and financed. Some of these state laws only permit specifically itemized fees and charges, a list that rarely includes GAP per se, but it may be classified as "other benefits" under some laws. Most of these laws permit "insurance." The result is that GAP can only be sold in that state if it is classified as insurance.

GAP Waiver Insurance. Authorized P&C insurers may issue GAP waiver insurance. The borrower pays a premium and receives a property insurance policy. (Alternatively, a master policy may be issued to a creditor and the borrower may receive a certificate or evidence of insurance.) In the event of a total loss, the insurance provides a benefit equal to 1) the borrower's remaining outstanding indebtedness, less 2) the primary property insurance benefits that have been collected by the creditor. This product is marketed by creditors and by independent P&C insurance agents.

GAP Insurance. A creditor that extends GAP waivers will usually purchase GAP insurance to protect against the potential loss to the creditor under the GAP waivers. Typically, the policy issued to the creditor is some form of contractual liability policy that insures all GAP waivers issued by the creditor.

Other GAP structures exist in the marketplace. The creditor may use an affiliate to provide the GAP insurance, or it may self-insure by retaining all risk associated with the GAP waivers that it issues.



Eligibility for GAP Waiver and GAP Waiver Insurance

Most credit is eligible for GAP waiver and GAP waiver insurance. Eligibility criteria vary on a case-by-case basis. The eligibility criteria are related to the credit, the underlying collateral, and the primary property insurance policy. Typical criteria are:

- Maximum credit term. GAP waiver and GAP waiver insurance are usually available only on credit with terms equal to or less than a maximum, such as 72 months.
- Maximum amount of credit. GAP waiver and GAP waiver insurance are only available on indebtedness up to a maximum dollar amount, such as $100,000.
- Type of property or collateral asset. Certain types or entire classes of collateral assets may be ineligible.
- Use of the property. Some property uses are prohibited. For example, property used for commercial purposes may be ineligible.
- Credit terms.
  - The collateral must have acceptable primary property insurance in effect before the GAP waiver or GAP waiver insurance is extended. The primary property insurance deductible may be limited to 1) a certain dollar amount, or 2) a percentage of the purchase price of the collateral.
  - The GAP protection must be purchased before the product is delivered.

The Insured Event

An insured loss occurs when, after a total loss, the amount of indebtedness at the time of the loss exceeds the benefits paid by the primary property insurance. The loss must be the result of physical damage or unrecovered theft, as defined in the primary property insurance policy covering the collateral. The amount of indebtedness is typically defined as the amount required to completely pay off the credit, however, this definition generally excludes delinquent amounts, including payments past due and accumulated late charges, and the value of items that can be cancelled, such as credit-related insurance products and extended service contracts.

The Underlying Credit

Any asset-backed credit, including leases and installment contracts, has the potential for GAP exposure and is a candidate for GAP waiver or GAP waiver insurance.

“Necessity-type” collateral, such as an automobile, creates the strongest need for GAP. When a total loss occurs, the borrower must replace the asset immediately and must relieve the obligation with respect to the credit quickly. Accordingly, the demand for such coverage is relatively high.

Markets and Marketing

Any credit secured by property for which the primary property insurance is limited to the property’s ACV has the potential for GAP exposure. Credit markets associated with automobiles, computers, motor homes, boats, and other property purchased with credit comprise a market where the demand for GAP waiver and GAP waiver insurance exists.

Creditors operating in these markets include automobile dealers, banks, leasing companies, credit unions, finance companies, creditors such as those specializing in automobile credit, creditors owned by manufacturers, and creditors owned by dealers, such as office equipment dealers. When one of these creditors extends a GAP waiver, it has a need for GAP insurance.

The Insurers

Independent insurers offer GAP waiver insurance directly to borrowers through unaffiliated creditors, agents, or brokers. Independent insurers also offer various forms of GAP insurance to creditors that have issued GAP waivers.

In addition, insurance companies owned by or affiliated with the creditors provide GAP waiver insurance and GAP insurance. These creditor-affiliated insurers may offer the product to other unaffiliated creditors as well.

The insurers writing GAP waiver insurance and GAP insurance must be authorized property and casualty insurers.

Underwriting Criteria

For the Borrower. Underwriting of the borrower generally involves classification of the risk in terms of the type of asset, classification of the asset within type, and application of other criteria. A determination is made as to whether the collateral asset is eligible and the appropriate rate to charge. For example, the criteria used for automobiles in a certain plan may consider:

- Purchase price of automobile as it relates to MSRP
- Credit term and interest rate
- Down payment amount
- Initial indebtedness
- Deductible
- Make and model
- New or used; model year and mileage if used
- Intended primary usage
- State (or other geographical consideration)
- Whether the automobile is leased or purchased

When evaluating intended use, the underwriter will determine if the vehicle will be used for personal or commercial purposes. Commercial use is further scrutinized, such as, “Will the vehicle be used for deliveries?” For other categories of property, the criteria may be completely different.

Once it is determined that the risk is eligible, a rate is calculated. Rate refers to the amount the borrower ultimately pays for GAP waiver. (This may not be the amount the creditor pays for

GAP insurance.) The rate may also reflect differences in the criteria. For example, the rate may be higher for certain models of automobiles or may vary with the interest rate or down payment. Rate may vary by type of credit arrangement.

Underwriting criteria vary widely from case to case. For credit extensions under $10,000, there may be very little underwriting criteria or none at all. The rating structure can be equally as broad, such as one rate for all risks. The insurer issuing GAP insurance to the creditor may impose underwriting criteria affecting the GAP waivers as a condition of issuing GAP insurance to the creditor.

For the Creditor. In addition to underwriting applied at the borrower level, underwriting analyses occur at the creditor level. At the creditor level, other criteria are considered, such as the type of creditor, the principal types of assets that the creditor finances, and the loss experience of the creditor as a whole and for various risk classes. The GAP insurer may do such underwriting analyses. Even when the creditor does not purchase GAP insurance, these are valuable criteria for analyzing the creditor's business.

Term of Coverage

For the Borrower. GAP waiver remains in force for the entire term of the corresponding credit, since it is a part of the credit obligation. GAP waiver insurance purchased by a borrower from a P&C agent may insure the entire credit term, or it may have a one-year or two-year term.

For the Creditor. GAP insurance purchased by a creditor to insure its GAP waivers will typically have a term equal to the remaining terms of the corresponding credit.

Benefit Conditions of GAP Waiver and GAP Waiver Insurance

Benefit Provided. The benefit is typically the difference between the insured indebtedness and the benefits paid under the primary property insurance in the event of a total loss. The insured indebtedness is the outstanding insured indebtedness on the date of loss less any delinquent payments, late charges, and insurance refunds. Under most GAP waivers, a total loss is defined to include unrecovered thefts. For an additional fee, some GAP waivers reimburse the primary property insurance policy's deductible, within limits, although this item is not technically part of the definition of the GAP waiver benefit.

Eligibility for Benefits. The following conditions generally must be met before the claimant is eligible to receive benefits under a GAP waiver or GAP waiver insurance:

- A GAP must be established.
- Acceptable proof of loss must be provided, such as a police report.
- The primary property insurance policy covering the asset must be in force at the time of loss. If none is in force, the National Automobile Dealers Association (NADA) retail value may be substituted and deducted in calculating the GAP benefits.
- The claim under the primary property insurance policy must be settled and the benefits paid.

Limits of Liability. Most GAP waivers and GAP insurance waivers have limits on the maximum liability:

- A maximum dollar limit per loss occurrence, such as $25,000
- A limit on the amount of the indebtedness that is included in the benefit calculation, such as 120% of NADA or Black Book value, or 120% of manufacturer's suggested retail price (MSRP)
- If the benefits include reimbursement of the primary property insurance deductible, the reimbursement has a dollar maximum, such as $500

Exclusions. Exclusions vary on a case-by-case basis, however, losses resulting from the following are usually not covered:

- War
- Fraud
- Use during criminal acts
- Wear and tear
- Racing
- Damage outside the U.S.

Rates

The amount of the GAP exposure changes over the term of the credit and depends on both the rate at which the underlying asset depreciates and the characteristics of the credit at its inception, such as interest rate, down payment, and term. The rate at which the asset depreciates is not known with certainty at the time that coverage is extended. All of these factors, as well as the likelihood of a total loss occurrence, are factored into rate development.

Rates are set by making estimates of the frequency of occurrence and the corresponding severity for different time periods. The development of adequate rates for GAP depends on the ability to accurately forecast frequency and severity of losses for each type of asset covered. For example, all vehicles do not depreciate at equal rates, thus the GAP exposure may vary widely within an asset class, as well as among asset classes.

When GAP waiver is obtained through the creditor, a one-time fee is collected at the inception of the credit. The borrower pays for coverage at the time of credit closing, but the purchase is usually financed. Few states regulate the fee paid by the borrower.

The creditor then pays an insurance premium for GAP insurance that is equal to or less than the fee the borrower paid the creditor. GAP insurance rates and forms usually must be filed with and approved by the insurance department of the state in which the policy is issued.

In the case of GAP waiver insurance issued directly by an insurer to a borrower, the premiums can be 1) single premiums corresponding to a policy term equal to the term of the credit, or 2) periodic premiums for a shorter period of coverage, such as one year.

Financing of the Cost and Regulation Z

As with credit-related insurance products, the borrower wants the cost financed. It is typical for the cost to be added to the amount financed. Most creditors are willing to finance the cost of the product.

In 1995, a class action lawsuit was filed in Illinois (McGee v. Kerr-Hickman Chrysler Plymouth, Inc. and GECC) alleging that failure to include the cost of GAP in the calculation of the annual percentage rate was a violation of Regulation Z. Sale of GAP virtually ceased for installment credit. GAP for leases continued, since leases were governed by Regulation M that appropriately addresses GAP.

The U.S. District Court of the Northern District of Illinois dismissed the lawsuit. The U.S. Court of Appeals affirmed the dismissal in August 1996.

While the lawsuit was progressing, some creditors pressed the Federal Reserve Board to clearly address GAP in Regulation Z. In October 1996, Regulation Z was amended. The cost of GAP can be financed and the cost does not have to be included in the APR if all of the following conditions are met:

- The extension of credit is not conditioned on the purchase of GAP.
- The borrower's purchase of GAP is voluntary, and the voluntary nature is disclosed.
- The cost and the term of coverage are disclosed.
- The borrower signs or initials a request for GAP after receiving the disclosures.

The changes to Regulation Z addressed debt cancellation contracts, but the Federal Reserve Board made it clear that GAP was considered a form of debt cancellation contract.

Although this amendment clarified the rules under federal law, state variations exist. State laws may exist or be adopted that are more protective of consumer rights than federal law.

Refunds

Some GAP waivers are non-cancelable, except for a cancellation within 30 days of issue or in the case of repossession. If a GAP waiver is cancelable, the fee refunded is generally equal to the unearned fee at the time of cancellation less a processing fee, such as $35. The unearned fee depends upon the rate at which fees are earned—a rate that differs by asset class and other characteristics. State regulations may mandate refund methods that result in amounts that differ from the unearned fee.

If GAP waiver insurance is canceled, the unearned premium at the time of cancellation is refunded. State regulations may specify the calculation method for the amount to be refunded.

If a GAP insurance policy is canceled, the refund is the sum of the refunds that are due on the underlying GAP waivers.

Licensing

When the creditor issues a GAP waiver to a borrower, state regulations determine licensing requirements. At the federal level, such activity is not regulated as insurance and is allowed with proper disclosure. In about one-half of the states, the issuance of GAP waivers is not considered insurance and does not require licensing; however, in some states such activity is considered insurance and licensing may be an issue.

When GAP waiver insurance is sold directly to a borrower, it is classified as inland marine, credit, or miscellaneous insurance. Depending on the state, the soliciting agent may have to be licensed to offer property and casualty insurance.

If a creditor purchases GAP insurance through an agent or broker to insure its obligations, the agent or broker must be appropriately licensed.

Available States

GAP waiver or GAP waiver insurance is available in one form or another in most states. GAP insurance is available in most states.

Advantages to the Producer

GAP allows the creditor to maintain customer goodwill and eliminate collection activity and related expenses associated with total losses. When a total loss occurs and a credit obligation remains after the primary property insurance benefits have been paid, the borrower must pay the balance before replacing the asset. Borrowers often do not have the resources to pay the GAP and to replace the asset. Such a situation is bad for the borrower and the creditor.

GAP allows the creditor to provide an additional service to its borrowers. Automobiles, in particular, and other assets often have prices that make it difficult for consumers to afford substantial down payments. Without a significant down payment, GAP protection is often necessary.

GAP insurance allows creditors to effectively manage an insurable risk by transferring the GAP risk to the GAP insurer.

Reserves

Policy Reserves. Under GAP, the policy reserves make provision for payment of future claims that have not yet occurred. Such reserves can be significant, since the coverage is typically for the entire term of the credit, which can be as long as six or seven years. The rate at which the premium earns is based upon the rate at which the exposure to a GAP loss decreases over the term of the credit. This exposure varies widely depending upon asset class, make and model within asset class, interest rate, down payment, and term of the credit. Since the indebtedness and the ACV decline at different rates, the exposure period may be shorter than the term of the credit, except for any refund liability. The earnings pattern also depends on whether the policy is cancelable or non-cancelable.

For GAP insurance, the policy reserves are the sum of the policy reserves for the individual GAP waivers that are in force.

Loss Reserves. Loss reserves are an estimate of the claims that will be paid on the losses that have already occurred but have not yet been paid. For GAP waiver and GAP waiver insurance, these reserves are incurred but not reported (IBNR) and case reserves. IBNR is an estimate that is usually based upon some indicator of claim activity, such as an *n*-month rolling average of earned fees/premiums or paid claims. Case reserves are typically set for each individual claim after a determination of the GAP that existed at the time of loss. Loss adjustment expenses and loss adjustment expense reserves are small, generally less than 10% of paid claims.

