Credit Insurance: Abuse and Reform

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CREDIT INSURANCE: ABUSE AND REFORM

INTRODUCTION

Credit insurance insures the health or life of a debtor for the amount of credit which he has obtained. Under a credit insurance policy the beneficiary is the creditor and, upon the death or disablement of the insured, the proceeds accrue automatically to the creditor completely discharging the debtor’s outstanding obligation. Today, in the United States, credit insurance covers nearly 85 percent of the total installment consumer credit, and is used by various kinds of creditors in every area of commercial indebtedness.

This comment will discuss the use, abuse and proposed reform of credit insurance. First, it will present a brief history of the commercial and judicial development of credit insurance. Second, it will describe and evaluate the propriety of certain credit insurance practices. Third, it will describe the

1 Credit life insurance repays the total amount of the outstanding debt in the event of the debtor’s death, while accident and health insurance pays the installment payments which become due while the debtor is disabled. There are several other forms of insurance, less frequently used, which fall in the general category of credit insurance. Property insurance can be used to provide a lender with immediate money in the event that the insured property is destroyed. Liability insurance may likewise secure property by covering the risk of liability arising out of the ownership or use of such property. Although a recent model state bill, the Uniform Consumer Credit Code, CCH Instal. Credit Guide, Uniform Consumer Credit Code, Final Draft, §§ 4.301-04 (Aug. 19, 1968) [hereinafter cited as the U.C.C.C.) contains provisions dealing with credit property and liability insurance (U.C.C.C. §§ 4.301-04), state legislators have generally felt that these forms are too seldom used to merit specific legislative regulation. Since credit life and credit accident and health have by far the largest use, and since concepts applicable to one form are generally applicable to all others, this comment will treat credit life insurance and credit accident and health insurance exclusively.


3 Hearings on the Consumer Credit Industry Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary, 90th Cong., 1st Sess., pt.1, at 2 (1967). The meteoric growth of credit and credit insurance since the end of World War II is evidenced by these statistics:

<table>
<thead>
<tr>
<th>END OF YEAR</th>
<th>CREDIT LIFE INSURANCE</th>
<th>CONSUMER CREDIT</th>
<th>% COVERED BY CREDIT LIFE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1945</td>
<td>365</td>
<td>2,462</td>
<td>15.0</td>
</tr>
<tr>
<td>1956</td>
<td>17,098</td>
<td>31,720</td>
<td>54.0</td>
</tr>
<tr>
<td>1962</td>
<td>36,011</td>
<td>48,243</td>
<td>79.0</td>
</tr>
</tbody>
</table>


Individual credit life insurance was first undertaken in 1917. At the end of that year there were 1000 policies in force covering less than one million dollars. In 1926 group credit life insurance was initiated and at the end of that year there were 500 master policies covering 4000 certificates and $500,000 of insurance. At the end of 1956 credit life insurance in force totalled 69 billion. . . .


4 E.g., commercial banks, sales and consumer finance companies, credit unions and retail stores. See Kedzie, Present Status, Characteristics and Trends, 1957 Ins. L.J. 334, 335.

major credit insurance reformers and analyze their proposed reform legislation. Fourth, it will suggest additional measures to cope with corrupt practices untouched or inadequately dealt with by such reforms.

I. COMMERCIAL AND JUDICIAL DEVELOPMENT OF CREDIT INSURANCE

A. Commercial Development

The emergence of mass production as the process used in American manufacturing created the possibility that the standard of living in the United States would rise to unprecedented heights. However, the full realization of the benefits of mass production requires the ability of the public to mass consume. In its first years, the undeveloped credit industry, preferring to secure its credit transactions with valuable property and large bank accounts, served exclusively the wealthy, and left vast, steadily-employed masses of potential consumers without credit. Gradually the credit industry began to cultivate the mass credit needed for mass consumption. Credit insurance played a key role in the extension of such credit.

Credit insurance appeared as a logical device to counterbalance the supposed risks of granting credit to otherwise unsecured borrowers. In the creditor's eyes, the low income worker has only one asset, his ability to earn enough money to repay loans made to him. This asset may be terminated by the worker's death or may be suspended upon accident or illness, with no other asset left to satisfy the lender's demand for repayment. The virtue of credit insurance is that in the event of the debtor's death or inability to work it creates another asset, the proceeds from the insurance policy, which automatically accrue to the creditor. Employment of credit insurance gives the borrower confidence that his debt will not survive his death or extend beyond his health to plague his family. From the lender's viewpoint, it provides expedient repayment without resort to the unpopular practice of hounding the debtor's family.

B. Judicial Development

The credit insurance issue first considered by the courts was whether a lender could require a prospective borrower to purchase credit insurance and, as a corollary, could deny him credit if he refused to do so. In the nineteenth century, possibly because of the extremely limited use of credit insurance, few courts were faced with this question. All courts that were, however, held required credit insurance illegal. The rationale of the courts was that such insurance was a lender's device to obtain interest beyond the percentage allowed by statute. As one court analyzed it, the loan of money and the sale of insurance were inextricably bound together in one and the same transaction.

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7 See id. at 330.
8 See id. at 334.
10 The common holding was that receipt of a premium for required credit life insurance was receipt of "additional interest." Cade, The Fundamental Issues of Consumer Credit Insurance, 1955 Ins. L.J. 76, 80.
11 See National Life Ins. Co. v. Harvey, 7 F. 805 (8th Cir. 1881).
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As the United States developed its highly industrial economy, credit buying became more necessary and consequently more prevalent. Courts rejected their original analysis of credit insurance, made a distinction between "interest" and money paid to obtain an insurance policy as security for a loan, and upheld the legality of the insurance requirement so long as the premium charge and amount of coverage were reasonable.

The courts were not prepared to condone required credit insurance as a means to increase the lender's profit. They made it clear that they were legitimizing credit insurance only in its use "as further security for the loan." As stated by one court: "In determining whether the insurance requirement is usurious or not, the test is whether the insurance is reasonably necessary to secure the loan." Thus the judicial guideline for the valid use of credit insurance became the purpose of that use by the lender. The bona fide purpose of achieving improved security was approved; the purpose of mere increased compensation for the use of money was disapproved. This rationale will be referred to as the "better security" test.

