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# Consumer Credit Insurance--A Need for Regulation in Kentucky

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CONSUMER CREDIT INSURANCE—  
A NEED FOR REGULATION IN KENTUCKY

There is no effective regulatory scheme in Kentucky for controlling consumer credit insurance. The abusive sales practices employed by creditors and insurers as well as the percentage of premiums retained by insurers after benefits are paid points out the vital public need for such regulation. In a recent statistical study the Kentucky Department of Insurance reported that in 1965, consumer credit insurance sales in Kentucky produced \$10,689,574 in premium payments to insurers, of which less than forty-six per cent was returned in benefits.<sup>1</sup> The vast majority of the balance was profit. While there is no way of knowing how many policies were sold to unwilling buyers, it has been generally estimated that abusive selling and rating practices cost Kentucky debtors \$3,000,000 last year.<sup>2</sup>

There has been a rapid growth of consumer credit insurance with its accompanying abuses since World War II.<sup>3</sup> Some statutory regulation of consumer credit insurance sold in connection with consumer loans, small loans, and industrial loans exists;<sup>4</sup> however, these statutes primarily control the credit transaction and not the accompanying insurance sale. There are no competitive pressures in the credit insurance market to help control abusive practices, and the buyer has no influence on the seller because of the industry's peculiar nature.<sup>5</sup> Kentucky and other states have not enacted adequate controls for consumer credit insurance, or, for that matter, for other fields of insurance. Because of this failure, the Senate Judiciary Antitrust Subcommittee is presently holding hearings to determine if federal control of insurance should be initiated.<sup>6</sup>

Consumer credit insurance secures specific financial obligations, in-

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<sup>1</sup> KY. DEP'T OF INS., REPORT ON CREDIT INSURANCE 17 (1967) [hereinafter cited as KY. REPORT]. The percentage between the total premiums paid and benefits returned is called the "loss ratio". "Credit insurance is so complicated that the only reasonable gauge of its cost to insured's is the loss ratio." Sheehan, *Credit Insurance From the Policyholder's Point of View*, 16 DISSERTATION ABSTRACTS 892 (1956).

<sup>2</sup> Peterson, *Credit Life Insurance: Who Should Pay and How Much?*, Louisville Courier-Journal & Times, Sept. 10, 1967, § A, at 1, col. 3.

<sup>3</sup> Total credit life insurance sales increased from \$365,000,000 in 1945 to \$62,672,000,000 in 1966. THE INSTITUTE OF LIFE INSURANCE, THE LIFE INSURANCE FACT BOOK 31 (1967).

<sup>4</sup> KY. REV. STAT. §§ 291.480, 288.560 (1962) [hereinafter cited as KRS].

<sup>5</sup> See text at notes 32-34 *infra*.

<sup>6</sup> This same committee has previously investigated credit insurance. SUBCOMMITTEE ON ANTITRUST AND MONOPOLY LEGISLATION OF THE SENATE COMMITTEE 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) [hereinafter cited as KANSAS HEARINGS].

cluding cash loans and credit sales of goods and services.<sup>7</sup> against the debtor's inability to repay his debt due to disability or death.<sup>8</sup> The insurance serves a useful purpose for both creditor and debtor.<sup>9</sup> The creditor benefits by having his debt partially secured and by avoiding collections or repossessions with their accompanying bad public relations. Moreover, the sale of consumer credit insurance usually produces additional income for the creditor since he acts as a paid agent for the insurer. The debtor benefits by having his liability secured in the event he is unable to repay it because of death or disability.<sup>10</sup>

There are two types of consumer credit insurance. Term life insurance, called consumer credit life, is the most popular.<sup>11</sup> It is written for the amount of the debt and covers the period of repayment. The other type, consumer credit accident and health insurance, is less popular. In Kentucky it accounted for less than fifteen per cent of the total consumer credit premium earned during 1965.<sup>12</sup> Accident and health premiums are about twice as high as those charged for credit life. This is because claims occur more frequently, and the detection

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<sup>7</sup> It has been labeled "peace of mind insurance." H. BLACK, BUY NOW, PAY LATER 179 (1961). Consumer credit insurance was created by Arthur J. Morris in 1917, as a way of securing installment loans under his Morris Plan. See Morris, *The Origin of Credit Life Insurance*, 11 PERS. FIN. L. Q. REP. 129-133 (1957).