For GAP insurance, the loss reserves and loss adjustment expense reserves are the sum of the comparable reserves for the individual GAP waivers that are in force.

Appendix A

General Concepts

Group Insurance, Master Policies, and Individual Insurance

Credit life insurance is available through group or individual insurance policies. Under a **group policy**, the contractual relation-ship is between the insurance company and the producer. The producer is issued a group policy, where the group is defined as the consumers obtaining credit from the producer. When insurance is elected, the borrower is enrolled in the group and receives a **certificate of insurance** as evidence of insurance. For example, if the producer is a bank, the bank is the group policyholder. Borrowers obtaining consumer credit at the bank and buying credit life insurance are certificateholders.

Under an **individual policy**, the contractual relationship is directly between the insurance company and the borrower. In this structure, the borrower receives an individual policy as evidence of insurance.

Most credit life insurance is offered under group policies. All states permit the borrowers from a creditor to be considered an eligible group. An individual policy is generally used in states with low group life insurance maximum limits. From the borrower's standpoint, there is no material difference between the two types of policies. From the insurer's standpoint, there is only a difference in the contractual relationship. There is no difference in the actual insurance provided or the premium rates charged.

When credit disability insurance was introduced in the 1940s, the group accident and health statutes did not permit the insurance. Gradually, the group accident and health laws and regulations were amended to allow the insurance. Today, almost all credit disability insurance is group insurance.

Group insurance in the P&C world is a relatively new concept. The principal P&C products—homeowners insurance, automobile insurance, and commercial insurance—involve a direct relationship between the insurer and the insured. For situations where group-type insurance is provided, the contractual form is a master policy. The insuring relationship is solely between the insurer and master policyholder, but individuals affected by the insurance, such as the borrower, might receive a certificate of insurance or a declarations page. In some situations, no evidence of insurance is provided, even though the individual pays the cost of the insurance.

As more credit-related P&C insurance products were developed, there was a need for the insurance to be defined as group insurance to take advantage of the group exemption from agent licensing laws. In particular, IUI is marketed along with credit life and disability group insurance products, so a common contractual form has practical value.

Credit-related insurance covering traditional P&C perils, such as property damage, has usually retained the master policy and the individual policy structures. Examples in the credit-related P&C world are:

- Credit property insurance
- Creditor-placed insurance
- Blanket collateral protection insurance
- Non-filing insurance

Most states now accept the group concept for IUI and credit property insurance, but a group policy is not permitted for all products in all states.

In credit-related insurance, the policy structure does not affect the borrower, the type of insurance provided, or the cost of the product. In other words, the insurer charges the same premium for IUI regardless of whether the structure is group insurance, individual insurance, or insurance issued under a master policy. It does not matter to the insurer, except to the extent that the insurer must comply with individual state requirements. The primary driver of the choice is agent licensing requirements that often vary significantly based on the policy structure.

Single and Joint Coverage

If there is only one borrower, single insured coverage is offered. If there is a co-borrower, joint insured coverage is offered for many products. It is always available for credit life insurance. It is occasionally available for credit disability insurance, credit IUI, and family leave insurance. The concept does not apply to credit-related property insurance or non-filing insurance.

Credit-related insurance laws and regulations generally limit the insurance benefits to the balance of the credit or the monthly payment of the credit. For installment credit, these amounts are clear. As a result, joint credit life insurance provides a death benefit if either joint insured dies, but only one benefit is paid if both die simultaneously. Under joint disability or joint IUI, a benefit is paid if either joint insured incurs a claim, but only one benefit is paid if both are on claim. The insurance benefits cannot exceed the monthly payment.

For open-end credit, the situation for life insurance is clear, but the situation for disability, IUI, and family leave is not clear. Under open-end credit insurance, the usual monthly indemnity benefit is the minimum monthly payment, but any monthly payment is acceptable up to the balance of the credit. Under these policies, a benefit may be paid to both insureds at the same time.

Actuarial Considerations

Aside from ratemaking (Appendix C), the primary actuarial work in credit-related insurance is the calculation of proper reserves and the determination of loss ratios based on actual experience. Reserves are necessary for statutory and GAAP (Generally Accepted Accounting Principles) financial statements, tax returns, and valid loss ratio calculations. As with all reserves, the calculation is based on a specific point in time—the **accounting date**.

The need for reserves is clear in credit-related insurance. On a single premium policy, the insurer receives the entire premium on the first day of the policy. The insurer agrees to pay all valid claims incurred during the policy term. On a monthly premium policy, the policy term is one month. All premiums are received for the month of insurance, but monthly indemnity benefits may continue for several years from claims incurred during the month of insurance.

Given a block of insurance policies in force on a particular accounting date, the insurer must establish a liability for all future claim payments. These payments arise from two events.

First, **policy reserves** provide for future benefits that will be paid on claims that happen after the accounting date. A provision must be made for claims that happen after the accounting date but before the end of the policy term.

Second, **loss reserves** provide for claim payments to be made after the accounting date on any loss that occurred before the accounting date. On the accounting date, some losses have occurred, but the claims have not been paid. A simple example is a property loss that occurs shortly before the accounting date. At some point after the accounting date, it will be reported to the insurer and ultimately paid. On disability and IUI losses, there may be more than one claim payment; a provision must also be made for the benefits that will be earned after the accounting date on claims in progress on the accounting date.

Policy Reserves for Single Premium Insurance

For most credit-related P&C products, policy reserves are unearned premium reserves. They are based on the assumption that the portion of the original premium applicable to the remaining term and benefits will be adequate to pay future claims. Gross premiums are used, so the method includes both the portion of the premiums to be used for claims and the portion to be used for expenses. If the business is profitable, the estimate contains an element of conservatism equal to the expense element, since the largest component of expenses, commissions to producers, are paid on the issue date.

The reserve is calculated by multiplying the original gross premium times an unearned premium factor. Factors are developed that represent the proportion of the remaining insurance compared to the total insurance provided over the entire term of insurance.

For most P&C products, unearned premiums are calculated using the pro rata method. If the policy has a twelve-month term, one-twelfth of the premium is earned each month. After one month has elapsed, the unearned premium is 11/12ths of the original premium. This method is appropriate for many of the credit-related insurance products in this book. For some products, the Rule of 78 method is appropriate; for others, some combination of the two methods is appropriate.

In preparing reserve factors for both bases, insurers may make an assumption that all policies are issued on the 15th of the month. Since most valuations are as of the end of a month, this results in a half-month correction factor. Factors for Rule of 78 and pro rata unearned premiums are:

$$\text{Rule of 78 unearned premium factor} = \frac{(t-.5)\times(t+.5)}{n\times(n+1)}$$

$$= \frac{t^2-.25}{n\times(n+1)}$$

$$\text{Pro rata unearned premium factor} = \frac{t-.5}{n}$$

Where n = the original term in months
t = the number of full or partial months remaining from the valuation date to the expiration of the policy
= n - [12 × (valuation year - issue year) + (valuation month - issue month)]

Policy Reserves for Single Premium Disability Insurance and IUI

Disability policy reserves are held on a gross unearned premium basis. Again, the concept is to hold back from earnings the remaining proportion of the original risk as of the accounting date. Unfortunately, there has not been a definitive study to establish the proper basis to earn disability premiums. Investigation of this matter has led to many debates but no resolution.

For life insurance, since the rate of mortality is approximately level over the short term of most policies, the ratio of the remaining exposure to the original exposure represents the proportion of original risk remaining. Disability is different—the maximum amount of a claim is affected by the remaining term. Under a 48-month term policy, the insured can earn 1 to 48 benefit payments depending on the timing and duration of the disability. Most claims do not last for the full remaining term. Claimants who recover may have subsequent disabilities.

For single premium credit disability, Rule of 78 unearned premium reserves may understate the proportion of remaining risk to original risk. Pro rata unearned premiums overstate the proportion. In recent years, a move to use the arithmetic mean, or average, of the two bases has gained wide acceptance. Generally, the **mean** is considered the proper basis unless an insurer can demonstrate the validity of some other basis.

Another approach is the **Rule of Anticipation**, also called the **Actuarial Method** or the **Pure Premium Method** in some regulations. Under this approach, the unearned premium is the gross single premium for the remaining term and remaining benefits. These unearned premiums are close to the mean of Rule of 78 and pro rata.

For IUI, the proportion of remaining benefits to original benefits may be closer to the pro rata pattern. The term of insurance and the maximum number of benefits per claim materially affect the pattern of claims.

Policy Reserves for Monthly Premium Business

For monthly premium business, the policy reserve may be zero if all premiums are due on the first of the month. Since the reserve valuation date is at the end of a month, the insurance has expired. Since the actual premiums are not received by the insurer until 15 to 45 days after the end of the calendar month, many insurers do not hold a policy reserve, regardless of the premium due date. This process applies to life, disability, and IUI.

For many open-end credit policies, the premiums are due on the billing date at the end of the month of insurance. Clearly, there are no unearned premiums, since the insurance has already been provided.

Some insurers hold a half-month reserve. The reserve held is one-half of the premiums reported in the prior month. This practice stems from the traditional group insurance assumption that, on average, policies are issued in the middle of the month and that premiums are due on the first day of the policy month.

Types of Loss Reserves

The critical actuarial work relating to loss reserves is to produce an appropriate estimate of the total benefits to be paid after the accounting date on all losses that have occurred on or before the accounting date. For various reasons, the total is separated into three categories. While an accurate separation into the categories is desired, the adequacy of the total is the crux of the matter.

Incurred But Not Reported (IBNR) provide for those losses that occur on or before the accounting date, but have not been reported to the insurer on the accounting date. After the accounting date, they will be reported, processed, and paid.

Case Reserves, Pending Claims, or Claims in Course of Settlement (CCS or ICOS) provide for those losses that occur and are reported to the insurer on or before the accounting date, but the payment has not been made. These would normally be the claims received shortly before the accounting date. The claims are in process, but the final payment has not been made.

IBNR and case reserves are the only loss reserves that apply to life insurance and many forms of P&C insurance, since only a single claim payment is involved.

For disability, involuntary unemployment, and family leave insurance, a series of future payments may be involved. These payments are classified as **accrued benefits** and **unaccrued benefits**. IBNR and case reserve amounts are technically the benefits relating to the period between the date of disability, involuntary unemployment, or family leave and the accounting date. These benefits are *accrued* by the claimant—the insured event has occurred, and the claimant has been on claim for a period of time. The benefits are already earned, only the paperwork needs to be completed.

Unaccrued benefits provide for the payments that will be earned after the accounting date if the claimant remains on claim. IBNR and CCS claimants can earn these benefits (where the first payment has not been made) as well as claimants who already are receiving benefits. Life insurers call these benefits the **present value of future unaccrued benefits**, but they may be called **present value reserves**, **continuing loss reserves**, or various other terms. In P&C terminology, they are generally considered a component of case reserves. For example:

Plan:	14-day retroactive
Monthly Benefit:	$100
Date of Disability:	December 1, 1997
Date Reported:	January 15, 1998
Estimated Period of Disability:	Six months
Accounting Date:	December 31, 1997

This is an IBNR loss. The IBNR reserve is the accrued benefit from December 1 to December 31 [= $100], representing the period of time that the insured borrower has already been disabled. The unaccrued benefit is $500 [= (6 months – 1 month) x $100], which is the estimated benefit to be earned after the accounting date from January 1, 1998 until the expected recovery.

Loss Reserve Methods

Policy reserves are calculated on a policy-by-policy basis using specified formulas. The calculation produces a precise number, but the answer is still an estimate.

An actuary rarely gets a feeling of precision when working with the loss reserves. Indeed, it is sometimes difficult to feel secure that the answer is even in the ballpark. All methods of loss reserving involve the application of prior experience and subjective judgment. Conditions change, so methods that worked in the past may no longer give good results. Both judgment and science are used to arrive at the final estimate.

The remainder of this section discusses methods of loss reserving that are used in practice. There is no implication that the methods discussed are the best methods or that they are always appropriate in the situations described. Setting of loss reserves is difficult and requires good professional judgment and knowledge of the business being evaluated. No method is perfect. Even the most sophisticated methods may fail to produce adequate reserves when changes are occurring in the underlying business or in the conditions affecting the duration or reporting of losses. Development of reliable factors depends on the availability of credible past experience that can be expected to apply to the business being evaluated. Although actuarial knowledge is useful in many aspects of credit-related insurance, this is one area where qualified actuarial expertise and judgment are required.

Insurers use four general methods to set loss reserves. The common applications in credit-related insurance are in parentheses:

1. Factor method (IBNR)
2. Lag triangle method, loss development method, or completion method (All loss reserves)
3. Case reserve method (Case reserves)
4. Loss ratio method

The **factor method** is widely used. Prior claim payment experience is studied to determine the actual experience during some time period in the past. The experience is related to a base quantity that will be available on the accounting date in question. Some common bases are:

- Disability, IUI, or family leave exposure measured by 1) the sum of monthly benefits in force, or 2) the sum of the monthly benefits on reported claims
- Premiums earned during the prior twelve months
- Claims paid during the prior twelve months

For example, prior experience may show that an appropriate IBNR factor is 75¢ per $1,000 of open-end credit balance. The factor is multiplied times the balance on the accounting date to estimate the IBNR reserve.

The **lag method or loss development method** is often used for disability insurance, IUI, and family leave insurance, but the method is appropriate for all products. A spreadsheet is set up for the calculation of the loss reserves. When the historical data are entered into the spreadsheet in the proper manner, they form a triangle. Using actuarial methods, the historical data are used to project the future payments in the missing portion of the triangle. The sum of these projected payments is the loss reserve at that point in time. For this reason, the process is often called the *lag triangle method* or the *triangle method*.

The same historical claim data can also be used to develop completion factors to implement the **completion method**. Prior experience is studied to estimate the average remaining duration of claim after the accounting date based on the elapsed duration of claim as of the accounting date. The resulting factors are multiplied times the appropriate monthly benefit.