The next questions considered by the courts were whether small-loan laws permitted the lender to charge the borrower for credit insurance in addition to the highest legal interest rate, and, if so, whether the lender could retain part of the premium as profit. By 1954, 43 states had enacted small-loan laws, 30 of which included a section similar to one enacted in New Jersey providing that "[i]n addition to the interest herein provided for no further or other charge or amount for any examination, service, brokerage, commission, expense, fee, or bonus or other thing or otherwise shall be directly

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12 Social and economic demands in the present era have made it practically imperative for the individual and business houses to borrow, and for the banks and investment institutions to loan in small and large amounts, as well as manufacturers and builders to extend credit on the product they sell.

13 See Union Cent. Life Ins. Co. v. Hilliard, 63 Ohio St. 478, 494, 59 N.E. 230, 233 (1900); see Friedman v. Wisconsin Acceptance Corp., 192 Wis. 58, 210 N.W. 831 (1926). A presumption has even developed that the charge is reasonable. "[O]ne who would attack the bona fides of such transactions must allege and prove that the insurance was taken out for the purpose of exacting usury ...." Heaberlin v. Jefferson Standard Life Ins. Co., 114 W. Va. 198, 203, 171 S.E. 419, 421 (1933).

14 The general rule is that a lender may require the borrower, as further security for the loan, to carry insurance and assign the policy to the lender without rendering the transaction usurious." Winter v. Murdock Acceptance Corp., 246 Miss. 698, 706, 149 So. 2d 516, 518 (1963); Equitable Life Assurance Soc'y v. Scali, 75 Ill. App. 2d 255, 220 N.E.2d 893 (1966).

15 Equitable Life Assurance Soc'y v. Scali, 75 Ill. App. 2d 255, 261, 220 N.E.2d 893, 896 (1966). Credit insurance is allowed "where the contract is entered into in good faith and where the evidence does not disclose the exaction of a higher premium than what is usual and customary ...." Friedman v. Wisconsin Acceptance Corp., 192 Wis. 58, 60, 210 N.W. 831, 832 (1926).

16 By the weight of authority, required credit insurance is permitted, "provided that the requirement is not imposed as a means of increasing the compensation for the use of money but for the bona fide purpose of obtaining better security." F. Hubachek, Annotations on Small Loan Laws 165-67 (1938).

or indirectly charged, contracted for, or received. . ." While this language seems clearly to prohibit the practice of charging the borrower for insurance apart from the interest charge, a minority of state courts dealing with similar language permitted lenders to sell and charge separately for credit insurance. Though the minority view seems clearly erroneous, today the question in many states is moot as a result of recent amendments to the statutes. Yielding to the pressure of the small loan industry, most states now allow creditors not only to sell credit insurance but also to profit from the transaction.

Since the lender neither owns nor contributes value to the credit insurance \( (i.e., \) security\( ) \), lender's profit cannot be deemed a cost of the new security. Hence it is submitted that the legislative authorization of lender's profit from the credit insurance transaction conflicts with the "better security" test. By adopting the position that a premium rate may be "reasonable" despite the fact that it contains an element that adds nothing to the lender's security, legislators have failed either to accept or to apply the "better security" test. It is submitted that this test is valid and it will be applied to all major credit insurance practices discussed in the next section.

C. Credit Insurance Today

The size and influence of credit insurance has grown enormously in recent years. Projections for the future are that the demand for credit security will continue to grow and thus assure the commensurate growth of credit insurance. With the expansion of credit insurance it is not surprising that, because of its natural virtues, it has gained widespread popularity. Unfortunately, its popularity has had deleterious side effects. Fortified by the

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19 The states were Arizona, Florida, New Mexico, Kentucky, Oklahoma, Utah, Virginia and West Virginia. Mors, Small-Loan Laws and Credit Insurance, 1954 Ins. L.J. 778, 784, 792. A minority state court underlined the classic distinction between the insurance transaction and the loan transaction, and determined that the premium was received as part of the defendant's insurance business and not in the course of its lending business. Consequently it held such a practice outside the interdicted class. Median v. Madison Fin. Co., 130 N.J.L. 140, 143-44, 31 A.2d 485, 487 (Sup. Ct. 1943), aff'd, 131 N.J.L. 160, 35 A.2d 714 (Ct. Err. & App. 1944).
20 A New Hampshire court gave the rationale of this minority interpretation. "In fair and practical analysis the requirement of insurance was for additional security. . . . The expense of obtaining the insurance was not an expense of making or securing the loan itself. It was the cost of the new security." Auto Owner's Fin. Co. v. Coleman, 89 N.H. 356, 357, 199 A. 365, 366 (1938).
21 Id. at 357, 199 A. 365, 366 (1938).
22 The premium or cost of such insurance when issued through any creditor shall not be deemed interest . . . and any benefit or return or other gain or advantage to the creditor arising out of the sale or provision of such insurance shall not be deemed a violation of any other law . . . . The insurance premium or other identifiable charge for such insurance may be collected from the insured or included in the finance charge or principal. . . .
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general popularity of credit insurance,24 small loan lenders have lobbied effectively to keep state legislatures from enacting strict regulations to eliminate abusive practices arising in the credit insurance industry.25 Moreover, as noted above, they have managed to secure an amendment to the small loan laws to allow lenders to profit legally from the sale of credit insurance.

Today a reform movement has arisen with the purpose of destroying the unquestioning confidence in credit insurance, and of convincing legislatures that the industry is corrupt and therefore needful of strict governmental regulation.

