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Debt Cancellation: the preferred alternative to credit insurance

Debt Cancellation: the preferred alternative to credit insurance

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Credit insurance products offered by U.S. lenders have seen better days. Since the first policy was sold in 1917, credit insurance has been routinely offered in conjunction with consumer installment debt. For decades, credit insurance has also been offered to protect credit card balances. Over time, millions of people have purchased this optional protection from their lender.

Today, credit insurance is in the decline mode of its business life cycle. Lenders are abandoning their credit insurance product and no longer offering it on certain types of loans. Some find it difficult to keep pace with the myriad of changing insurance regulations. Others are frustrated with the resulting interstate inconsistencies in product, price, and eligibility provided to their customer base. Simply stated; the product is worn-out!

Many lenders are looking for an alternative to a credit insurance product. And they are finding one based on something called a debt cancellation agreement. What follows is a practical guide to understanding this growing alternative.

What is Debt Cancellation?

In simple terms, a debt cancellation agreement may do one or more of the following:

- cancel the debt or monthly payments
- defer payment on existing debt (typically referred to as debt deferment or debt suspension)

Most lenders in the U.S. are authorized to offer a debt cancellation agreement to the lending customer. The three basic components of any such agreement involve: amending the lending agreement, charging a fee, and canceling the debt upon death, disability, involuntary unemployment, or other defined life events.

You will find variations of debt cancellation, which are called debt "deferment" or debt "suspension". For this document, we will use the term "debt cancellation" to encompass the product variations of debt deferment, debt suspension and the like. While each program is different and terminology may vary somewhat, the end results of a given program are clear:

- If a lump sum benefit is provided, the outstanding balance is cancelled
- If a monthly benefit is provided, features may include: canceling the entire monthly payment, canceling only the interest for the month, or canceling the interest as well as reducing the principal loan balance.

Actual programs offered by today's lenders often use combinations of the above. Some programs forgive the outstanding balance while others forgive monthly payments for a period of time. Some programs defer a monthly payment requirement and stop accruing interest during the benefit period. With any type of debt cancellation agreement, the lender does not have to eliminate the entire debt — the lender may cancel a set amount, cancel a percentage, or cancel after a set period of time. While having many choices in product design may seem a bit overwhelming, it is what makes debt cancellation such an excellent alternative to credit insurance. Once a lender defines the product that makes sense for their lending situation and customer base, they can then offer a single, consistent product to all customers, in all places throughout the U.S.

To understand the simplicity of debt cancellation, it is helpful to compare it to traditional credit insurance products still offered today.

Credit Insurance	Debt Cancellation
3 party contract between lender, insurance company and borrower	2 party contract between an authorized lender and borrower
Insurance certificate conveys protection provided	Loan addendum conveys the debt cancellation agreement
Regulated by each state department of insurance	Regulated by the lenders governing body (the OCC for national banks, OTS for thrifts or NCUA for federal credit unions)
Some form of insurance license is required to sell in each state	No insurance license required to sell a debt cancellation agreement
No product flexibility. Benefits, price and more are defined by regulation and/or require state approval	Product is designed by the lender to provide benefits and price that customers will buy
Product benefits, price, eligibility and more will vary by state	A lender can offer one consistent product in all places it does business in the U.S.
Insurance product	Lending product – not insurance
Origin year was 1917	Origin year was 1964
Decline phase of business life cycle	Growth phase of business life cycle

While there are many differences between credit insurance and debt cancellation products, there are three important similarities. Like credit insurance, a debt cancellation agreement is offered to the customer as an option — this form of protection like credit insurance is optional and must be clearly disclosed as such. Further, debt cancellation agreements must abide by Regulation Z disclosure requirements. And finally, customers receiving benefits from either credit insurance or a debt cancellation agreement, should consult their tax advisor regarding federal and/or state tax implications of benefits.