For example, a study may show that claimants who have been disabled 90 to 119 days remain disabled for four additional months on average. On the accounting date, the sum of the monthly benefits on all claimants who have been disabled for this period is tabulated. The reserve is this sum times the factor of four. Factors are adjusted if the maximum remaining term of a particular claim is less than the factor.

Under the lag method and the completion factor method, more than one prior accounting date is studied. Generally, studies are made of each prior year using a December 31 accounting date. For example, factors are developed by tracking the disability claims incurred on or before December 31, 1996. Then separate factors are developed by tracking the disability claims incurred on or before December 31, 1995, and so on. The results from the different accounting dates are reviewed for consistency and trends. The final factors are a blend of the studies from several different accounting dates.

The **case reserve method** is the easiest to understand and apply. It is used for known claims under disability insurance, IUI, and most property insurance. A knowledgeable claims person reviews each reported claim. For disability and IUI, an estimate is made of the remaining time of the claim; the reserve is the product of the estimated remaining months of claim times the claimant’s monthly benefit. For pending property claims, the exposure on the loss is available from the claim forms that are submitted; the reserve is the estimate of the claim payment considering the amount of the loss, the policy deductibles, and other limitations. Case reserves must be tested by the type of experience data used for the factor or lag method. The runoff from prior years is studied to judge whether prior years' reserves were adequate.

The **loss ratio method** is occasionally used when the data are not present to apply the other methods. If the incurred claim/earned premium loss ratio is known, the incurred claims can be calculated as the product of the loss ratio times the earned premium. Subtracting paid claims from incurred claims gives the loss reserves in total. However, the experience loss ratio cannot now be calculated, because the relationship is circular. This method is implemented in practice by assuming a loss ratio; thus, the results are only as good as the assumption.

For each of these methods, an insurer has the option of whether or not to discount the future payments for the time value of money when determining reserves to be used in financial statements. The short-term nature of the future payout on most credit-related insurance reduces the necessity for such discounting. Except for disability and IUI loss reserves, the effect would be small.

Using an interest discount for disability reserves can reduce the reserves 5% to 8%, depending on the interest rate selected and the maximum number of benefits that can be earned. Most IUI policies have a stated maximum number of benefits of twelve or less, so the effect of an interest discount is more modest. Many insurers forgo discounting for interest and just consider the omission as an element of conservatism.

Loss Ratios

The profitability analysis used for most credit-related insurance business is the loss ratio approach, since most elements of the premium dollar can be expressed as a percentage. The only proper basis of calculating loss ratios is the ratio of incurred claims to earned premiums. This is called the **incurred loss ratio** or **incurred/earned loss ratio**.

Incurred Claims =

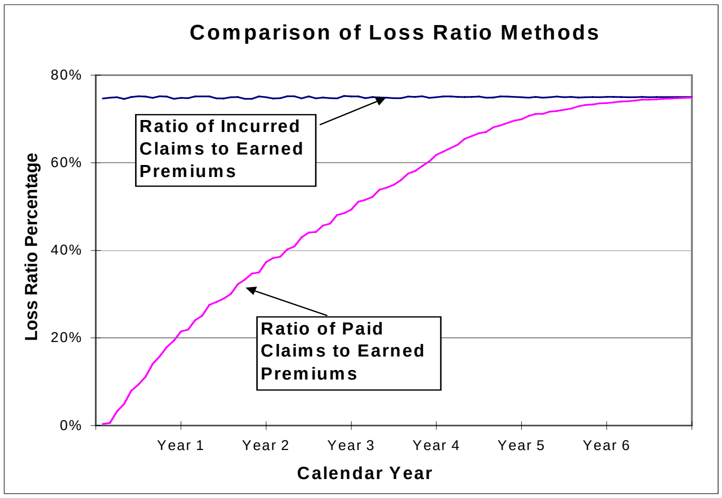
Paid Claims
- Loss reserves at the beginning of the period
+ Loss reserves at the end of the period

Earned Premiums =

Gross premiums collected - refunded premiums
+ Unearned premiums at the beginning of the period
- Unearned premiums at the end of the period

Incurred Loss Ratio = Incurred claims / Earned premiums

With proper reserves, this loss ratio will be the best estimate of the ultimate loss ratio on a block of business. Other loss ratios may be demonstrated based on paid data, such as 1) the ratio of paid claims to written premiums (**paid loss ratio**), or 2) the ratio of paid claims to earned premiums (**paid/earned loss ratio**). Either of these ratios will understate the ultimate loss ratio. The figure below shows the development of the incurred loss ratio and the paid/ earned loss ratio on an actual block of single premium disability business from inception to expiry.



Appendix B

Credit Disability Insurance on Installment Credit

Definition

Credit disability insurance on installment credit is single premium loss of income insurance purchased in conjunction with closed-end installment credit that provides a level monthly benefit while the insured is totally disabled during the term of insurance. The monthly benefit equals the required monthly payment.

Insurance on Installment Credit

Most credit-related insurance is tailored to provide insurance exactly matching the particular installment credit. **Term of insurance** is defined by the term of the credit, normally expressed in months. The **effective date** and the **termination date** of the insurance are set by the corresponding dates of the credit. Voluntary termination of the credit by early repayment terminates the insurance in most states. On early termination, a **premium refund**, approximating the cost of insurance for the remaining term and benefits, is paid to the borrower.

Credit disability insurance may be provided as a companion policy to a credit life policy or as a **rider** benefit to a credit life policy. The companion policy is a group insurance policy where the group is defined in the same manner as in the life insurance policy. The rider form may be attached to an individual or group credit life policy. There are few, if any, differences in benefits provided or premium rates charged.

There are few exclusions. The principal exclusion is for pre-existing conditions, which are described later. The other common exclusions are for normal pregnancy and for self-inflicted conditions.

Disability insurance is offered only to the primary borrower in most cases. While this practice is a throwback to earlier times when single-income families were the norm, there are practical reasons. Even now, many spouses work at part-time jobs or in avocations, making the determination of disability more difficult. In addition, the cost of disability insurance is such that even insurance on a single life is expensive. Although a need may exist, the cost for joint disability insurance is prohibitive for many borrowers. It is permitted in about 40 states.

Conditions of Eligibility

A number of conditions must be met to qualify for insurance. The borrower must enter into a consumer credit obligation. All eligible borrowers under age 65 must be offered insurance if prima facie rates are charged. There is an **actively-at-work** requirement, but this is generally a condition of the credit extension as well.

The borrower must usually meet any underwriting require-ments for life insurance, even if credit disability insurance is the only insurance that is purchased. In addition, disability insurance applicants may have to answer an additional question concerning non-life-threatening conditions that may cause disability, such as back or neck problems.

Determination of Disability

To qualify for benefits, the insured must meet the definition of disability specified in the policy. The **any occupation** definition of disability means that the insured is unable to perform the regular duties of any occupation for which the insured is reasonably suited by reason of education, training, or experience. The **own occupation** definition is easier to meet and only requires that the insured is unable to perform the essential duties of the insured's usual occupation.

For many people, there is little difference between the definitions. The distinctions arise in specialized occupations, such as airline pilots or doctors where a relatively minor condition could hamper some activities, or in occupations requiring physical activity. For example, a serious back injury may disable a pipe welder from welding (own occupation) but not from an office job (any occupation).

By practice or regulation, the own occupation definition is generally the criteria for short-term disabilities, but the any occupation test must be met for long-term claims. For example, Texas requires an insurer to apply the own occupation definition during the first twelve months of a claim; to receive benefits beyond the twelfth month, most insurers require that the claimant also meet the any occupation test.

Benefit Provided

Under installment credit obligations, the monthly benefit is the monthly payment as defined by the credit. Most credit-related insurance policies provide a benefit based on the actual number of days disabled. The daily benefit is one-thirtieth of the monthly payment.

Benefits continue until the disability ceases or until the termination date of the credit, whichever comes first.

Elimination Period

All credit disability policies require that the insured remain disabled for a certain number of days before any benefits are payable (the **elimination period**). This practice eliminates short-duration claims, which create as much administrative work as large claims. Eliminating the short-duration claims significantly reduces the premium. The longer the elimination period is, the lower the premium.

Fourteen-day and thirty-day elimination periods are the industry standards. A 14-day elimination period means that the insured must remain disabled more than 14 days before any benefit is payable for a particular disability. Once the elimination period is satisfied, it does not have any other impact on the benefits due under the policy. In prior years, shorter elimination periods were used, notably three days and seven days. A seven-day elimination period is still permitted in some states, but the premium cost is rather high.

Elimination Period Benefit

There are two methods used to determine the benefit payable for the time disabled during the elimination period:

1. **Non-retroactive benefit** means that no benefit is payable for the elimination period. Benefits begin to accrue only after the elimination period has elapsed. For a 14-day elimination period, the non-retroactive benefit begins with the fifteenth day of disability.
2. **Retroactive benefit** means that a benefit is payable for the elimination period. Once a claimant has been disabled the required number of days in the elimination period, benefits accrue from the first day of disability.

Examples of Disability Benefits

Coverage:	**14-day retroactive benefits**
Days Disabled:	60
Monthly Benefit:	$300
Disability Benefit:	= 60 x ($300 / 30)
	= $600

Coverage:	**30-day non-retroactive benefits**
Days Disabled:	25
Monthly Benefit:	$300
Disability Benefit:	None

Coverage:	**30-day non-retroactive benefits**
Days Disabled:	60
Monthly Benefit:	$300
Disability Benefit:	= (60 - 30) x ($300 / 30)
	= $300

Pre-Existing Condition Exclusion

Credit-related insurance may be offered to borrowers without inquiry about any existing health problems. To obtain the credit, the applicant is presumably in good health, is actively at work, and possesses the ability to repay the credit. If health questions are asked, they are usually designed for life insurance and relate to serious conditions affecting mortality. There are health conditions that are disabling but not life threatening, such as back problems.

The cost of underwriting and the delays in accepting insurance are not acceptable given the size of the credit-related insurance premium and the amount of insurance. Still, the borrower may have existing impairments that may cause future disabilities. A **pre-existing condition** is an impairment for which the insured has been treated prior to the effective date of the insurance.

Insurers have the option of covering claims caused by pre-existing conditions or excluding claims caused by them. Most credit disability policies exclude claims caused by pre-existing conditions, and the standard exclusion is a **six-and-six exclusion**. Under this exclusion, a disability is not covered if:

- The insured receives treatment within the six months prior to the effective date of the insurance, **and**
- The insured is disabled due to the pre-existing condition within six months after the effective date of the insurance.

Both conditions must be met. If the last treatment precedes the effective date by more than six months, the disability is covered. If the disability starts more than six months after the effective date, the disability is covered. The following examples illustrate how the exclusion is applied.

Date of Last Treatment	Effective Date of Insurance	Date Disability Began	Benefits Payable
3-15-97	6-30-97	9-15-97	No
3-15-97	6-30-97	3-15-98	Yes
9-15-96	6-30-97	9-15-97	Yes
9-15-96	6-30-97	3-15-98	Yes

Figure B.1 - Application of the Six-and-Six Exclusion

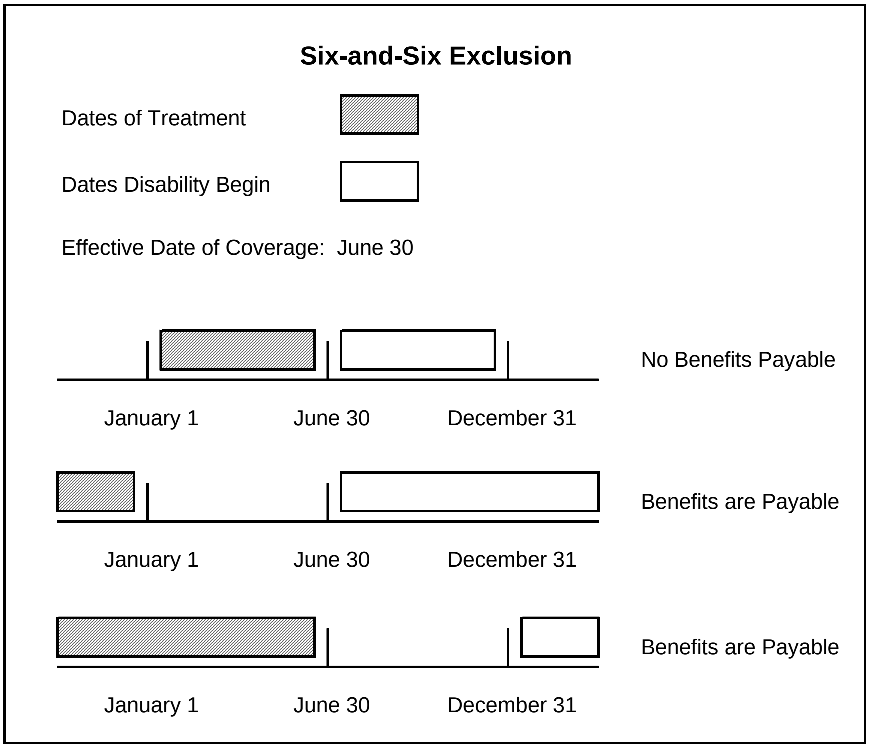


Figure B.2 - Application of the Six-and-Six Exclusion

Premium Rates

Each state sets prima facie rates for each plan of insurance. They are the maximum rates that an insurer may charge without demonstrating the need for higher rates. Most insurers charge the prima facie rates, except in the credit union market. For credit unions, the claim experience varies significantly depending on the industry of the credit union's members. When most members are employed in heavy industry, the rates charged may exceed prima facie rates.

A single premium is charged for the full term of protection provided based on a table that varies by plan of benefit and term of coverage. The same premium rate is charged regardless of age, sex, or occupation of the borrower.