<sup>8</sup> Hereinafter "debt" will include borrower and buyer debt. At the end of 1965, 83% of all consumer installment debts were protected by credit life insurance. Presently consumer installment debts amount to \$63.6 billion; credit life insurance amounts to \$63 billion. The largest single type of installment credit is on the purchase of automobiles. Other types include personal loans, home improvements, consumer goods of all description, and a variety of other consumer installment credit. Banks account for approximately \$30 billion of the loans or 44%, while sales finance companies, credit unions, and consumer finance companies collectively issue another \$30 billion in credit. Retail outlets account for about \$8.2 billion. Picone, *Insurance Today*, J. COMMERCE, Feb. 16, 1967. See also THE INSTITUTE OF LIFE INSURANCE, *supra* note 3, at 31. The average size credit life policy in force in 1966 was \$890.

<sup>9</sup> Hereinafter the terms "creditor" and "debtor" will identify the parties to any non-commercial installment "debt" transaction. "Consumer credit insurance" is not to be confused with "credit insurance" bought by creditors as protection from merchantile loss through inability of commercial business debtors to pay their obligations. "Credit insurance" is never issued to retail creditors whose ultimate consumer is the debtor. "Credit insurance" is bought by the creditor for protection of his own assets, the same as he would buy fire insurance, "Consumer credit insurance" is bought for the retail installment debtor's protection from liability and is almost always paid for by the debtor. See 13 G. COUCH, *CYCLOPEDIA OF INSURANCE LAW* § 48.37 (2d ed. 1965).

<sup>10</sup> Over sixty per cent of balances unpaid at death are paid by the debtor's family. Dunbar, *Administrative Rate Fixing on Credit Life*, 14 PERS. FIN. L. Q. REP. 16 (1959).

<sup>11</sup> Consumer credit life insurance will hereinafter be called "credit life." "Regular life" insurance is all other life insurance except that sold in connection with a debt as security for default due to death. "Individual credit life" is that sold to the debtor as opposed to "group" coverage bought by the creditor.

<sup>12</sup> KY. REPORT 5.

of fraudulent disability claims requires expensive investigation.<sup>13</sup> Since the same general principles apply to both credit life and credit accident and health insurance, and the greater abuse is found in credit life because of its more prominent use, the remaining discussion will focus on credit life.

#### NATURE OF CREDIT LIFE

Credit life insurance policies are tailored to fit the specific needs of the creditor. In order to lower administrative costs, underwriting requirements are simplified and policy provisions are standardized. Adverse losses causing high premiums and administrative burdens are kept at a minimum by carefully excluding high risk debtors from coverage. Individuals known to be in poor health and certain classes of debtors, such as small loan debtors who have no other security, may be excluded by the policy. Most policies, whether group or individual, call for identification of the policy holder, vital statistics, date of loan, policy amount, premium amount, rate, name of creditor beneficiary, termination date, and such other information and limitations as are necessary or desirable to complete the contract.<sup>14</sup> Generally there is a minimum and maximum age limit, but the rate does not vary with age. Usually no medical examination is necessary, and many policies have no exclusionary limitations. Although most regular life policies will not closely approximate the variable and sometimes minimal amount of the debt, a special feature of credit life is that it can be written for just this amount. Furthermore, regular life is written for a longer period of time than the usual debt, though the regular term life policy may approximate the period of the debt. Credit life, however, terminates when the debt is liquidated.

Credit life may be level term coverage fixed at the amount of the original debt for the period of the debt. However, decreasing term coverage is more readily adaptable to installment repayment. Here the amount of insurance coverage automatically decreases as the balance of the debt is decreased by installment repayments, making the insurance equal to the unpaid loan balance at all times. When a debt is repaid by installments, the average debt outstanding over the installment period is fifty per cent of the original debt. Thus, the

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<sup>13</sup> To limit minor claims, consumer accident and health insurance is sold in two ways. One plan has a deductible initial period of time, often thirty days, after which the policy operates to assume the debt for the duration of the disability. The other plan pays retroactively for the total period of disability if disability exceeds the deductible period. D. KEDZIE, CONSUMER CREDIT INSURANCE 14 (1957) [hereinafter cited as KEDZIE].