As part of a lenders "information return reporting" or form 1099 requirement, you should find that for both credit life and disability benefits as well as debt cancellation benefits, do not require you to file a form 1099 for the benefit provided to your customer. A recently obtained Internal Revenue Service Private Letter Ruling stated that a lender was not required to issue form 1099's for the debt cancellation benefits provided to their customers. Your tax department should review this issue while establishing your tax reporting procedures for either credit insurance or debt cancellation benefits.

How did Debt Cancellation come about?

Debt cancellation agreements find their origin with the Office of the Comptroller of the Currency (OCC). It was March 1964 when the OCC issued what was eventually codified as regulation 12 C.F.R. 7.7495 stating:

> *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.*

Despite the newfound powers in 1964, little to no debt cancellation products were offered by banks until the late 1980's. It was 1986 when the market-place originated. That year, the state of Arkansas adopted a new credit insurance regulation that severely limited the compensation that could be paid to a bank. This prompted one bank, First National Bank of Eastern Arkansas, to offer debt cancellation agreements in an effort to restore its lost revenue and continue to serve its customers. The bank believed that the debt cancellation regulations would be less restrictive than the new credit insurance regulation and they advised the Arkansas Insurance Department of their intentions. The department sent a reply to the bank affirming that debt cancellation agreements would not be regulated by the insurance department, and therefore the bank began offering debt cancellation agreements to its lending customers.

Credit insurers did not like this event and the precedent it set. The industry leaders contacted the insurance department and argued that debt cancellation agreements were insurance products and should therefore be regulated as such. The department reversed its earlier ruling and advised the bank it would take action if it issued these agreements. The bank filed a lawsuit and won. Later, the Eight Circuit Court of Appeals upheld the local court decision that debt cancellation agreements are not insurance when issued by a national bank. Credit insurers continued the fight, yet the U.S. Supreme Court chose not to review the case, and the debt cancellation marketplace came to life.

With the end of the court battles, a few innovative lenders began launching debt cancellation agreements in the late 1980's and early 1990's. In the late 1990's the marketplace grew significantly. One example is credit card programs, where most top lenders have transitioned to the new product and today cards representing 82% of credit card receivables are offered some form of debt cancellation, suspension or deferment agreement.

The authority to issue these debt cancellation agreements is granted under federal law and supercedes state banking or insurance laws or regulations.

Regulations over the years have broadened the "life events" that may be considered in these agreements. In addition, on April 18, 2001, the OCC proposed to add to its regulations that address debt cancellation and debt suspension with a focus on facilitating a customer's informed choice and discouraging inappropriate or abusive sales practices.

Should you consider Debt Cancellation?

To determine if a debt cancellation product approach will be better for your organization and customer base, it is best to begin by taking an "inventory" of your current credit insurance program. Here are some questions to ask yourself:

Customer benefits:

1. Do you feel most customers are able to understand the product, benefits, and price of your credit insurance product?
2. Are you able to add more value and attract more customers with the current credit insurance offering?
3. Is your credit insurance product relevant to the life events people care about protecting today?

People issues:

1. Is employee turn-over making it difficult to keep your sales people properly licensed to sell credit insurance?
2. What percent of sales people are ineligible to offer and sell credit insurance?
3. How many customers were not offered credit insurance due to lack of an eligible sales person being available?
4. Are your sales people offering your credit insurance product 100% of the time to all customers?

Systems issues:

1. How much time and money is spent each year maintaining insurance rate tables, age edits, and benefit adjustments?
2. How much time and money does it cost to comply with new insurance regulations?

Compliance issues:

1. Is your current credit insurance program compliant?
2. How much time and money is spent to ensure the resulting products, rates, forms and insurance agent licensing required are in compliance at all lender locations and on all marketing, sales and training materials?
3. Are your sales and service people acting in a compliant manner with current insurance regulations?

Performance issues:

1. Have you seen lack of customer interest in your credit insurance product, or among your sales people?
2. Have sales measures been in decline?
3. What percent of customers with loans, credit lines and credit card accounts are electing the optional protection? What are the trends?