	Benefit Plan			
Term of Coverage	14-Day Retro (14R)	14-Day Non-Retro (14 NR)	30-Day Retro (30R)	30-Day Non-Retro (30NR)
12	$2.20	$1.50	$1.50	$1.15
24	3.00	2.15	2.15	1.50
36	3.80	2.90	2.85	2.05
48	4.30	3.25	3.20	2.35
60	4.70	3.60	3.55	2.70

Figure B.3 - Sample Premium Rates Per $100 of Initial Gross Indebtedness

A sample premium under the 14-day retroactive plan is:

Term:	12 months
Initial Gross Indebtedness:	$600
Premium Rate (14R, 12 months):	$2.20
Premium	= $2.20 x ($600 / $100)
	= $13.20

Claim Filing

Once disabled, an insured must file a claim to receive benefits. A claim form is obtained from the creditor or directly from the insurer. The insured, the insured's physician, and the insured's employer must complete portions of the form. This information is returned to the insurer, who reviews the form and determines whether the insured qualifies for benefits.

Many claims are **first and final** payments. The insured waits until the disability is over and files a claim for the entire period of disability. These are usually short-duration claims.

On longer claims, the insured must complete a **Continuance of Disability** form monthly. These forms are simpler than the initial form and primarily serve to establish that disability has continued. The insured must prove continued disablement at monthly intervals if the insured wants to receive the benefit payments at monthly intervals. Otherwise, the insured must make timely monthly payments to keep from incurring late charges under the credit obligation. Insurers will accept claims covering periods longer than a month, but they will not pay a claim until proof of the continuance of the claim has been received. For severe disabilities, insurers may have special procedures requiring less paperwork.

Appendix C

Ratemaking

Introduction

This appendix is a general overview of the principles of ratemaking as they apply to credit-related property and casualty insurance products. Entire books have been written about the ratemaking process, so this section should only be taken as an overview, not as a definitive treatment of the subject. Additional considerations apply to ratemaking for specific products.

Insurance ratemakers strive for rates with the following characteristics:

- Expected premium income exceeds expected losses and expenses.
- Premium rates contain an adequate provision for contingencies, i.e., enough *loading* to allow the insurer to absorb claim volatility and catastrophes. Some risk can be transferred to a reinsurer. However, not all of the risk associated with contingencies can be ceded to reinsurers, nor is such a situation desirable. For many products reinsurance may not be available, thereby making the proper pricing for contingencies more critical.
- Expected profits provide a return on investment that is adequate. Profits must meet owners' expectations so that adequate capital is available for a particular insurer and for the industry.
- Premium rates must comply with state regulations. All states have insurance departments that review rates. The departments require that rates be adequate, not excessive, and not unfairly discriminatory.
- Premium rates should be stable from period to period on an inflation-adjusted basis. Rate changes are difficult to administer, and frequent changes are bad for customer goodwill.

- For credit-related products, the rate structure must be simple. Many of these products are offered through credit cards and credit delivery and billing systems. The rates must be easy to apply in practice.

The ultimate goal of ratemaking is to charge an adequate and equitable price for every risk. Limits on technology, regulatory resistance to certain risk classification schemes, and conflicts between a product's characteristics and the pricing requirements may make this goal difficult to achieve.

Exposure Base

Rates are expressed as a rate per unit of exposure. A unit of exposure is expressed in terms of the **exposure base** that in turn varies by the type of insurance. For example, the exposure base for automobile insurance may be in *car years*—one unit of exposure is one car exposed to loss for one year. The value of a structure and the outstanding balance on a credit card are examples of other exposure bases.

The desired characteristics of an exposure base are:

- Observable
- Measurable
- Easy to record
- Not subject to manipulation by the insured
- Easy to understand

Once the exposure base and the unit of measurement have been determined, the ratemaker develops rates per unit of exposure.

A premium is calculated by multiplying the rate times the number of units of exposure. For example:

Given: An IUI gross single premium rate of 40¢ per $100 of monthly payment per month of insurance term

A monthly payment of $500

An insurance term of 24 months

Determine the number of exposure units

= $500 / $100 = 5 units of exposure

Calculate the single premium:

= (Exposure units) x (Number of months) x (Rate per exposure unit per month)

= 5 x 24 x 40¢ = $48.00

A Loss Versus a Claim

Loss refers to an event, such as death, disability, involuntary unemployment, or automobile accident. The insured files a *claim*. The claim is adjudicated to determine if the loss is a *covered loss*. If the loss is covered, then a *covered (or insured) claim* exists. Then the *amount of loss* and the *amount of claim* are determined.

(Insureds do become disabled, for example, but there is no covered claim because of a policy exclusion. Implied in this book and in most literature using the term *loss* is the adjective *covered* or *insured*, as in covered loss. Unless otherwise noted, one can assume that loss statistics refer to losses that qualify as covered claims under the policy provisions.)

In the health insurance world and the P&C world in general, a definite distinction exists between *amount of loss* versus *amount of claim*. Under a CPI policy, a loss causing damage to an insured automobile may have an *amount of loss* equal to $1,000, but an *amount of claim* equal to $600, because of deductibles, depreciation, or other adjustments.

In the life insurance and disability insurance worlds, the term *claim* is synonymous with the term *loss*, and the adjectives covered or insured are implied. Since the policy provisions define the "amount of loss," it is the same as *amount of claim*.

It is possible to have a covered loss and a covered claim with a zero *amount of claim*. For example, if a policy has a calendar year deductible, covered losses do not result in any claim payment until the deductible is exceeded. But in general, the term *claim* implies some claim payment. A few examples may help delineate the distinction.

<u>Credit Life Insurance.</u> An insured dies; a loss has occurred. The policy defines the life insurance benefit that, by definition, is the amount of loss. If the claim is filed and the documentation is complete, a claim has also occurred, and the amount of claim equals the amount of loss.

<u>Credit Disability Insurance.</u> An insured becomes disabled for a period exceeding the elimination period; a loss has occurred. The policy defines the disability insurance benefit that, by definition, is the amount of loss. Assuming the claim is filed and the documentation is complete, a claim has also occurred, and the amount of claim equals the amount of loss.

<u>Credit Property Insurance.</u> An insured has damage to covered property; a loss has occurred. The amount of loss is the dollar loss to the property. Assuming the claim is filed and the documentation is complete, a claim has also occurred. The amount of claim equals the amount of loss less any deductibles or other adjustments.

It may be more precise to refer to IBNR losses, since a claim has not been reported. It is difficult to determine whether a "claim in course of settlement" is a loss or a claim, but since the term is primarily used by the life insurance world, it is not surprising that it is written, *claim* in course of settlement.

Frequency and Severity

Losses for any time period can be decomposed into loss frequency and loss severity. *Loss frequency* is the number of losses that occur during the period. *Loss severity* is the dollar amount of losses that occur during the period. *Average loss frequency* is the number of losses incurred divided by number of earned exposures. *Average loss severity* is the dollar amount of losses incurred divided by the number of losses incurred. Loss cost per unit of exposure equals average loss frequency times average loss severity.

For example, consider a creditor-placed automobile policy with 1,000 exposures (insured vehicles) for a term of one year. If 100 losses occur during the year, the loss frequency is 100, and the average loss frequency is equal to .10 [= 100 / 1,000]. If the 100 losses resulted in total losses of $500,000, loss severity for the entire portfolio is $500,000, and the average loss severity is $5,000 [= $500,000 / 100].

Claims for any time period can be decomposed into claim frequency and claim severity. *Claim frequency* is the number of claims that occur during the period. *Claim severity* is the dollar amount of claims that occur during the period. *Average claim frequency* is the number of claims incurred divided by number of earned exposures. *Average claim severity* is the dollar amount of claims incurred divided by the number of claims incurred. *Claim cost per unit of exposure* equals average claim frequency times average claim severity.

Incurred Loss Ratio

The *incurred loss ratio* is the ratio of incurred claims for the accounting period divided by the earned premiums for that same period. The premium earnings pattern should be chosen to match the claim incurral pattern. If this is the case, in principle, the incurred loss ratio will remain constant over all periods <u>if</u> the underlying claim pattern is stable. Actual experience is not expected to demonstrate a constant loss ratio.

It is ironic that the term *incurred <u>loss</u> ratio* is used by both the life insurance and the P&C insurance worlds extensively. To be precise, the term should be *incurred <u>claim</u> ratio*.

Data for Ratemaking

Earned premiums, loss and claim experience, and expense levels for a risk class provide the basic data used for ratemaking. Data are collected and organized by time periods; the most common periods used are:

- Accident year
- Policy year
- Calendar year

Within each of these methods, data can be stratified by risk class, such as territory, coverage, policy term, or creditor.

Frequently, the available data are incomplete, inconsistent, or sparse when stratified by risk class, or of suspicious quality. Important steps in the ratemaking process are 1) evaluating the quality of the data, and 2) making appropriate adjustments in order for the data to be useful. When a new program is being developed, data on the particular coverage may not be available. The ratemaking process requires informed actuarial judgments throughout the process, regardless of the apparent quality or abundance of data.

The Components of Premium Rates and the Component Rating Formula

Claim Cost. Claim cost, also referred to as net premium, or pure premium, is the amount needed to pay claims. From the insurer's perspective, it is the cost of goods sold. It is a dollar amount typically expressed as a function of the exposure.

In practice, claim cost is usually computed as an average. Actual claim frequency and claim severity are observed, and a claim cost is computed. This computed claim cost is an estimate of the true underlying claim cost. As the insurer compiles more data, this estimate should become closer to the true underlying claim cost.

The extent of the variability of observed claim cost from the underlying claim cost is a measure of risk. The greater the variability, the greater the risk. In particular, there is the risk that future claim costs will be higher than expected claim costs and may exceed premiums. This risk is quantified as the volatility in the observed data used in calculating the claim cost. This risk is taken into consideration when computing gross premiums in the form of a risk load (or contingency loading).

Many pricing models assume that history will repeat itself, however, things change over time. It is important to examine claim cost data periodically and to change rates as needed. In addition, the appropriateness of the underlying claim model that is used to determine the claim cost component should be tested periodically.

Trending. Historical claim costs are often *trended*, i.e., adjusted for inflation or other factors. In certain lines of business, losses and claims are measured over long periods of time. The data may be several years old. Historical costs may be adjusted for inflation to correspond to the period in which the losses will be incurred or the claims paid.

Contingency Loading. After adjusting for inflation, the claim cost component can be considered to be an estimate of the expected claim cost for the period in which the rates being developed are to be used. However, claim cost is itself a random variable, and the claim cost that will actually be observed in the upcoming period will probably be different from the expected claim cost. Consequently, some provision for the variability of future claim costs is made and is commonly known as contingency loading.

Process risk is the variability of claim costs. The degree of the variability can be estimated using statistical methods. The amount of loading needed for an adequate level of safety can be estimated. Loading for process risk is the equivalent of increasing the premium rate so as to increase the probability that the premiums will exceed the actual claim costs.

There are other risks that can be provided for, such as catastrophe risk. Ratemaking data often contains no catastrophe occurrences, due to the infrequency of such events. Individual insurers may not have good catastrophe data causing pricing uncertainty. The typical remedy is to purchase catastrophe reinsurance at a fixed premium. For some credit-related products, there is a catastrophe reinsurance market, but there is no catastrophe reinsurance market for some lines, such as IUI. The direct writing insurer must retain the catastrophe exposure.

Expenses. Expenses can be categorized as fixed or variable. *Fixed expenses* are expenses that do not change over some relevant range of premium volume. Examples of fixed expenses are rent, maintenance, and utilities. Suppose that for premium volumes between $50 to $150 million, an insurer's rent will not change. In this case, the so-called relevant range is $50 to $150 million. Beyond $150 million, the situation may be such that the insurer will need additional infrastructure to process and service the additional business and would need to lease additional space.

Variable expenses are expenses that are directly proportional to some quantity, such as premium volume. Examples of variable expenses include agent commissions and premium taxes. Suppose that agent commissions are equal to 30% of premiums produced. In this case, the agent commission expense will behave exactly as premiums behave. If premiums produced equal zero, then the agent commission expense equals zero.

Total expenses (TE) = Fixed expenses (F) + Variable expenses (V)

If P = Premium volume, then:

Total expenses, as a percentage of premiums

= V% +[100 x ($F / $P)]

Some credit-related P&C insurance products have relatively small claim costs when compared to other components that the gross premium rate must cover, such as marketing expenses. For some products, the expenses associated with the business may approach or exceed the magnitude of the claim cost.

Loss adjustment expenses (LAE) are included as part of the claim costs by most P&C ratemakers, but as a part of general insurer expenses by life insurance ratemakers.

Investment Income. Insurers generally collect a premium, a portion of which is set aside for the payment of future claims. The actual cash received by the insurer is the premium minus up front expenses. The insurer invests this cash until it is used to pay claims or expenses. After all claims and expenses have been paid, the remainder goes to increase surplus or to pay dividends to the owners of the insurance company. The investment income earned on this cash flow is a component used in ratemaking.

Another source of investment income is the investment income earned on the portion of the insurer's capital base (or surplus) allocated to the product being priced. The allocated capital will determine the amount of investment income.

Profit and Return on Invested Capital. Profit may be considered the component of premium that represents the return on owners' investment. It equals premiums plus investment income less claims, expenses, and possibly federal income taxes.

Target profit is the return desired by the providers of the insurer's capital. It is commonly called *return on equity (ROE).*

To determine the profit component for ratemaking purposes, the investment income earned on surplus must be determined; however, it is first necessary to determine the amount of capital invested by product line. This amount is difficult to determine, because there is no single number that constitutes an appropriate level of capitalization for a product or for an insurer in total.