II. Abuses

There is no consensus as to what group caused the upsurge of inequitable methods in the credit insurance industry. Although some blame the small loan people exclusively,26 it is possible that abuses existed in the industry long before the rise of the small loan institutions.27 Regardless of the source of abuse, it is apparent that the unprecedented growth of credit insurance and subsequent recognition of clearly dishonest practices have now combined to attract public attention.28 While Congress is conducting hearings to determine the necessity of federal regulation of the credit insurance industry,29 two nationally prominent groups have already proposed uniform state legislation for this area. As a basis for the subsequent discussion of this

26 "All available evidence indicates that the area of abuse is largely confined to the field of small-loan lending." The assertion is grounded in the alleged "undeniable historical fact" that the unscrupulous lender, affected by statutory crack-downs on the brokerage plan, immediately entered the credit insurance industry. See Cade, The Fundamental Issues of Consumer Credit Insurance, 1955 Ins. L.J. 76, 78.
27 Conceding the impact of the small loan types, the writer feels that the often repeated sentiment that credit insurance was very beneficial to the borrower may have unconsciously induced its seller to feel justified in raising its price well above the cost-plus-ordinary-profit level. Since awareness of abuse is not always coextensive with the existence of such abuse, the absence of complaint before the small loan lenders turned to credit insurance does not establish the absence of abuse in previous credit insurance operations. Since there are no statistics available from this period, the writer's feeling that inequitable methods may not be solely attributable to small loan types is based exclusively on a skepticism that businessmen unregulated could deal with a captive market and small borrowers without some degree of profiteering.
28 "We have observed a rising tide of public indignation against this type of insurance... I believe these practices have become so widespread that they should be dealt with as an industry problem." Vol. I, 1949 Proceedings, National Association of Insurance Commissioners 20. Hearings on the Consumer Credit Industry Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary, 90th Cong., 1st Sess., pt. 1, at 2 (1967).

To call this the "Age of the Consumer" may be a little premature, but certainly the fact that more consumer-oriented legal writing has appeared in the past five years than in any such prior period reflects an emphasis in this area. E.g., Symposium on Consumer Protection, 64 Mich. L. Rev. 1197 (1966); Consumer Credit: A Symposium, 8 B.C. Ind. & Com. L. Rev. 387 (1967); Consumer Protection: Symposium, 29 Ohio St. L.J. (1968).
model state legislation, this section will present both practices dealt with
and practices ignored by such legislation. Each category of practices will be
described in detail and evaluated in terms of the “better security” test
described above.

A. Practices Sought to be Eliminated by Legislation

The first five practices are so generally deemed abusive that both the
lending companies and the industry-oriented organizations have proposed
corrective measures which have already been adopted by some state legis-
latures. 30

1. Amount.—Predictably, the practice most readily deemed abusive is that of
insuring the life or health of a debtor in excess of the outstanding indebtedness.
As noted above, the justification for requiring a person to purchase credit insur-
ance is to cover the risk of monetary loss upon the debtor’s death or in-
capacity. Since the risk of loss is measured by the amount of outstanding loan
plus interest on the principal, the lender has no right to require the debtor to
purchase insurance in excess of this amount.

There are three basic methods by which a creditor can over-insure his
debtor. First, he can simply require his customer to purchase a policy for an
amount in excess of the total amount of original indebtedness. Second, he
can provide a policy of level term insurance in an amount equal to the
original indebtedness. 32 This practice is equitable if the debtor is not required
to repay the debt until the end of the term. But if, as is usually the case, the
debtor repays in installments at various periods, the debtor will be overinsured
by an amount equal to the difference between the original loan and the
balance of the loan. Third, if the debtor feels that he will be unable to repay
the debt by the due date, he may seek to refinance or renew his loan. The
debtor is in a weak bargaining position, especially when failure to make the
due payment would mean forfeiture of a chattel, for example an automobile
or a television. With the debtor in a compromised position, the creditor often
requires a new insurance policy to cover the extended period of indebtedness
while at the same time he leaves the old policy in force. 33 The two policies
naturally insure the debtor for an amount substantially larger than the out-
standing debt. While any one of the above-mentioned practices results in
inequitable charges, absent regulation, there is no reason why two and some-
times all three may not be employed to compound the detriment of the debtor.

2. Term.—The practice of extending insurance coverage beyond the term of
the debt is a variation on the excessive-amount abuse described above. The
gravamen is again that the creditor has no direct claim to the money which he

30 NAIC, Model Bill for the Regulation of Credit Life and Credit Accident and
Health Insurance. Vol. I, 1958 Proceedings, National Association of Insurance Commis-
Insurance Commissioners 127-28.


32 Hearings on the Consumer Credit Industry Before the Subcomm. on Antitrust
and Monopoly of the Senate Comm. on the Judiciary, 90th Cong., 1st Sess., pt. 1, at
63 (1967).

33 Id.
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could receive as beneficiary under the policy. When the risk of default is no longer present because the debt has been satisfied, the creditor's insurable interest in the debtor is extinguished.

Coverage beyond the term of indebtedness can arise in two ways. First, the creditor may, for example, simply issue a two-year policy to cover an indebtedness due to be repaid in one year. The second method is slightly more subtle. If the debtor repays the loan before the due date, the creditor should refund that portion of the insurance premium covering the remaining months of indebtedness. If he fail to do so, the debtor is paying for insurance that the creditor has no right to demand.

3. Non-Disclosure.—Disclosure in this context is the communication by the lender or insurer to the debtor of material facts about the insurance policy which are particularly within the knowledge of the lender. Non-disclosure itself is not harmful to the debtor if the creditor is not employing abusive practices. However, the assumption of disclosure laws is that, if the debtor does not know the particulars of the insurance contract, the possibility is increased that other abuses will develop. Non-disclosure is an abuse because concealment of relevant facts from the debtor, who is in no position to obtain them elsewhere, allows the creditor more easily to perpetrate other abuses.

4. Requirement That the Credit Insurance be Purchased Through the Lender.—Many lenders are themselves either authorized to operate an insurance business or are connected with an insurance company as its affiliate, financial dependent or subsidiary. If, beyond making a proper demand that the borrower obtain insurance as security, the lender demands also, as a condition precedent to granting the loan, that the debtor purchase such insurance at the lender's insurance company, the creditor receives an indirect gain at the expense of the borrower and through a requirement that in no way increases the security for the loan. This gain is undeserved because it does not compensate risk undertaken, service rendered or expenditure made in favor of the debtor, but rather results from the creditor's exploitation of a superior bargaining position. Since insurance from any state-authorized insurance company can ordinarily provide protection equal to that provided by the lender's insurance company, the lender's interest in preventing a loss does not justify the further demand that the purchase be made from an insurer of the lender's choosing. The creditor's only reason for making the second requirement is apparently to secure monetary gain, a reason which clearly does not justify this practice.