Change issues:

1. If you have built an infrastructure to support credit insurance products within your organization, are you willing to consider change?
2. What affect will change have on your people, processes and technology areas?

Making the transition to Debt Cancellation products

In designing your product, begin by thinking "What does my customer want and value?" Like credit insurance, serving the customer and paying off the promise of protection in a time of need remains a key to success. But unlike credit insurance, debt cancellation provides much more flexibility to meet those customer needs. Remember it is your product to build — review your lending business, loan products and customer base to determine which features and benefit options will work best. You can have benefit structures designed to protect all forms of consumer indebtedness.

With product design, it is important to focus on protecting certain "life events" that are relevant to your customer, the lending situation and within regulation. The resulting product may include benefits that cancel the debt upon loss of life, provide monthly benefits for short-term disability, or cancel the debt in the event of a total and permanent disability. You may elect to offer an involuntary unemployment benefit that cancels payments in the event of job loss.

The product design options can go on and on…including divorce-in-process protection as well as protection for the newly married that in either case defers payments for a period of time to ease the financial difficulties associated with these major "life events".

Dealing with the financial risk of Debt Cancellation

Financial risk with debt cancellation is greatly different than a traditional credit insurance program. Credit insurance is a three-party contract between the lender, the insurance company and the borrower. The insurance company most often takes the underwriting risk associated with such programs. Debt cancellation is a form of "self-insurance," a two-party agreement between the lender and the borrower. The lender has the risk of a customer experiencing a protected "life event" and defaulting on all or some portion of the intended loan re-payment.

A lender may choose to either:

- simply fulfill its obligation under the debt cancellation agreement, cancel the debt or monthly payment, and set up reserves for future benefits that will be activated under the debt cancellation agreement, or
- fulfill its obligation under the debt cancellation agreement as stated above, and then transfer all (or some) of the risk to an insurance company through a contractual liability insurance policy (CLP). This approach gets the benefit obligation off the lender's balance sheet since no reserving would be required.

It is recommended that lenders limit their risk associated with debt cancellation programs, especially if loan securitization is done or consistent earnings are desired. In some cases, regulatory directives will guide or even mandate the choice for a lender.

Selling your Debt Cancellation product

This is where the real excitement comes into play with debt cancellation. The opportunity to reach your customer base with ease and efficiency is greatly improved over credit insurance programs. Here are just a few examples of selling successes reported by lenders today:

- With an appropriate product design deployed, you will have a product that is relevant and more applicable to your lending situation. More customers will be interested in protecting their indebtedness with the optional debt cancellation type product over those who considered credit insurance.

- 100% of your sales people will be eligible to sell and you can choose to compensate them for selling—debt cancellation is like any loan product you may sell today and your compensation, rewards and recognition strategy should follow.
- If you use direct marketing to sell loans, credit cards and the optional protection — the once lengthy and complex credit insurance disclosure statement goes away. Your new debt cancellation disclosure will be made understandable and convey consistent, uniform protection and rates in all places you do business. With telemarketing, you should find the product is easier to convey over the telephone and your telemarketing people will not be required to hold an insurance license.
- Everyone involved from your salespeople to customers and from systems team to compliance team will like uniform and consistent product design and price for all places you do business. All will benefit from a straightforward and common disclosure of the debt cancellation product — the loan addendum or credit card agreement amendment. You will no longer have to store, or program and print different credit insurance forms and certificates for each state. You will see a reduction in the time and money it takes to manage your program.

Conclusion

Making the transition to a debt cancellation program is the key to re-invigorating your traditional credit insurance program and improving results.

The product is flexible; you control the features, benefits and pricing that will work best for your customers, differentiating yourself in the marketplace and creating value for your customers. You will reduce your compliance risk and substantially increase your opportunities to sell the optional program through various marketing channels, while decreasing the load on your compliance team. And your loans will be better protected, reducing costs from delinquency through charge-off.

Today's lenders will review the benefits of a debt cancellation approach and find it the preferred choice in consumer lending protection programs.

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