There are various parties interested in the level of an insurer's capital, and they do not all have similar interests. Some of the entities that concern themselves with the level of the insurance industry's capital base are:

- **Rating Organizations.** Rating organizations like to see insurers with capital sufficiently adequate to absorb a fair amount of loss volatility. What constitutes adequate capital for these purposes varies by line of business. Poor ratings from the rating organizations can negatively impact an insurer's ability to remain competitive. Insurers have an interest in maintaining sufficient capital to achieve the highest ratings.
- **State Regulators.** State regulators like to see sufficient capital for reasons similar to those of the rating organizations. Regulators have the public's interest in mind and want insurers to maintain sufficient capital to avoid failure under a reasonable set of circumstances. If an insurer does not comply with legal minimum capital requirements, action can be taken that can cause the insurer to lose business, or in an extreme case, be forced to cease doing business.
- **Owners.** Shareholders or investors provide the capital in this economic system. Their desire is an equitable return on the invested capital that reflects the relative risk of the investment. If a product's premium rates generate a certain level of profit, the less capital invested in the product line, the greater the return on investment to the owner. In order to attract and maintain a capital base, the insurer must provide owners with a competitive return on investment. In a competitive market for capital, higher returns attract more capital.
- **Insureds.** The insurers' customers, or insureds, are primarily interested in the policy benefits being paid. The insurer must have sufficient capital to honor its obligations to its insureds in the event reserves are inadequate. Obviously, from the insureds' perspective, more capital is better.

The insurer must satisfy the rating agencies, state regulators, owners, and customers, all at the same time. Perhaps within this set of competing demands exists an optimal amount of capital. The ROE implied by the profit component must be based upon a capital level that reconciles to the insurer's overall capital base. For example, if capital requirements are underestimated, a rate will be set such that profit is not sufficient to achieve the target ROE. Conversely, if capital is overestimated, the profit component will be such that rates are too high and likely not be competitive.

Component Rating Formula. Once the individual components have been determined, they are combined in the component rating formula to determine the gross premium rate. In general, the component rating formula (also referred to as the pure premium method or the loss cost method) is:

If R = Gross premium rate per exposure unit
C = Risk-loaded claim cost per exposure unit and LAE
F = Fixed expenses per exposure unit
I = Investment income factor as a percentage of premium
V = Variable expense factor as a percentage of premium
P = Profit (return on equity) factor as a percentage of premium
R = [C + F] / [1 + I - V – P]

Claim costs and fixed expenses are not directly related to premium; they are determined as fixed amounts per unit of exposure, and are therefore in the numerator of the formula. Variable expenses and profit are dependent upon premium, are determined as a percentage of premiums, and are therefore used in the denominator of the formula. Investment income, which is earned on premium cash flow and capital (or surplus), is expressed as a percentage of premiums and is therefore in the denominator of the formula.

Loss Ratio Pricing

Loss ratio is often used to determine gross premium rates for credit-related insurance. To achieve a predetermined loss ratio, the premium rate equals the claim cost component divided by the desired loss ratio. The result is a gross premium rate with an expected loss ratio equal to the desired value. When state laws or regulations specify the loss ratio that must be used in the calculations, the method is called *benchmark loss ratio pricing*.

Risk Classification and Relativities

Risk classification is segregating risks that have different claim costs for the same coverage. For example, suppose that for the same policy, a dwelling of construction type A in Territory 5 has on average a 20% higher claim cost than a dwelling of construction type A in Territory 6. The objective is to use classification criteria that combine individual risks into groups that are relatively homogeneous with respect to claim costs.

The first step in developing a risk classification plan is to determine the classification criteria. In practice, the classification criteria are referred to as *relevant risk factors*, or *risk factors*. Each risk factor has some impact upon claims—different levels of a risk factor correspond to different levels of claim cost. The idea is to develop a rating plan that properly accounts for the impact of the risk factors upon expected claim costs. Examples of risk factors are geography (territory, region, state), make and model (in the case of automobiles), and demographic characteristics (age, sex).

Risk factors must be clearly defined, measurable, and administratively feasible in terms of the insurer's ability to observe, measure, and verify them in practice. Moreover, they must be practical with respect to the insurer's ability to apply a rating plan given technology constraints.

In practice, after consideration of all the criteria listed above and perhaps other company or state regulatory considerations as well, some set of risk factors that explain some portion of claim cost variation are chosen. For each risk factor, there is a **vector of differentials** (or **relativities**), each with a base cell valued at one. The following example illustrates these concepts.

Suppose there are two risk factors for a creditor-placed homeowners policy written in a particular state, construction type, and territory. Further suppose that relativities have been developed for the different observed levels of each risk factor and the results are as follows:

Territory	**Territory Relativity**
1	.2
2	.4
3	.6
4	.8
5 (base cell)	1.0
6	1.2
7	1.4
8	1.6

Construction Type	**Construction Type Relativity**
A	.3
B	.7
C (base cell)	1.0
D	1.5

Assume the base premium for a home is $1,000 per year, i.e., the premium for a dwelling in Territory 5 and Construction Type C. The rate for a dwelling with the same value in Territory 2 and of Construction Type B (assuming the relativities are multiplicative) is $280 per year [= $1,000 x .4 x .7].

The result of classifying risks with respect to relevant risk factors and rating each risk accordingly should be a reasonable amount of reduction in the claim cost variability within each risk class.

Experience Rating

Risk classification systems allow the insurer to collect the “correct” net premium from the average risk within the class. Risk classification can reach a point of diminishing returns, even though there may be substantial claim cost variability remaining in each risk class after categorizing the risks. Experience rating can be applied to further refine the rating process and develop more accurate rates for risks within the risk classes.

One approach used in credit-related products is to apply experience rating methods at the creditor level. The methods vary by product type but can be categorized as either retrospective or prospective. A retrospective rating plan can be implemented wherein a premium refund is paid to a policyholder pursuant to some schedule that is a function of the actual loss ratio. Alternatively, a prospective rating plan can be implemented in which previous experience is used to determine future rates.

Credibility

Up to this point, analyses done to determine such things as claim costs and relativities have assumed that there were sufficient data available such that the results were credible. In practice, this is not always the case. Often, the data available that pertain to the specific ratemaking situation are somewhat sparse. The ratemaker usually wants to use the most recent and pertinent data, but the data may not be fully credible.

The methods of credibility theory provide the ratemaker with a set of tools for dealing with such situations. In basic terms, the more data that are available, the more reliable are the indications. Applying credibility theory, one can determine the amount of data, such as earned premiums or number of claims, which is needed for partial credibility or full credibility. Then the amount of data actually available for the ratemaking project is assigned a credibility factor, typically denoted with the letter Z [$0 \le Z \le 1$].

Suppose that the number of occurrences needed for full credibility, is 5,000; that there are 500 observed occurrences; and that this number of occurrences has a credibility factor of .316.

$$Z = \sqrt{\frac{500}{5000}}$$
$$= .316$$

If a ratemaker is developing the relativity for a territory, a relativity of 1.0 is used unless data for the territory are credible. Now suppose the territory's data indicate a net premium of 1.8 times the average. The territory's relativity equals:

Z x (observed territory relativity) + (1 - Z) x (base relativity)

= .316 x (1.8). + .684 x (1.0) = 1.253

Glossary

NOTE: Definitions in this glossary provide meanings applicable to credit-related insurance. Some words also have broader meanings.

Acceptance Corporation. A finance corporation formed by a manufacturer of consumer products to provide financing that is made available through the seller of its products, typically automobiles and other expensive machinery or equipment.

Accidental Death and Dismemberment (AD&D) Insurance. Term insurance that provides a benefit if death occurs as a result of accidental means within 90 (or so) days following an accident or if dismemberment occurs. The benefit is the stated amount of insurance.

Accidental Death (AD) Insurance. Term insurance that provides a benefit if death occurs as a result of accidental means within 90 (or so) days following an accident. The death benefit is the stated amount of insurance.

Account. A single credit-related relationship between a borrower and a creditor, such as a credit card account or an escrow account.

Accounting Date. The *as of* date on which an accounting statement is prepared, generally the last day of the accounting period.

Accrued Benefit. An insurance benefit that has been earned but has not yet been paid. For example, a person disabled on December 1 has 30 days of accrued benefit as of December 31 if the claim has not yet been paid.

Active Life Reserve. In life insurance terminology, an insurer's liability for estimated benefits to be paid after the accounting date on insureds that are in good health on the accounting date. Also called *policy reserve* or *unearned premium reserve*. For life insurance, there is a different type called *mortality reserve*.

Actively-at-Work Requirement. A policy requirement that the borrower must have worked thirty or more hours per week for one or more months prior to the effective date of the insurance in order to qualify for the insurance.

Actual Cash Value. In property insurance, the market value of property.

Actuarial Justification. In policy filing work, the process of demonstrating that proposed premium rates meet the regulatory standards for fairness and reasonableness.

Actuarial Memorandum. In policy filing work, a document demonstrating that proposed premium rates, refund formulas, and other policy calculations meet the regulatory standards for fairness and reasonableness.

Actuary. A person who applies probability and statistical theories to the practical problems of insurance and related fields. The actuary's primary roles relate to the calculation of premium rates, valuation of reserves, and forecasting of financial results.

Adjudication. The process of determining the validity of a claim for insurance benefits and establishing the amount payable under the claim.

Adverse Selection. The tendency of people to buy insurance products when they believe that they have a higher-than-average probability of a loss.

Affinity Credit Card. A credit card marketed to a member of a group, such as a university alumni association.

Age-Banded Product. A credit-related insurance product with premium rates that vary based on the issue age of the insured, normally using 5-year or 10-year age bands.

Aggregate Limits. A total limit on the benefits of an insurance policy or a specific coverage within a policy. This limit can be stated as a dollar amount or as a percentage of some other item, such as 80% of the actual cash value of the property.

All Risk Coverage. Coverage against all causes of loss, except for specifically excluded events.

Amount Financed. The dollar amount borrowed.

Annual Percentage Rate (APR). The effective annual rate of interest contained in a credit obligation.

Anti-Selection. The tendency of people to buy insurance products when they believe that they have a higher-than-average probability of a loss.

Any Occupation ("Any Occ") Disability. A disability that causes a claimant to be unable to perform the essential duties of any occupation for which the claimant is reasonably qualified by training, education, or experience.

Appoint an Agent. A process by which an insurer notifies the state insurance department that a licensed agent will solicit insurance on the insurer's behalf.

Asset. Something of value used to secure credit. Also called *collateral* or *collateral asset*.

Asset-Backed Credit. Credit secured by collateral.

Assignment of Commission. In a state where a corporation cannot be licensed, the agent assigns the commissions received from the sale of credit-related insurance to the employing corporation.

Assuming Reinsurer. An insurance company that accepts the risk under an insurance policy that was issued by another insurance company.

Automated Tracking System. In collateral protection insurance, a data processing system that canvasses a credit portfolio for borrowers who have not maintained the required insurance protection on collateral.

Balloon Credit. A credit obligation in which repayment consists of a series of installment payments and a final larger payment.

Bank Holding Company. A corporation that owns other legal entities, including at least one bank.

Benchmark Loss Ratio. In state laws and regulations, the presumed loss ratio on which prima facie rates are based. Also, the loss ratio used to determine whether the benefits provided are reasonable in relation to the premium charged.

Beneficiary. The party that will receive the benefits from an insurance policy.

Benefit. Payment made by an insurance company to the named beneficiary after a loss occurrence covered by the insurance policy.

Benefit Period. The period of time that a claimant can receive benefits under a policy providing monthly indemnity benefits, such as credit disability insurance, involuntary unemployment insurance, or family leave insurance.

Bill of Sale. A written agreement between two entities calling for the buyer to pay a certain amount of money for an item owned by the seller.

Blanket Collateral Protection Insurance on Titled Personal Property. Insurance for every extension of credit in the creditor's portfolio that is collateralized with eligible personal, titled property against physical loss or damage from any external source.

Borrower. A consumer entering into a credit obligation by receiving cash or purchasing a consumer product.

Bundled Product. The marketing practice of offering only a combination of insurance products to borrowers that is often used in the marketing of open-end credit-related insurance. Also called *packaged product*.

Captive Lease Company. A leasing company owned by an automobile manufacturer or other manufacturer of consumer products.

Case Reserve Method. A loss reserve set by a knowledgeable claims person who reviews a reported loss and estimates the total remaining benefit payable.

Cash Advanced. Principal of the credit.

Cash Credit. The borrower receives cash for the purchase of consumer products or for other expenditures in return for entering into a credit obligation.

Casualty Insurance. Insurance against any loss or liability resulting from an accident or event, excluding certain losses that are within the scope of other insurances, such as fire or marine insurance.

Catastrophe Hazard. The contingency that an abnormally large number of claims occur, such as the calamities of a hurricane (credit property insurance) or sudden financial depression (involuntary unemployment insurance).

Cede. To transfer the risk under an insurance policy from one insurance company to another insurance company.

Ceded Premium. The premium paid to the assuming reinsurer by the ceding insurer for the assumption of an insurance risk.

Ceding Fee. The percentage of ceded premium retained by the ceding insurer in a reinsurance transaction for the ceding insurer's general expenses, premium taxes, and profit.

Certificate of Insurance. The document issued to the insured borrower by the insurance company under a group or master policy.

Cession or Cession Statement. A periodic report provided by the ceding insurer to a reinsurer showing the cash transactions of the accounting period. The accounting period may be monthly or quarterly.

Chattel. An article of moveable personal property, as distinguished from real property. Examples include furniture, automobiles, livestock, and farm equipment.

Chattel Mortgage. A legal instrument under which personal property stands as security for the credit. The borrower maintains possession of the property as long as there is no default.

Claimant. A borrower covered by an insurance policy that files a claim for a loss covered by the policy.

Claim in Course of Settlement (CCS, CICS, ICOS). The component of loss reserves for a claim that has occurred and has been reported to the insurance company prior to the accounting date but has not yet been paid on that date. Also called *pending claim*.

Claim Reserves. The life insurance term used to describe loss reserves. See *loss reserves.*

Closed-End Credit. Credit for a specified amount and a fixed term. The amount borrowed cannot be increased.

Closed-End Monthly Outstanding Balance Insurance. Credit life and disability insurance on closed-end installment credit that is offered using monthly outstanding balance premiums instead of single premiums, typically only found in the credit union market.

Co-Borrower. A second borrower who is obligated under a credit obligation.

Collateral. An asset pledged by a borrower to secure credit.

Collateralize. The process of pledging security.