5. Reverse Competition.—Reverse competition, its causes and effects, are as follows. First, since the charge for insurance is such a minute part of the total amount of the loan, the debtor is not motivated to select his lender on the basis of a comparative study of insurance charges. Second, because the small borrower needs money much more than the lender needs the individual borrower's business, the lender has virtually a captive market. Consequently, the lender is in a position to dictate the choice of insurance coverages, premium rates, insurer

34 Id.
and agent. The lender has no interest in securing low premium rates because from this premium he takes his "lending agent's commission." Indeed, the larger the premium, the larger the commission the lender receives. Insurance companies compete with one another, not to provide the lowest premium rate for the borrower, as is the case with their regular customers, but to provide the largest commission to their lending agents. Naturally, the easiest way to increase the size of commissions is to raise premium rates. It is therefore clear why this competition, which forces rates up rather than down, is called "reverse competition."

Proposed corrections of reverse competition have generally concentrated on one or the other of its two aspects: premium rates and lender compensation. Disagreement on the proper solution to the problem of reverse competition is not merely one of tactics, however, for there is no consensus as to which aspect, high premium rates or lender compensation, is the "abuse" involved. These difficulties will be examined more fully in Section IV.

B. Practices Not Recognized by Legislation as Abusive

Unlike the preceding five practices, the next three have not been dealt with in a formal legislative proposal. Therefore, the following section will not only present the practices but will also suggest factors to be considered in attempts at correction.

1. Lender Receives Uncompensated "Loan" from the Borrower.—The creditor charges and receives from his debtor a lump sum to cover the entire cost of the insurance. However, creditors generally do not transfer this amount to the insurer in a single payment, but pay the insurance companies in monthly installments. The creditor's possession of such money, without having an obligation to pay it to anyone for a certain period of time, amounts to a loan from the borrower to his creditor. Creditors' use of borrowers' money without compensating them for it is an inequitable practice.

There are two possible methods of removing this inequity. First, the lender, whose business it is to know the value of money on time, could give the debtor a discount on the total premium charge not presently due the insurer. This practice would reduce the charge to the debtor to a level below the sum of the monthly premiums. Second, the creditor could be directed to forward the total premium charge directly to the insurer. The value to the insurer of possessing this money for the period in advance of its due date could be pre-calculated and applied to reduce the original premium charge.

The second method is more desirable because it avoids the inevitable administrative expenses of operation through a middleman, the lender. These

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34 Lender compensation refers to any money a lender receives in the course of the credit transaction in excess of his clerical cost of supplying such insurance to the borrower.
36 Id. at 548.
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expenses can only result in smaller discounts. Furthermore, the insurer's expense in recording the receipt of monthly premiums, undoubtedly higher than recording one lump payment, raises its total cost and produces higher premium rates.

2. Individual Form Insurance.—There are two forms of credit insurance, individual and group. Under the individual form, the credit insurance policy naming the lender as chief beneficiary is purchased by and delivered to the borrower. Under group form the lender purchases the master policy which provides coverage for all his borrowers. Generally each debtor pays the creditor a flat rate to cover his portion of the insurance premium and receives a certificate of insurance.

It has been long and unsuccessfully argued that individual form insurance should be outlawed on the grounds that it is much more expensive than group while it provides no better security for the lender. A congressional report analyzed the difference between the two forms:

[W]here ... group credit insurance is employed, the source of extra profit to the lender is so modest as to afford little temptation. ... Conversely, however, where the individual policy of credit insurance is sold, the policy is paid for by the borrower. A commission is paid to the seller. ... This situation places temptations before the unethical lender which too often are irresistible.

A 1964 national survey indicates that, on the average, debtors were charged 53.7¢ per hundred dollars of debt insured per year for group form while individual form insurance cost debtors 110.9¢ for the same coverage.

42 There are two kinds of group insurance. The most widely used kind is contributory group under which the borrower or debtor pays for his share of the insurance premium. The less common type is noncontributory group under which the lender or creditor pays for the entire premium. Hearings on the Consumer Credit Industry Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary, 90th Cong., 1st Sess., pt. 1 [containing Staff of Senate Comm. on the Judiciary, 83rd Cong., 2d Sess., Report on the Tie-in Sale of Credit Insurance in Connection With Small-Loans and Other Transactions (Comm. Print 1955)] at 232-33.
45 Vol. II, 1964 Proceedings, National Association of Insurance Commissioners 478, 481. This conclusion was reached by use of two statistics: first, the total amount of benefits paid both for individual and for group policies, expressed in terms of a percentage of earned premiums; second, the total amount of benefits paid both for individual and for group policies, expressed in terms of the cost per $100 of coverage for a 12-month period. The two statistics were fitted into a simple equation to obtain the total cost of the premium per $100 per year.
Thus, when the lender is the original buyer of the credit insurance (group form) he pays less than half the rate paid by the borrower for individual form insurance. Furthermore, while the higher clerical costs of administering the individual form account for part of the difference in premium rates, the chief reason for the disparity between premiums was the fact that under group form lenders received 5.13¢ per hundred per year in commissions while under individual form lenders received 42.47¢ per hundred per year. Since individual insurance provides the lender with no better security than that provided by the less expensive group form, there seems to be no justification for requiring the borrower to purchase the more expensive form. Arguments that prohibition of the individual form of credit insurance would seriously affect the lender's profit and thereby discourage him from

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**GROUP**

Step 1

| total amount of benefits | 58.5% | 100% |
| total cost of benefits   | 31.4¢ | X¢ group premium per hundred per year |

Step 2

58.5% x X¢ = 100% x 31.4¢

Step 3

58.5X = 3140

Step 4

X = 3140 / 58.5

Step 5

X = 53.7¢ = group premium per $100 per year

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**INDIVIDUAL**

Step 1

| total amount of benefits | 30.2% | 100% |
| total cost of benefits   | 33.5¢ | X¢ individual premium per $100 per year |

Step 2

30.2% x X¢ = 100% x 33.5¢

Step 3

30.2 X = 3350

Step 4

X = 3350 / 30.2

Step 5

X = 110.9¢ individual premium per $100 per year


46 Id.

47 Id. Group Commissions comprised 9.9% of the total group premium. 9.9% x 53.7¢ = 5.3¢. Individual form commissions comprised 38.3% of the total group premium. 38.3% x 110.9¢ = 42.47¢.

entering the field, or that the lender should have the freedom to choose the form of insurance that he will require, are ill-directed. Required credit insurance is justified, not as a profit-making encouragement to lenders to use this device, but strictly as security for lenders.