Collateral Protection Insurance (CPI). Insurance secured by a creditor in the event that the borrower fails to provide property insurance on the collateral of credit as required by the creditor. Also see *creditor-placed insurance*.

(Creditor-Placed) Collateral Protection Insurance on Real Property. A form of homeowners insurance that is unilaterally placed by the creditor to protect its interest in the collateral of a mortgage when the mortgagor fails to provide proof of homeowners insurance.

Commercial Credit. Credit extended to a business that may be guaranteed by an individual, typically the owner of the business.

Commercial Credit Insurance. Insurance that indemnifies a business for credit losses arising from failure by another business to pay amounts owed. Commercial credit insurance is **not** a form of consumer credit-related insurance.

Commission. The amount of money paid to the producer of insurance business, usually a percentage of the premiums that are produced for the insurer.

Commission Caps. A limitation on the maximum compensation paid by an insurer to a general agent and a producer.

Compensating Balance. A deposit in a financial institution by an insurer on which the interest paid on the deposit is less than market rates, usually in a non-interest-bearing checking account.

Completion Method. A method of loss reserving for monthly indemnity products where prior experience is studied to estimate the average remaining period of claim after an accounting date, given the number of months of claim that has elapsed. Factors are developed that can be applied based on the time the insured has been on claim as of the current accounting date.

Conditional Sales Contract. A credit obligation in which possession of the property passes to the buyer, but the title remains with the seller until all payments are made as agreed to in the contract.

Consumer Credit. A financial transaction in which a borrower receives cash, or purchases a consumer product, by agreeing to repay the amount advanced by the creditor.

Consumer Credit Insurance Association (CCIA). A national organization of more than 180 insurance companies providing life, disability, unemployment, and property insurance in connection with consumer credit obligations. CCIA is dedicated to preserving and enhancing the availability, utility, and integrity of insurance products delivered through financial institutions or in conjunction with financial transactions.

Contestable Period. A period, usually two years, following the effective date of the insurance during which misrepresentations made by the insured in an application for insurance may be used as a reason to deny a claim. After the contestable period, a valid claim may not be denied because of misrepresentations, except in cases of fraud.

Contingent Commission. See *retroactive compensation*.

Continuing Claim Reserve. For disability insurance, involuntary unemployment insurance, and family leave insurance with monthly benefits, the component of loss reserves for a claim that has occurred prior to the accounting date and for which a claimant has received at least one disability, involuntary unemployment, or family leave insurance benefit payment. The reserve is the estimate of the benefits that will be earned and paid after the accounting date.

Contractual Liability (Protection or Policy). The assumption of a liability (beyond what is required by law) by one party based on the terms of a contract.

Contributory Premium. Insurance where the borrower has the option to purchase credit-related insurance by paying an identifiable premium.

Coverage. Contingencies that are insured under an insurance policy. This word has several other meanings in the insurance world.

Credibility. In ratemaking, loss reserving, and profitability studies, the degree of confidence placed on the observed experience as a predictor of the true experience. The degree of confidence is usually determined by the amount of earned premiums, the number of lives insured, or the number of claims.

Credit. A transaction where the borrower receives cash or a consumer product and agrees to repay the obligation with monthly payments.

Credit Accident and Health Insurance (A&H). Another term for credit disability insurance.

Credit Card Protection. A P&C insurance in which the benefit is equal to the deductible that is levied when unauthorized charges are made under the card—generally $50.

Credit Disability Insurance. Loss of income insurance purchased in conjunction with a credit obligation that provides a benefit in the event of total disability during the term of insurance.

(Lump Sum) Credit Disability Insurance. Loss of income insurance purchased in conjunction with a credit obligation that provides a single payment after an insured is disabled for the qualifying period, often 90 days, during the term of insurance. The benefit equals the outstanding balance on the credit.

(Monthly Indemnity) Credit Disability Insurance. Loss of income insurance purchased in conjunction with a credit obligation that provides a monthly benefit while the insured is totally disabled during the term of insurance. The monthly benefit usually equals the required monthly payment.

(Monthly Indemnity) Credit Disability Insurance on Installment Credit. Single premium loss of income insurance purchased in conjunction with closed-end installment credit that provides a level monthly benefit while the insured is totally disabled during the term of insurance. The monthly benefit equals the required monthly payment.

(Monthly Indemnity) Credit Disability Insurance on Open-End Credit. Monthly premium, monthly renewable loss of income insurance purchased in conjunction with open-end credit that provides a monthly benefit while the insured is disabled, up to the limits specified in the policy. The monthly benefit usually equals the minimum monthly payment due under the open-end credit obligation on the initial date of disability.

Credit Involuntary Unemployment Insurance. Loss of income insurance purchased in conjunction with a credit obligation that provides a benefit in the event of involuntary unemployment during the term of insurance.

(Lump Sum) Credit Involuntary Unemployment Insurance. Loss of income insurance purchased in conjunction with a credit obligation that provides a single payment after an insured is involuntarily unemployed for the qualifying period, often 90 days, during the term of insurance. The benefit equals the outstanding balance on the credit.

(Monthly Indemnity) Credit Involuntary Unemployment Insurance. Loss of income insurance purchased in conjunction with a credit obligation that provides a monthly benefit while the insured is involuntarily unemployed during the term of insurance. The monthly benefit usually equals the required monthly payment.

(Monthly Indemnity) Credit Involuntary Unemployment Insurance on Installment Credit. Single premium loss of income insurance purchased in conjunction with closed-end installment credit that provides a level monthly benefit while the insured is involuntarily unemployed during the term of insurance. The monthly benefit equals the required monthly payment.

(Monthly Indemnity) Credit Involuntary Unemployment Insurance on Open-End Credit. Monthly premium, monthly renewable loss of income insurance purchased in conjunction with open-end credit that provides a monthly benefit while the insured is involuntarily unemployed, up to the limits specified in the policy. The monthly benefit usually equals the minimum monthly payment due under the open-end credit obligation on the initial date of involuntary unemployment.

Credit Life Insurance. Term life insurance purchased in conjunction with a credit obligation that provides a death benefit in the event of an insured's death during the term of the insurance. The benefit is equal to the indebtedness of the credit.

Credit Life Insurance on Installment Credit. Single premium term life insurance purchased in conjunction with installment credit that provides a death benefit in the event of an insured's death during the term of the insurance. The benefit is equal to the scheduled indebtedness of the credit.

Credit Life Insurance on Open-End Credit. Monthly premium, monthly renewable term life insurance purchased in conjunction with open-end credit that provides a death benefit if the death occurs during the month. The death benefit is the outstanding balance of the credit on the date of death.

Creditor. A lender of money, or a vendor or lessor of consumer products, for which repayment is made through a credit obligation.

Creditor-Placed Insurance. Insurance purchased unilaterally by the creditor, subsequent to the date of the credit obligation, providing insurance against loss to property pledged as collateral resulting from fire, theft, collision or other perils that would either impair the creditor's interest or adversely affect the value of the collateral. It is purchased according to the terms of the credit obligation when the borrower fails to provide required insurance. The cost of the insurance is charged to the borrower.

Creditor-Placed Insurance on Titled Personal Property. Property insurance purchased unilaterally by the creditor, who is named as the insured, subsequent to the date of the credit.

Credit Property Insurance. Property insurance purchased in conjunction with a credit obligation that insures consumer products purchased with the credit proceeds, or pledged as collateral, against specified loss occurrences causing damage to, or disappearance of, the property.

Credit Property Insurance on Installment Credit. Single premium property insurance purchased in conjunction with closed-end installment credit that insures consumer products purchased with the credit proceeds, or pledged as collateral, against specified loss occurrences causing damage to, or disappearance of, the property.

Credit Property Insurance on Open-End Credit. Monthly premium, monthly renewable property insurance purchased in conjunction with open-end credit insuring consumer products, that are bought via the credit, or pledged as collateral, against specified loss occurrences causing damage to, or disappearance of, the property.

Credit-Related Insurance. Insurance offered in conjunction with consumer credit. Policy terms and benefits are related to the specific consumer credit obligation.

Credit Union. Non-profit institutions that provide savings and lending services for members who share a common bond, such as employment at a particular company.

Critical Period Coverage. Disability insurance and involuntary unemployment insurance in which the benefit period is a stated number of months, rather than the full remaining term of the credit.

Debt Cancellation Contract (DCC). An agreement between a creditor and a borrower under which the creditor agrees to modify the credit obligation in the event of the borrower's death, disability, involuntary unemployment, family leave, or other named event. The credit is cancelled if death occurs. The requirement to make a monthly payment, the interest due for the month, and the principal due for the month are cancelled if one of the events occurs.

Debt Deferment Contract (DDC). An agreement between a creditor and a borrower under which the creditor agrees to modify the credit obligation in the event of the borrower's death, disability, involuntary unemployment, family leave, or other named event. The credit is waived if death occurs. The requirement to make a monthly payment and the interest for the month is waived if one of the events occurs.

Declarations Page(s). The summary page(s) in a P&C insurance policy that contains key information about the policy. Also called the *dec page*.

Decreasing Term Life Insurance. Term life insurance in which the amount of insurance decreases during the term of the policy.

Deductible. The part of a loss that the claimant must pay.

Deed of Trust. Conveyance of property to one person to be held in trust for another.

Deemer Provision. State law or regulation specifying that an insurer can assume (or deem) that a policy filing is approved unless the insurance department objects within a specified period of time, usually 30 to 90 days.

Default. The situation in which a borrower fails to make the payments required under a credit obligation or otherwise breaches the contract.

Deficiency Letter. In an automatic tracking system, the letter to the borrower stating that sufficient insurance is not in place on the collateral.

Depreciation. The loss in value of an asset over a period of time.

Deviated Rate. Any premium rate that is different from the state's prima facie rate.

Direct Mail Marketing. A form of direct response marketing where a consumer product is offered directly to a consumer via the mail.

Direct Tabulation Method. A method of setting loss reserves under which the claim department totals the benefits payable on claims that have been received but not paid on the accounting date.

Direct Writer. The insurer issuing an insurance policy.

Disability Insurance. A form of accident and health insurance that provides a benefit in the event of total disability during the term of insurance.

Dismemberment Insurance. Insurance that provides a benefit in the event that the insured is dismembered.

Downward Deviation. A premium rate that is less than the prima facie rate.

(Mandatory) Downward Deviation. A reduction in premium rates required by state regulation when the loss ratio for a case is less than the benchmark loss ratio.

Dual Interest Coverage. Coverage that protects the interest of the borrower and the creditor. A claim can occur without the creditor's interest being impaired.

Early Termination. Termination of a closed-end credit obligation prior to the scheduled maturity date.

Earned Premium. Premium dollars collected (or written) for the accounting period, plus the unearned premium at the beginning of the period, minus the unearned premium at the end of the period.

Effective Date (of Insurance). The day insurance begins.

Eligibility Requirement. Conditions within an insurance policy that a borrower must meet in order to qualify for insurance.

Elimination Period. In disability, involuntary unemployment, or family leave insurance, the specified time period a claimant must remain disabled, unemployed, or on leave before any benefits are payable. Also called the *waiting period*.

Endorsement. A separate form, attached to and made a part of an insurance policy, that adds an additional coverage to the policy or modifies a provision in the policy. An endorsement can provide a supplementary benefit, increase a policy benefit, or limit a policy's coverage. Also called *rider*.

Equity. In real estate, the value of the property in excess of the outstanding credit.

Escrow Account. Money set aside from monthly payments made by a homeowner to the mortgagee to pay for property taxes and homeowners insurance.

Evidence of Insurance. The individual insurance policy or certificate of insurance provided to the insured stating the amount of insurance, premium, term, description of coverage, exceptions, limitations, and restrictions.

Exclusion. A contingency not insured by an insurance policy.

Experience Rating. An adjustment to the insurance premium rate reflecting the claim history under a group or master policy.

Experience Refund. See *retroactive compensation*.

Expiry. Termination as the result of completing the original term of insurance.

Extended Service Contract (ESC), or Extended Warranty. A contract, typically offered by a retailer, such as an appliance dealer or a consumer electronics dealer, to a customer that extends many of the provisions of the manufacturer's warranty for a period of time beyond the expiration date of the manufacturer's warranty.

Factor Card or Factor Chart. Printed material used by a credit officer to calculate a credit-related insurance premium.

Factor Reserve Method. A method of setting loss reserves under which prior claim experience is studied to determine the actual experience during a time period in the past. A factor is developed from the prior experience that can be applied to a known quantity on the current accounting date to calculate reserves.

Family Leave Insurance. Loss of income insurance under which a benefit is paid if the insured takes an unpaid leave of absence for up to 90 (or 180) days in the event of certain family situations, such as sickness of a family member, birth, or adoption.

Family Leave Insurance on Open-End Credit. Monthly premium, monthly renewable loss of income insurance purchased in conjunction with open-end credit that provides a monthly benefit during an unpaid leave of absence from employment resulting from specified causes, up to the limits specified in the policy. The monthly benefit usually equals the minimum monthly payment due under the open-end credit obligation on the date that the leave begins.

Farm Credit Bank. An organization that provides credit to farmers.

Fee Income. Income to a producer generated as a result of offering insurance or ancillary products to their customers.

Finance and Insurance (F&I) Specialist. An individual employed in an automobile dealership who is trained to handle the financing and insurance matters of an automobile sale.

Finance Company. A company that lends money to consumers or businesses. Deposits are not accepted. Funds are obtained from banks, financial institutions, and other sources.

First and Final Payment. A disability, involuntary unemployment, or family leave insurance claim in which the initial claim represents the total claim.

Flat Cancel. The termination of an insurance policy that occurs after the policy has been in force, where the effective date of the termination is the issue date of the insurance.

Flesch Scoring Method. An objective method for assessing readability of text material that judges the document's difficulty of comprehension by counting the syllables in the words and the number of words in a sentence.

Flood Insurance. Insurance protecting against damage caused by overflowing or rising water.

Free Look Provision. A policy provision that allows the borrower to purchase insurance, think about it for 30 days, and, if not satisfied for whatever reason, cancel the policy and receive a full refund of all premiums.

Front Commission. See *front compensation*.

Front Compensation. Compensation paid to the producer that is a flat percentage of the premium. If installment credit is terminated prior to maturity, the borrower receives an unearned premium refund, and there is a chargeback to the producer for the unearned front compensation.

GAP Blanket Policy. GAP protection provided for all of its leases by a lessor who absorbs the cost of the product.

GAP Exposure. A deficit between the outstanding principal balance of credit and the actual cash value of the collateral at the time of a total loss. In the case of a lease, the GAP exposure typically equals the difference between the outstanding lease obligation remaining at the time of loss and the actual cash value.

GAP Insurance. An insurance policy purchased by the creditor from a P&C insurer that insures the contractual liability assumed by the creditor to its borrowers under GAP waivers.

GAP Waiver. GAP exposure protection purchased by a borrower from the creditor, where the contractual terms of the protection are contained in the credit obligation or in an addendum to the credit obligation.

GAP Waiver Insurance. GAP exposure protection purchased by a borrower from the creditor or from a P&C insurance agent, where the contractual terms of the protection are contained in an insurance policy between the borrower and the P&C insurer.

General Agent. A licensed and appointed agent representing an insurer, but not as an employee of the insurance company.

Generally Accepted Accounting Principles (GAAP). The principles of accounting that apply to the preparation of financial statements for most U.S. corporations.

Good Health. A state of health free from any disease or bodily infirmity of a substantial nature which 1) affects the general soundness and healthfulness of the system seriously, or 2) materially increases the risk to be assumed by the insurer.

Good Health Statement. A simple form of underwriting where the borrower signs a statement representing that he or she is in good health to the best of the insured's knowledge and belief.

Gross Coverage. Credit-related insurance that insures the gross indebtedness of the credit.

Gross Indebtedness. The total amount owed under closed-end credit. It includes principal and interest.

Gross Minus Refunded Premiums. Gross premiums collected by the insurer minus premium refunds paid by the insurer. Also called *G-R premiums* and *net written premiums*.

Gross Unearned Premium. The portion of the original gross premium representing the value of the unexpired insurance. The portion can be determined using a number of methods, including the Rule of 78, Pro Rata, or the Rule of Anticipation.

Gross Written Premiums. Gross premiums collected from the insureds on new insurance issued during the reporting period.

Group Exemption. In states with the group exemption, an individual does not need to be licensed to enroll insureds under a group policy.

Group Policy. An insurance policy issued to a producer, in which the group is defined as borrowers obtaining credit from the producer. The insured borrower is enrolled in the group and receives a certificate of insurance as evidence of insurance.

Home Equity Line of Credit. A pre-approved borrowing limit based on the equity a homeowner has in the home.

Hospital Daily Indemnity Insurance. Health insurance that provides a benefit if an insured is hospitalized during the term of insurance. The benefit is a stated dollar amount for each day the insured is hospitalized. Benefits are typically stated per $100 per day.

Inception-To-Date Earned Premium. Premium earned from the effective date of a policy through the current date.

Increasing Term Life Insurance. Term life insurance in which the amount of insurance increases during the term of the policy.

Incurred But Not Reported (IBNR). The component of loss reserves for a loss that has occurred prior to the accounting date but that has not yet been reported to the insurance company on that date.

Incurred Claims. The total cost of all claims that occur during the accounting period; equal to paid claims, minus the loss reserves at the beginning of the period, plus the loss reserves at the end of the period.

Incurred Loss Ratio or **Incurred/Earned Loss Ratio.** The ratio of incurred claims to earned premiums, normally expressed as a percentage.

Indebtedness. The amount owed.

Individual Insurance Policy. An insurance contract directly between the insurance company and the person insured. The insured receives an individual policy as evidence of insurance.

In Force. The amount of insurance currently in effect.

Initial Gross Indebtedness. Under a closed-end installment credit obligation, the initial net indebtedness plus the scheduled interest charges over the term of the credit.

Initial Net Indebtedness. The total amount advanced under closed-end installment credit, which normally includes the principal of the credit plus the insurance premium.

Inland Marine Insurance. A “catch-all” category of insurance defined in P&C laws and regulations and in statutory statements of P&C insurers. It includes exposure of property to various perils, with the primary characteristic that the property is moveable.

Installment Credit. Consumer credit where the borrower agrees to repay the credit in substantially equal monthly payments. Typical transactions are cash credit and installment sale contracts.

Installment Sale Contract. Credit where the purchaser receives a consumer product in exchange for entering into a credit obligation requiring periodic payments.

Instrument Filing Fee. The cost of filing a document with the government. Also called *filing fee* or *recording fee*.

Insurable Interest. When a person or organization has an interest, financial or otherwise, in preserving the value of something.

Involuntary Unemployment (IU). An event beyond the control of the employee that results in the termination of current employment. Examples include layoff, firing, lockout, or strike.

Involuntary Unemployment Insurance (IUI). Loss of income insurance that provides a benefit in the event of involuntary unemployment during the term of insurance.

Joint Coverage. A credit-related insurance policy insuring two borrowers who are both obligated under the credit obligation.

Joint Premium Multiple or **Joint Multiple**. A premium rate for joint coverage that is expressed as a percentage of the single coverage rate.

Lag Method. A method of loss reserving where prior experience is studied to estimate the total of all payments that will be made after an accounting date on all losses that have occurred on or before the accounting date. Also called the *lag triangle method* and the *loss development method*.

Lease. A contract granting use of real estate, equipment, or a vehicle during a specified period of time for a specific amount of money. Ownership of the asset never transfers to the user of the asset.

Lessee. The borrower or user of an asset under a lease.

Lessor. The creditor or owner of an asset under a lease.

Letter Cycle. In creditor-placed insurance, a series of letters produced by a tracking system to notify a borrower of insufficient insurance. The borrower is informed of the action that is required of the borrower, the timing of the action, and the action the creditor will take if the borrower does not comply.

Level Gross Coverage. Level term life insurance insuring the gross indebtedness of the credit that is repaid in a single payment.

Level Term Life Insurance. Term insurance in which the amount of insurance stays constant during the policy term.

Liability. An obligation to pay money or an estimate of an amount that will become payable.

Licensed Agent. A person soliciting insurance must obtain a state license to conduct a solicitation in that state.

Lien. A claim on another person’s property as security for credit.

Lienholder. The entity holding a lien, such as a creditor.

Limited Dual Interest Coverage. Coverage that protects the interest of the borrower and the creditor but limits the benefits to the creditor’s interest.

Limited Insurance License. A less demanding and more restrictive form of agent licensing that is permitted in some states. An examination for this type of license is not as comprehensive as an examination for a full insurance license. In some states, an examination is not required.

Limit of Liability. The maximum insured; it can be expressed on a "per credit" basis or a "per policy" basis. The maximum can be a dollar amount, a loss ratio, or a function of some other variable, such as earned premiums.

Line of Credit. Open-end credit with a pre-approved limit.

Loss of Income Insurance. Disability insurance and involuntary unemployment insurance offered as a combined package.

Loss of Time Insurance. Canadian term for *involuntary unemployment insurance*.

Loss Ratio. The ratio of claims to premiums, normally expressed as a percentage.

Loss Reserves. An estimate of claim payments to be paid after the accounting date, on losses that have occurred prior to the accounting date. Categories of loss reserves are *incurred but not reported claims*, and *case reserves* (*claims in course of settlement*, and *continuing claims)*.

Lump Sum Coverage. Disability or involuntary unemployment insurance in which the benefit is paid in a single sum.

Master Policy. An insurance policy that covers a group of borrowers who receive certificates of insurance as evidence of insurance under the policy.

Member-Pay Insurance. Credit-related insurance in the credit union market with contributory premiums.

Minimum Monthly Payment. The amount a borrower must pay on a credit card, a revolving charge card, or a line of credit to maintain the availability of the credit.

Monthly Benefit. A disability, involuntary unemployment, or family leave insurance benefit paid monthly during the continued disability, unemployment, or leave of absence of the insured. Also called *monthly indemnity benefit*.

Monthly Outstanding Balance (MOB) Insurance. Credit-related insurance having monthly premiums that are calculated as a function of the outstanding balance of the credit.

Monthly Payment. The payment due each month from the borrower to reduce the amount of the credit.

Monthly Renewable Term Insurance. An insurance policy that is renewed each month for a term of one month when the policyholder pays the premium.

Morbidity Cost. The cost of insurance benefits provided under a disability insurance policy.

Morbidity Table. A set of values showing the probability of disability at given ages. The most common tables used for credit disability insurance are the 1964 Commissioners Disability Table (1964 CDT), the 1968 Credit Disability Table, the 1974 Credit Disability Table, and the 1985 Commissioners Individual Disability Table A (1985 CIDA).

Morris Plan Bank. A type of bank formed during the first half of this century under a franchise arrangement conceived by Arthur J. Morris. The concept enabled a working class borrower to obtain bank credit using earning power as collateral.

Mortgage. Credit secured with real property.

Mortgagee. A creditor who provides credit secured by real property.

Mortgage Impairment Insurance. A form of title insurance on credit secured by real estate, excluding first mortgage credit, that protects the creditor's interest in the event that the creditor forecloses on real property and is unable to collect because of an undisclosed encumbrance or other legal obstruction to the title of the property. Also called *foreclosure impairment insurance* and *lender impairment insurance*.

Mortgagor. A borrower who secures credit using real property as collateral.

Mysterious Disappearance. Burglary, theft, or vandalism without clear evidence that a crime occurred, other than disappearance of the item.

Named Peril Policy. An insurance policy that only insures against the perils that are specifically itemized in the policy.

Net (or Net Payoff) Coverage. Credit life insurance with a death benefit equal to the scheduled net indebtedness of the credit.

Net Indebtedness. The amount due under a credit obligation at a specific point in time.

Net Plus One (or Plus Two or Plus Three). Credit life insurance with a death benefit equal to the scheduled net indebtedness of the credit plus one monthly payment.

Net Written Premiums. Gross premiums collected from the insureds on new insurance less the premium refunds paid to those insureds who terminated their insurance prior to maturity.

Non-Contributory Premium. Credit-related insurance provided to all borrowers with the premium paid by the creditor.

Non-Filing Insurance (NFI). Insurance that protects a creditor in the event that the creditor suffers a loss as a result of its failure to perfect its security interest in the collateral by not filing a lien against the security with government authorities. The cost of the insurance, which is less than or equal to the government filing fee, is passed on to the borrower. Also called *non-file insurance* or *non-recording insurance*.

Non-Recording Insurance. See *non-filing insurance*.

Non-Resident Agent License. An insurance license that permits an out-of-state agent to solicit insurance in the state.

Non-Retroactive Benefit. Under a disability, involuntary unemployment, or family leave insurance policy, coverage where benefits are not payable for the time the insured is disabled, unemployed, or on leave during the elimination period.

Obligor. The party responsible for performing pursuant to the provisions of an extended service contract or a vehicle service contract, typically either 1) the selling retailer, 2) the manufacturer, or 3) the contract administrator. Also called *named obligor* and *contractual obligor*.

Open Claim. A claim that is under investigation or in a benefit-paying status.

Open-End Credit. Consumer credit under which the amount of credit extended may be increased at any time by additional borrowing up to the account's credit limit. The term of the credit is not fixed. The borrower makes a monthly payment in any amount ranging from the creditor's required minimum payment up to the outstanding balance of the credit.

Outstanding Balance. The amount due under a credit obligation at a specific point in time. Also called the *net indebtedness*, *outstanding net indebtedness*, and the *outstanding principal balance*.

Outstanding Net Indebtedness. See *outstanding balance*.

Outstanding Principal Balance. See *outstanding balance*.

Override Commission. Compensation paid to a general agent on the business produced by the agent, normally expressed as a percentage of net written premium.

Own Occupation ("Own Occ") Disability. A disability that causes a claimant to be unable to perform the essential duties of the claimant's usual occupation.

Packaged Product. The marketing practice of offering only a combination of insurance products to borrowers that is often used in the marketing of open-end credit-related insurance. Also called *bundled product*.

Paid/Earned Loss Ratio. The ratio of paid claims to earned premiums, normally expressed as a percentage.

Paid Loss Ratio. The ratio of paid claims to collected (or net written) premiums, normally expressed as a percentage.

Pending Claims. See *claims in course of settlement*.

Penetration Rate. The percentage of eligible borrowers who purchase credit-related insurance.

Per Credit Limit. A liability limit per each credit insured by a policy, typically stated as a dollar amount.

Per Occurrence Limit. A liability limit for any one occurrence of a loss relating to a single credit obligation.

Personal Line of Credit. A pre-approved borrowing limit that is not secured by collateral.

Personal Property. Generally, an item owned by a person that is moveable, as compared to a home that is considered real property.

Physical Damage Insurance. P&C insurance that covers personal property against damage to the property resulting from a covered peril.

Point-of-Sale (POS) Marketing. Offering a product to borrowers at the time of the credit application or closing.

Policyholder. The individual or corporation who is the named insured under an insurance policy.

Policy Limits. Limitations on an insurer's liability under an insurance policy.

Policy Reserve. An insurer's liability for estimated benefits to be paid after the accounting date on insureds that are not in claim status on the accounting date.

Pre-Existing Condition. An impairment for which the insured has received treatment prior to the effective date of the insurance.

Premium. The consideration paid for insurance.

Premium Rate. The price of a unit of insurance.

Premium Refund. When credit-related insurance is terminated prior to the scheduled maturity date, the unearned portion of the original insurance premium that is paid to the borrower. Also called *refunded premium* or *refund*.

Present Value of Amounts Not Yet Due. See *present value of unaccrued benefits*.

Present Value of Unaccrued Benefits. A life insurance term for the component of loss reserves for the monthly indemnity benefits that will be earned by the claimant after the accounting date on a claim that has occurred prior to the accounting date. Also called *present value reserve* or *the present value of amounts not yet due*.