A suggested remedy would require the insurance commissioner to set a single premium rate without regard to the form of the policy used (individual or group). The justification for this suggestion is that, if the commissioner authorizes different rates for individual and group forms, the lender will naturally choose the higher premium, the rate which affords him the highest commission. It is submitted that simple deletion of the sections currently authorizing individual form insurance from both bills discussed below would effectuate more directly the desired result. A compromise measure would require the lender to provide and disclose fully to the borrower the merits and costs of both group and individual form insurance. Under this plan the lender would obtain his needed security and the borrower would have the option of obtaining the benefit of lower cost insurance.

3. Secret Insurance.—The most recently criticized practice involves retailers who, in connection with revolving credit accounts, take out insurance policies on their customers and add the premium charges to their balances without consulting the customers. This practice combines several of the abuses discussed above, including both non-disclosure, which may hide excessive amounts of insurance for an over-long term, and a variation of the required purchase-through-lender.

III. Reformers and Reform Legislation

For the purpose of avoiding federal action in the field of credit insurance, two prominent national groups have proposed uniform legislation specifically to regulate the credit insurance industry. The first organization to formulate such legislation was the National Association of Insurance Commissioners (NAIC). In response to a 1955 Senate subcommittee report threatening federal action if states did not regulate effectively the credit insurance industry, the NAIC is a voluntary, cooperative organization of insurance commissioners from all the states with the announced objectives of establishing ways and means of fully protecting the interests of policyholders. Its recommendations “although advisory only have been responsible for a substantial amount of insurance regulations.” D. Kedzie, Consumer Credit Insurance 133 (1957).

To those individuals who abhor the thought of Federal interference with the business of insurance, who desire the continued regulation of the industry by the several States, the subcommittee has this final admonition:

. . . . The patience of the Federal Government with those who would abuse the good name of insurance some day may come to an end.

Hearings on the Consumer Credit Industry Before the Subcomm. on Antitrust and
the NAIC began to draft consumer credit legislation. The result was a Model Bill to Provide for the Regulation of Credit Life Insurance and Credit Accident and Health Insurance. Though many of the major independent insurance companies opposed it as too lenient, the majority of the commissioners felt that this proposal was an improvement, a workable bill with a chance of enactment. Within a year of its adoption by NAIC, the Model Bill or similar legislation was enacted into the insurance codes of 17 states; and by May 28, 1962 the Model Bill or similar legislation had been adopted in 31 states.

The second organization involved in credit insurance regulation is the National Conference of Commissioners on Uniform State Laws, author of the Uniform Commercial Code. This group, after four years and nine working drafts, approved a Final Draft of the Uniform Consumer Credit Code on July 30, 1968. Already the Code has gained the endorsement of the American Bar Association and will soon be presented to state legislatures.

The two legislative attempts bisect what the discussion of reverse competition revealed as actually a single integrated transaction consisting of three parties: the lender, the borrower and the insurer. The NAIC, as its title suggests, is primarily insurance-oriented. Historically, it has limited its rules, regulations and legislative proposals to insurance matters. Thus, it is not surprising that its credit insurance legislation proposes regulation of insurance companies alone. The Uniform Laws group, on the other hand, while not limited to any particular area of legislation, has focused on the debtor-credi tor relationship and, when treating the credit insurance industry, restricts its regulation to the debtor-creditor aspect.
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Though they propose legislation from different vantage points, the groups agree that credit insurance is beneficial to both lenders and debtors, that credit insurance may be required as a condition precedent to granting credit, and that credit insurance must be regulated to insure its "reasonable" use.

The relationship between the proposals of the two groups becomes clearer upon comparison of their various substantive provisions which, as noted above, are limited to the "agreed areas of abuse" described in Section II. More specifically, this section will evaluate how effectively the provisions prevent these abuses.

1. Amount of Insurance.—The Model Bill provides that the amount payable on the death or disability of the insured "shall at no time exceed the scheduled or actual amount of unpaid indebtedness, whichever is greater." The Code offers basically the same protection but relaxes the requirement for a retailer providing credit insurance in connection with a revolving charge account. Recognizing that the balances of revolving charge account debtors vary constantly, the Code requires that for such accounts retailers need only retain a "reasonable" relationship between the amount of the policy and the debt it secures.

The practice of refinancing loans which results in double coverage is also treated. The Model Bill provides: "If the indebtedness is discharged due to renewal or refinancing prior to the scheduled maturity date, the insurance in force shall be terminated before any new insurance may be issued. . . ." The Code language is to the same effect. As written, these sections afford satisfactory consumer protection from the abuse of over-insurance by prohibiting: (1) initial over-insurance, (2) duplicate insurance on refinanced loans and (3) over-insurance resulting from a change of the debtor's credit status or the nature of the debt.

U.C.C.C. § 4.102(3).

67 The Code recognizes that the creditor may require credit life, accident or health insurance, but provides that if he does, he is not permitted to make a separate charge to the debtor for such insurance. U.C.C.C. § 3.202(2)(b) for consumer loans; section 2.202(2)(b) for consumer credit sales. Instead the creditor must pay for the insurance out of the finance/service charge. (The term "finance charge" is used in connection with consumer loans while the term "service charge" is used in connection with consumer credit sales.) Section 3.201(1) establishes the maximum finance charge of consumer loans; section 2.201 establishes the service charge for consumer credit sales.