Present Value Reserves. See *present value of unaccrued benefits*.

Prima Facie Rate. A maximum rate for credit-related insurance that is set by state law or regulation. The rate may be used by an insurer without further justification of its reasonableness within a particular state. The rate is judged *on its face* to produce a reasonable benefit in relationship to the premium charged.

Primary Borrower. The first-named borrower on a credit obligation.

Principal (of a Credit Obligation). The cash advanced to the borrower or the portion of the product's purchase price that is financed.

Private Label Credit Card. A credit card distributed by a specific retailer that can only be used to purchase products and services from that retailer.

Producer. The corporate entity making the credit-related insurance presentation to the borrower, such as an automobile dealership, a bank, a credit union, a finance company, or a retailer.

Producer-Owned Insurance (or Reinsurance) Company. An insurance company owned or controlled by a producer for the purpose of insuring, or reinsuring, the credit-related insurance business sold by the producer.

Programmable Calculator. A hand-held calculator or personal computer that is programmed to do the premium calculation for the cost of credit-related insurance.

Proof of Insurance. The evidence that insurance is in force, such as a dec page, a certificate of insurance, or an individual insurance policy.

Proof of Loss. The requirements specified in an insurance policy that must be met by the claimant to establish a valid claim, such as evidence of loss or establishment of an insured condition, such as disability.

Property Damage Liability Insurance. P&C insurance that covers damage to another individual's property.

Property Insurance. Insurance providing financial protection against the loss of, or damage to, real or personal property caused by insured perils.

Pro Rata. There are two meanings. The most common meaning is “in equal proportions.” The second meaning is “in proportion to.”

Pro Rata Unearned Premium. A formula for calculating the portion of the original premium that has not yet been exposed to risk, where the apportionment is an equal proportion for each unit of time. For example, if the term of insurance is twelve months, one-twelfth of the premium is apportioned to each month. Also called *straight line earning basis*.

Qualifying Period. The period of time an insured must remain disabled or involuntarily unemployed to qualify for a lump sum benefit.

Rate Chart. Printed material used by a credit officer to calculate a credit-related insurance premium.

Real Property. Property that is not moveable, such as land, a home, and any other permanent structure.

Recording Fee. See *instrument filing fee*.

Refunded Premium (or Refund). See *premium refund*.

Reinsurance. The transfer of risk from one insurance company, the ceding insurer, to a second insurance company, the reinsurer.

Reinsurance Treaty. The contract defining the reinsurance relationship between the ceding insurer and the reinsurer.

Reinsurer. An insurance company that accepts the risk on an insurance policy that was written by another insurance company. Also called *assuming reinsurer*.

Report and Remittance. Monthly reports received from each producer of credit-related insurance regarding the business issued and refunds made during the month. Remittance for the gross premium minus refunded premium, less any deducted compensation, is sent to the insurer along with the supporting documentation.

Repossessed Vehicles Coverage. Coverage that insures the creditor against 1) all physical losses or damage from external causes to repossessed vehicles while in the process of being repossessed, or while being held by the creditor subsequent to the repossession, and 2) the cost to recover the property.

Reserves. An estimate of the future claim payments that will be paid after the accounting date on business that is in force on the accounting date.

Reserve Valuation. A periodic calculation of the reserves for in force insurance policies.

Resident Agent. An agent licensed in the agent’s state of residency.

Residual Value. In a lease agreement, the value of the consumer product, normally an automobile, at the end of the lease term.

Retention Fee. The ceding fee charged by a ceding insurer under a reinsurance arrangement.

Retroactive Benefit. Under a disability, involuntary unemployment, or family leave insurance policy, a benefit that is payable from the first day of disability, unemployment, or leave if the claimant remains disabled, unemployed, or on leave for the required waiting period.

Retroactive Compensation ("Retro"). Compensation to the producer that is paid only if the business is profitable. Also called *contingent commission* or *experience refund*.

Revolving Charge Account. Open-end credit extended by a creditor solely for the purchase of products from an affiliated department store or other retailer of consumer products.

Rider. A separate form, attached to and made a part of an insurance policy, that adds an additional coverage to the policy or modifies a provision in the policy. A rider can provide a supplementary benefit, increase a policy benefit, or limit a policy's coverage. Also called *endorsement*.

Rule of 78. A mathematical formula for calculating the sum of the digits from one to any specified number (n). The formula is: $\frac{n \times (n + 1)}{2}$

The sum of the digits from 1 to 12 equals [(12 x 13) / 2] or 78. Also called *the sum of the digits*.

Rule of 78 Unearned Premium. A formula for calculating the portion of the original premium that has not yet been exposed to risk that uses the Rule of 78 to determine the apportionment.

Rule of Anticipation Unearned Premium. A formula for calculating the portion of the original premium that has not yet been exposed to risk that uses the gross single premium for a policy having the same benefits and term as the unexpired insurance to determine the apportionment. Also called *single premium method*.

Salvage (Rights). The insurer's right under a P&C policy to take ownership rights to any remaining value of the damaged property.

Salvage Value. The remaining value of property after the insurer has taken ownership rights to damaged property. Salvage value can equal zero.

Scheduled Interest Charges. The interest charges anticipated over the scheduled credit term calculated at the inception date of aninstallment credit obligation.

Second Mortgage. Credit secured by equity in the borrower's home that is in excess of a first mortgage lien.

Secured Credit. Credit secured by collateral.

Security Agreement. A document stating that the creditor can take possession of the collateral under certain circumstances.

Service Fee. A flat percentage of the insurance premium that is paid to the producer as compensation for the administrative services provided by the producer. Also called *service expense reimbursement* and *administrative expense allowance*.

Single Interest Coverage. Coverage that protects the creditor's interest only.

Single Life Coverage. Credit-related insurance that provides protection on only one life, that of the primary borrower. The term "life" does not imply life insurance, just one insured.

Single Payment Credit. Credit where the only payment due is on the maturity date of the credit. Also called *level credit*.

Single Premium (Insurance). Protection that is purchased with a single payment at the inception of the insurance.

Single Premium Decreasing Gross Coverage. Credit life insurance insuring the gross indebtedness, paid for with one premium that is charged at the inception of the insurance. The amount of insurance decreases each month by the amount of one monthly payment, commonly used for closed-end installment credit.

Single Premium Decreasing Net (or Net Payoff) Coverage. Credit life insurance insuring the net indebtedness, paid for with one premium that is charged at the inception of the insurance. The benefit is equal to the scheduled outstanding net indebtedness, commonly used for variable interest rate installment credit, for long-term credit, and where mandated by law or regulation.

Single Premium Level Gross Coverage. Credit life insurance insuring the gross indebtedness on single payment credit, paid for with one premium that is charged at the inception of the insurance.

Six-and-Six Exclusion. A disability is not covered if the insured becomes disabled from a pre-existing condition within six months after the effective date, if any treatment for that pre-existing condition occurred within the six months prior to the effective date.

(Rolling) Six-and-Six Exclusion. In credit life and disability insurance on open-end credit, an advance is not insured if the insured dies or becomes disabled within six months after an advance, if any treatment for that pre-existing condition occurred within the six months prior to the advance.

Skip and Confiscation Coverage. Coverage to protect a creditor against a loss due to the disappearance of the borrower with the collateral and subsequent default on the credit or the collateral being confiscated by a public authority and subsequent default on the credit.

Specialty Lines Insurer. Insurers who provide specialized insurance products, such as credit property insurance. Also called a *specialty insurer*.

Statutory Accounting Principles (SAP). Accounting principles, embodied in state statutes, that are the basis of the statutory financial statements filed annually with the state insurance departments by all insurance companies.

Stop Loss. A clause in an insurance policy that limits the insurer’s loss to a specified dollar amount or to a specified loss ratio.

Straight-Line Earning Basis. See *pro rata unearned premium.*

Stream of Payments. In a lease transaction, the monthly lease payments coming due during the term of the lease.

Surcharge. An increase in the premium rate where the insured has certain characteristics that pose a higher level of risk than the standard risk.

Telemarketing. Direct response marketing where consumer products are offered directly to consumers via the telephone.

Termination Date. The last day insurance is scheduled to be in force.

Term of Insurance. The length of time insurance is scheduled to be in force, normally expressed in months.

Third Party Administrator (TPA). A service corporation that performs administrative functions that are normally done by the insurer in accordance with a written service agreement.

Titled Property. Property in which the ownership is evidenced by a written document referred to as the title. Examples include real property and automobiles.

Title Insurance. Insurance protecting the insured against any loss caused by defects of title to real estate, where the insured has an interest as owner, mortgagee, or otherwise.

Total Amount Advanced. The principal plus the insurance premium on installment credit.

Total and Permanent Disability. A disability meeting the "any occupation" disability test that is expected to continue for life.

(Lump Sum) Total and Permanent Disability Benefit. A disability benefit that is paid in a single sum once the total and permanent definition of disability is satisfied.

Total Loss. A claim where the cost to repair an item is more than its actual cash value.

Truncated Coverage. Any credit-related insurance product in which the term of insurance is less than the term of the credit.

Truncated Disability Coverage. Credit disability insurance with a term of insurance shorter than the term of the credit. Disability benefits terminate when the insurance terminates.

Truncated Life Coverage. Credit life insurance with a term of insurance shorter than the term of the credit.

Unaccrued Benefit. A monthly indemnity benefit that may be earned after the accounting date on a loss that has occurred prior to the accounting date under disability and involuntary unemployment insurance.

Unbundled Product. A credit-related insurance product that is offered individually rather than as a bundled (or packaged) product.

Underwriting. In ordinary life and P&C insurance, the process of obtaining information from an applicant for insurance and determining whether the applicant qualifies as a standard risk, qualifies for discounts, must pay additional surcharges, or is declined.

Underwriting Condition. A requirement an applicant for an insurance policy must meet in order to qualify to purchase the insurance.

Underwriting Criteria. See *underwriting condition*.

Underwriting Question. A question used to determine whether an applicant for insurance fulfills an underwriting condition.

Underwriting Statement. A representation signed by the borrower regarding the borrower's prior and current health condition.

Unearned (Gross) Premium. The portion of the original gross premium that represents the value of the unexpired insurance. The portion can be determined using a number of methods, including the Rule of 78, Pro Rata, or the Rule of Anticipation.

Unearned Premium Reserve. A liability of an insurance company representing the portion of the original gross premium that has not yet been exposed to loss. It equals the unearned (gross) premium.

Uni-Age Premium Rate. A premium rate that is the same for all issue ages.

Uniform Decreasing Term Life Insurance. Term life insurance where the amount of insurance decreases by an equal amount each month during the term of the policy.

Unisex Premium Rate. A premium rate that is the same for both sexes.

Unsecured Credit. Credit extended solely on the borrower's promise to repay.

Upward Deviation. A premium rate in excess of the state's prima facie rate.

Variable Reference. An item that is left blank when a policy form is filed with a state insurance department. The variable item may include maximum term, maximum amount, and maximum age.

Vehicle Service Contract (VSC), or Extended Service Contract. A contract, typically offered by an automobile dealer to a customer, that extends many of the provisions of the automobile manufacturer's warranty for a period of time beyond the expiration date of the automobile manufacturer's warranty.

Voluntary Termination (of Credit). Repayment of credit prior to the scheduled maturity date.

Waiting Period. See *elimination period*.

Written Premiums. Gross premiums collected from the insureds on new insurance less the premium refunds paid to those who terminate insurance prior to maturity.

Zone Determination. A review of the physical position and geographical location of a property to determine if the property is susceptible to flooding. In flood insurance, the determination is whether the property is in a Special Flood Hazard Area.

Abbreviations

Common abbreviations used in credit-related insurance.

A&H	Accident and Health (Insurance)
ACV	Actual Cash Value
AD&D	Accidental Death and Dismemberment (Insurance)
APR	Annual Percentage Rate
CCIA	Consumer Credit Insurance Association
CCS	Claims in Course of Settlement
CPI	Collateral Protection Insurance
DCC	Debt Cancellation Contract
ESC	Extended Service Contract
F&I	Finance and Insurance
FNMA	Federal National Mortgage Association
GAAP	Generally Accepted Accounting Principles
IBNR	Incurred But Not Reported
ICOS	Claims in Course of Settlement
IU	Involuntary Unemployment
IUI	Involuntary Unemployment Insurance
MOB	Monthly Outstanding Balance
MSRP	Manufacturer's Suggested Retail Price
NADA	National Automobile Dealers Association
NFI	Non-Filing Insurance
NFIP	National Flood Insurance Plan
OB	Outstanding Balance
P&C	Property and Casualty
POS	Point of Sale
ROE	Return on Equity
SAP	Statutory Accounting Principles
SFHA	Special Flood Hazard Area
TPA	Third Party Administrator
VSC	Vehicle Service Contract

Index

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About CREDITRE

CREDITRE provides actuarial, accounting, and management consulting services to insurers and reinsurers underwriting credit-related insurance products and offers high quality training materials and seminars about these insurance products.

Its goal is to provide services that enhance the availability of credit-related insurance products. The central focus is providing assistance and training to the home office staffs of the insurers offering these products. In addition, it assists the producers through direct advice to the producers and management services to producer-owned reinsurance companies.

The consulting practice is specialized and is limited to credit and mortgage insurance products. We consult on a broad range of topics. Over the last few years, the consulting can be summarized into the following general categories:

- Valuation of blocks of credit-related insurance. We have prepared valuations for more than thirty credit-related insurance blocks since 1990 and have participated in over twenty acquisitions or mergers in the industry.
- Product development, product pricing, and policy filing assistance. Most of our work has been involved with open-end disability, involuntary unemployment, and family leave products. We prepare actuarial memoranda that are included in the policy filing packages and support the requested rates. We have participated in the development of a number of debt cancellation contracts.
- Expert testimony and arbitration. We have participated in over thirty court cases, providing consultation and expert testimony. We have represented the industry at a number of regulatory hearings. In reinsurance arbitrations, we have served as an expert witness and as an arbiter.