However, the creditor may make a separate charge for credit insurance (in addition to the finance or service charge) "if the insurance coverage is not a factor in the approval by the lender of the extension of credit, and this fact is clearly disclosed in writing to the debtor, and if . . . the debtor gives specific affirmative written indication of his desire to do so after written disclosure to him of the cost thereof." U.C.C.C. § 3.202(2)(b); § 2.202(2)(b) for consumer credit sales. The requirement that the debtor freely choose to pay for credit life, accident and health insurance before he is charged separately for it seems difficult to enforce because the lender can subtly but effectively influence the debtor's freedom of choice.

68 NAIC, Model Bill § 4A(1); B. Curran, supra note 65, at 330, 331.
69 U.C.C.C. § 4.202(2).
70 NAIC, Model Bill § 5; B. Curran, supra note 65, at 332.
71 "A creditor may not contract for . . . insurance which duplicates insurance . . . previously contracted for . . ." U.C.C.C. § 4.110(2).

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from level term insurance coverage of a loan whose balance is periodically decreased by installment payments.

2. Term of Insurance Policy.—Both drafts limit the terms of insurance coverage to the period of time for which the debt remains unpaid.\footnote{The term of such insurance shall not extend more than fifteen days beyond the scheduled maturity date. In all cases of termination prior to scheduled maturity, a refund shall be paid or credited as provided in Section 8.} Further, the Model Bill requires that the insurance policy or certificate indicate when the insurance coverage begins and when it ends.\footnote{NAIC, Model Bill § 6B; B. Curran, supra note 65, at 332-33.} These sections should be effective because they contain a clear definition of illegal practices and require that the insurer indicate his particular practice on the face of the policy. In such an open atmosphere lenders are not likely to attempt to contravene the statute.

3. Requirement That the Insurance be Purchased Through the Lender.—Under the Model Bill the borrower has the right "of furnishing the required amount of insurance through the existing policies of insurance owned or controlled by him or of procuring coverage through any [state authorized] insurer . . . ."\footnote{NAIC, Model Bill § 11; B. Curran, supra note 65, at 336.} but the lender has no obligation to inform him of this right. This provision is not effective. First, the burden placed upon the debtor to know and to demand his right is too great, for it is not realistic to expect the debtor to have knowledge of the credit insurance statute. Second, the lender who profits from the sale of credit insurance is not eager to inform the borrower of his right.\footnote{Cf. Comment, Consumer Credit Insurance, 55 Nw. U.L. Rev. 355, 361 (1960).}

The Code is curiously inconsistent regarding notice to the debtor of his right to provide other insurance. With respect to minor credit insurance types, credit property and credit liability insurance, the lender must furnish "a clear and specific statement . . . that the debtor may choose the person through which the insurance is to be obtained. . . ."\footnote{U.C.C.C. § 3.202(2)(a) for consumer loans; for consumer credit sales, U.C.C.C. § 2.202(2)(a).} By contrast, with respect to credit life and credit accident and health insurance, the lender is not required to disclose the option right.\footnote{U.C.C.C. § 3.202(2)(b) for consumer loans; for consumer credit sales, U.C.C.C. § 2.202(2)(b).} It is difficult to view this anomaly as other than a compromise.

The Code contains a further impediment to the debtor's exercise of his right to assign already existing policies or to procure the required insurance from a source other than the lender. Even if the debtor should know his right and, despite his poor bargaining position, have the confidence to attempt to exercise it, the creditor may "for reasonable cause decline the insurance provided by the debtor."\footnote{U.C.C.C. § 4.109.} Thus, the borrower who may have procured valid insurance independently must either capitulate and purchase from the lender, or seek his loan elsewhere. This limitation on the borrower's exercise of his right of choice should
be deleted from the Code. In addition, both the model bills should require
the creditor to inform the debtor of his right to furnish the required insurance
by means of existing policies or through a policy issued by any state-authorized
insurer.

4. Disclosure.—The disclosure sections reveal examples of how the Model Bill
and the Code divide the regulation of the credit insurance industry. The Model
Bill directs the insurance companies as to what they are to disclose, while the
Code does the same to creditors. Although both proposals recognize the
benefit to the debtor of disclosure of material facts regarding his insurance,
they differ in the amount of information deemed “material.” The Code merely
requires that the creditor send his borrower an individual policy or group
certificate and that, if insurance coverage is delayed for any reason, he notify
the borrower. The Model Bill requires insurers to disclose many more
details. The insurer must

set forth the name and home office address of the insurer, . . . the
premium of payment, . . . a description of the coverage including the
amount and term thereof, and any exceptions, limitations and
restrictions, and shall state that the benefits shall be paid to the
creditor to reduce or extinguish the unpaid indebtedness and, . . .
that any . . . excess shall be payable to a beneficiary, other than
the creditor, named by the debtor or to his estate.

With the addition of the borrower’s right to provide his own insurance
mentioned in the preceding subsection, the Model Bill provisions appear to be
sufficient. However, since the insurer may occasionally fail to supply these
details, and since the cost of supplying them is minimal, the Code should
require lenders to provide the same information. With both lender and in-

surer supplying this information, the borrower would have the best opportu-
nity to learn the facts pertinent to his insurance.

5. Reverse Competition.—The catalogue of credit insurance abuses in Section
II characterized premium rates and lender compensation as aspects of a larger
problem, reverse competition, and noted that suggested controls for reverse
competition have centered on one or the other of these aspects. Both the Model
Bill and the Code chose to ignore lender compensation and seek to control
reverse competition exclusively through premium rate regulation.

80 NAIC, Model Bill § 6B; B. Curran, supra note 65, at 332-33.
81 The Model Bill, while providing that the amount charged the debtor for any
credit insurance “shall not exceed the premiums charged by the Insurer, . . .” NAIC,
Model Bill § 8D; B. Curran, supra note 65, at 335, nowhere disapproves of the creditor’s
receipt or retention of a portion of this premium as a commission, service fee, expense
allowance, dividend, experience, rating refund or rate credit. Indeed, the Code explicitly
legitimizes lender compensation.

This Article does not require a creditor to grant a refund or credit to the
debtor if . . . (b) the creditor pays or accounts for premiums to the insurer in
amounts and at times determined by agreement between them; or (c) the
creditor receives directly or indirectly under any policy of insurance a gain or
advantage not prohibited by law.

U.C.C.C. § 4.108(2).
Premium rate regulation, under both the Code and the Model Bill, requires insurance companies to submit their forms and premium rate schedules to the state insurance commissioner (the Code's Administrator of Consumer Credit is not consulted), who may disapprove the form or schedule of premium rates "(a) if the benefits provided therein are not reasonable in relation to the premium charge . . . ." If the Commissioner disapproves of the form or schedule, the insurer may not issue insurance policies in the state.

Neither act enunciates the criteria which a Commissioner should consider in the determination of the "reasonableness" of the rates. In place of criteria, the NAIC has officially recommended that the Commissioner employ a 50 percent loss ratio test as the sole test or benchmark of reasonableness. A 50 percent loss ratio means that at least one-half of the total premium charge is used to pay claims. Under this test, a premium rate substantially in excess of twice the claims paid must be considered unreasonable. In practice, the standard is highly flexible; the benchmark established by the Commissioner is merely a prima facie rate, and companies whose claims are substantially higher than average may obtain a variance.

The 50 percent loss ratio is concrete and easy to apply but, because it is not the product of any certain factors or based on any articulated theory, the 50 percent figure must be deemed arbitrary. There appears to be no reason why it is preferred to 48 percent or 52 percent. It is an honest but arbitrary attempt to gauge reasonableness. Perhaps an arbitrary test is sometimes justifiable, for example if the consequences of the arbitrary test are immaterial or if there is no method to arrive at a more meaningful figure. In this situation, however, the

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82 NAIC, Model Bill § 7A; B. Curran, supra note 65, at 333; U.C.C.C. § 4.203.
83 NAIC, Model Bill § 7B; B. Curran, supra note 65, at 334; U.C.C.C. § 4.203(2).
84 NAIC, Model Bill § 7C; B. Curran, supra note 65, at 334; U.C.C.C. § 4.203(1)
(the creditor may not use a disapproved form).
85 Examples of such factors are lender's cost, insurer's cost and insurer's profit.
86 See Vol. I, 1961 Proceedings, National Association of Insurance Commissioners 298. In recent years there has been a movement within the NAIC to incorporate the 50% loss ratio into § 7B of the Model Bill. See Vol. II, 1960 Proceedings, National Association of Insurance Commissioners 478. To date, advocates of such a resolution have been unsuccessful.
88 For years there has been skepticism whether the "discretionary authority of this kind [given the Commissioner in the Model Bill] will be used with sufficient vigor to check profiteering in credit life insurance." Peters, How Should Credit Life Insurance Be Regulated, 1958 Ins. L.J. 529, 531. In 1964 an NAIC report confirmed these early suspicions. A two-year study conducted in states which had adopted the Model Bill and whose commissioners had supposedly adopted the 50% loss ratio test revealed that the individual loss ratio for life insurance was 30% and that for accident and health it was 32%. Vol. II, 1964 Proceedings, National Association of Insurance Commissioners 479, 482.

One reason why commissioners may not enforce rigorously the 50% loss ratio test is that they generally seek to promote more lending and insurance business in their states. Hearings on the Consumer Credit Industry Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary, 90th Cong., 1st Sess., pt. 1, at 166 (1967). Naturally, strict regulation works against this aim. Another reason is that commissioners are pressured by creditors and insurers to permit profitable rates and practices and, unfortunately, debtors can bring no corresponding pressure. Id.

Although this topic deserves as much scrutiny as any other possible abuse, the magnitude and complexity of the problem exceed the scope of this comment.
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consequences are material because the test permits lender compensation in opposition to the sole justification for credit insurance—adequate loan security.

The model provisions dealing with reverse competition attempt to control only premium rates. It is submitted that premium regulation alone cannot eliminate reverse competition. By limiting the size of the premium, rate regulation limits proportionately the size of the lender's compensation, but can never eliminate it. Since lender compensation is the root cause of reverse competition, any regulation such as premium regulation which does not deal effectively with lender compensation fails to eliminate reverse competition. Therefore, by its failure to eliminate the insurer's interest in an expanding premium to meet the lender's constant demand for a larger "commission," the Code and Model Bill fail to cope with reverse competition.

IV. UNCOMPLETED REFORM

The two sponsors of uniform legislation have failed to proceed beyond the areas of obvious abuse. In the areas in which they have sought reform, their proposed corrective measures are sometimes too narrow or misdirected. Consequently, the inherent evil of credit insurance, reverse competition, along with several other abuses, remains the source of excessive debtor charges. So long as the industry permits such conditions it openly invites federal action. Already a Senate subcommittee has commenced hearings in this area and has amassed voluminous materials relating to abusive credit insurance practices.

In light of this clear indication that Congress is dissatisfied with current state legislation in this matter, there are several steps that states must take in order to convince an increasingly consumer-conscious Congress that they are capable of eliminating present abuses. Some of these additional steps were listed in Section II B. Most of the steps were suggested in Section III as supplementary measures strengthening regulation already proposed in model state legislation. In this final section solutions are proposed for the most important abusive practices not yet recognized by model state legislation.

A. Scope of Credit Insurance Regulation

Beyond the problems of discovering and fashioning legislative corrections for the abusive practices discussed in the previous sections, further difficulties inhere in the determination of what credit insurance transactions and what

88 Mr. Dean Sharp, Assistant Counsel for the Senate Antitrust and Monopoly Subcommittee, has estimated that from 1959 to 1966 the public was overcharged $700 million. Hearings on the Consumer Credit Industry Before the Subcomm. on Antitrust and Monopoly of the Comm. on the Judiciary, 90th Cong., 1st Sess., pt. 1, [containing Hearings on Credit Insurance Before the Wisconsin Department of Insurance (1966)] at 530.

89 National insurance reports have shown that mere "limitation" on the size of the premium fails to eliminate the lender's capacity for and ability to obtain oversized "commissions" from the premium. Vol. I, 1961 Proceedings, National Association of Insurance Commissioners 296. It should be noted that in states which, by adopting the NAIC Model Bill, attempted to limit the size of the premium, the lenders received 38.3% of the total earned premiums as commissions. Vol. II, 1964 Proceedings, National Association of Insurance Commissioners 478.

credit insurance parties should be exempted from regulation. This subsection will consider four exceptions contained in the model legislation.

1. *Transactions Lasting Over 5-10 Years.*—The Code does not cover credit transactions in which a payment is scheduled more than ten years after extension of credit. The Model Bill does not cover credit transactions lasting over five years. These exceptions allow unscrupulous financers of mobile homes, home improvements and other types of consumer financing, beyond these periods, to charge excessive rate, fail to cancel or refund on repayment and double up on coverages. State legislatures seeking a comprehensive bill should omit these proposed exceptions and adopt the position that all credit insurance transactions should be regulated.

2. *Occasional Use.*—The Model Bill and Code both except from regulation isolated transactions of credit insurance engaged in by those not in the regular business of extending credit. The exception is unjustified because unusual costs resulting from the occasional nature of the business in question can be taken into account by the Commissioner in his determination of the valid premium rate for that particular case. State laws must eliminate this exception, for occasional abuses should no more be tolerated than frequent abuses.

3. *"Separate" Charge.*—The Code excepts from regulation lenders who do not make a "separate" insurance charge to the borrower. This exception produces inconsistent results not based on any difference in substance. If the lender sets out a figure representing the credit insurance charge in a separate place of the lending agreement, his loan is regulated; but if he adds the amount of his credit insurance charge to the amount of the interest charge, translates that sum back into a percentage and presents this percentage as the credit charge (one figure), it is not regulated.

The word "separate" may be interpreted as demanding a physical separation into two distinct figures, a meaning which allows lenders easily to avoid regulation. However, a court could reject this interpretation by looking to the substance and concluding that one-figure loans were also regulated by the credit insurance bill. In any event, the exceptions created by the "separate" language should be eliminated. Every credit insurance transaction should be regulated.

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91 NAIC, Model Bill § 2A(2); B. Curran, supra note 65, at 330; U.C.C.C. § 4.103(a).
93 NAIC, Model Bill § 2A(2); B. Curran, supra note 65, at 330; U.C.C.C. § 4.103(1)(b).
95 For example, a lender may advertise loans without credit life insurance at one rate, and loans with credit life insurance at an interest rate of ½ of 1% higher although the maximum premium rate for credit life insurance in that state for that lender is 44¢ per $100 of initial indebtedness. This seemingly harmless ½ of 1% gives the lender 50¢ per hundred (½ of 1% of $100 is 50¢, 6¢ in excess of the authorized charge.
96 Thus, where lenders offer loans at different rates depending on whether or not they include credit insurance, these loans would be regulated because the difference between the two rates would obviously be the charge for the credit insurance.
4. Administration.—The present proposals envisage two administrative officials, the Commissioner of Insurance and the Administrator of the Uniform Consumer Credit Code, neither of whom is empowered to regulate all aspects of the credit insurance industry. The arrangement is unsatisfactory. The credit insurance device has always required the cooperation of lenders and insurers. As devices to exact unjust profit from borrowers become more and more sophisticated, involving the interaction of several parties (lenders, insurers, lender-owned insurance companies), the need grows for an agency with industry-wide perspective to recognize, and corresponding power to correct, abusive practices and schemes.

A second reason for the inadequacy of the presently proposed arrangement is the likelihood of administrative overlap and conflict. Though the Code Administrator is subordinate to the Insurance Commissioner when the Commissioner is dealing with insurance companies, there are unsettled questions of jurisdiction in less clear-cut areas. For example, it remains uncertain whether the Administrator could disapprove a lender's use of an insurance program whose premium rate had been authorized by the Commissioner. Or, after noting an abuse in a lending institution, would the Commissioner have to remain idle while the Administrator takes no action in the matter?

Realistic reform must recognize credit insurance as the hybrid that it is. Thus, the lending transaction and the insurance transaction should be regulated by the same agency. Realistic treatment requires the amalgamation of the two proposed model agencies under either the Administrator or the Insurance Commissioner, or at least the creation of a small specialized agency independent of both the Administrator and the Commissioner.

Whichever plan is adopted, the administrator of credit insurance would have exclusive jurisdiction over both lenders and insurers connected with credit insurance. He would supervise the industry and, while enforcing the regulatory provisions, would pursue investigations to uncover newly developing abuses. The expertise which he would develop regarding the credit insurance industry would naturally exceed that obtained by officials with more general duties. His largest task would be the ongoing collection and analysis of data obtained from insurers and lenders. Given information of insurer's cost, lender's cost and insurer's profit, he would establish prima facie premium rates.

B. Reverse Competition

As noted in the discussion of reverse competition, lender compensation is the root cause of artificially inflated premium rates. If states are serious in their efforts to eliminate the latter, they must prohibit the former. A decision to prohibit lender compensation is justifiable on two grounds. First, as mentioned, lender compensation causes artificial premium costs which must be borne by the borrower. Second, though the term "lender compensation" sounds valid, in the context of credit insurance it refers to the money which a lender takes "in return" for demanding and receiving security for his loan.

97 See notes 65, 66 supra.
Ordinarily compensation refers to the amount paid a person for services rendered. Thus, "lender compensation" is no "compensation" at all, but a euphemism more accurately termed "lender profit."

It is urged that state legislatures implement regulation preventing lenders from profiting from a captive market transaction justifiable only for its security value to the lender. Borrowers should not pay more for credit insurance merely because they lack the bargaining position to demand and receive a fair price for their insurance. The means to eliminate reverse competition, and thereby to insure a fair insurance premium rate, is to prohibit "lender compensation." Rates established without reference to lender compensation would more closely approximate the fair market rate, the amount the borrower would pay if he purchased such coverage directly from the insurer in the open market, plus the lender's bona fide clerical expenses of providing the insurance.

Finally, these measures can be enacted and easily implemented. There is no abuse in the credit insurance industry of such a nature that only federal legislation can eliminate it. It remains to be seen whether the states will act in this matter to avoid impending federal legislation.

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