<sup>14</sup> 3 KY. ADMIN. REG. I-CL&C-1-12 (1955); See also KEDZIE 119-32.

decreasing term coverage is approximately fifty per cent less than level term coverage, and it provides a corresponding reduction in premium costs. Many states, including Kentucky, prohibit coverage exceeding the debt at any given time.<sup>15</sup>

Credit life insurance may be written either on an individual or a group plan basis.<sup>16</sup> Under the individual plan, the debtor purchases the policy, pays the premium, and either assigns the policy to the creditor or names him beneficiary. The debtor's estate or a third party becomes the secondary beneficiary for all proceeds beyond the amount necessary to satisfy the debt.<sup>17</sup> For convenience of the debtor and creditor most credit life is written by the creditor, who has also been licensed as an agent of the insurer.<sup>18</sup> His commission is often as much as eighty-five per cent of the premium.<sup>19</sup> Although the creditor handles all administrative matters, including claims adjustment, his cost in this regard is negligible, having been estimated at less than five cents per one hundred dollars of coverage.<sup>20</sup>

The premium is calculated for the total period of the debt and is paid in a single installment at the time the policy is issued.<sup>21</sup> Generally the premium payment is advanced to the insurer by the creditor who then adds that amount to the debt to be repaid in installments. If at any time prior to the maturity date the debt is terminated through repayment by the debtor, or by operation of the policy, the prorated unused portion of the premium is refunded to the policy holder or his heirs.<sup>22</sup>

Under group policy coverage the creditor is the policy holder and the beneficiary. He holds a master policy, which remains in effect indefinitely. Debtors are automatically covered when the debt is incurred, and if the debtor dies before repayment the policy settlement goes to the creditor and must be used to liquidate the debt. The

<sup>15</sup> KRS § 304.841 (3) (1962); 3 Ky. ADMIN. REG. I-CL&C-8 (1955).

<sup>16</sup> KRS § 304.841 (1962) provides for group insurance with the creditor as policy holder. In 1965, credit life premiums earned consisted of 71% group premiums and 29% individual premiums. KY. REPORT 12.

<sup>17</sup> 44 C.J.S. *Insurance* § 208 (1945).

<sup>18</sup> KRS §§ 304.510-74 (1962) and 3 Ky. ADMIN. REG. I-CL&C-6 (1955) require that all policies be issued by duly licensed agents. Some creditors sign the insurer's name, who latter ratifies the contract. Some non-agent creditors send the policy out to the insurer to be signed.

<sup>19</sup> KEDZIE 103.

<sup>20</sup> REPORT OF THE COMMITTEE TO INVESTIGATE ALL INSURANCE RATES AND PRACTICES CONCERNING CREDIT LIFE, CREDIT ACCIDENT AND HEALTH AND CREDIT PROPERTY INSURANCE SOLD IN SOUTH CAROLINA 23, 96th Legislature (1965) [hereinafter cited as SOUTH CAROLINA REPORT].

<sup>21</sup> KRS § 288.530(10) (1962) allows credit life insurance charges to be a cost of the small loan.

<sup>22</sup> Kentucky requires the formula used to be filed for approval with the Insurance Commissioner. 3 Ky. ADMIN. REG. I-CL&C-4 (1955). The Rule of 78 is generally followed in determining minimum refund. KEDZIE 73-74.

policy limitations are similar to those in an individual plan. Again the creditor acts as the insurer's agent, but he does this only for administrative purposes since no policies are sold. On group insurance the creditor's premium may be calculated on the single premium method also, or it may be determined by the outstanding balance method. The latter is more popular due to its simplicity. With the outstanding balance method the creditor pays the premium each month based on a fixed rate per one thousand dollars of his total debt outstanding.<sup>23</sup> Payments may be absorbed as an overhead cost, or the debtor's share may be charged to him totally or partially.<sup>24</sup>

Under a group policy the creditor cannot receive a commission since he cannot be an agent and policy holder at the same time. This would constitute an illegal premium rebate as an inducement to sale.<sup>25</sup> However, it is a common practice among consumer credit insurers to offer to group policy holders "premium adjustments" or a return to the lender policy holder, variously termed a 'retrospective rate,' 'experience refund,' 'premium refund,' or a 'dividend.'<sup>26</sup> The payment is based on the mortality experience of a given lender's insured debtors and grows as losses decrease. This "experience refund" may be refunded as cash or as credit on the creditor's next monthly premium.<sup>27</sup>

The refund benefits the insurer with a favorable loss experience because it creates an incentive for the creditor to select low risk debtors. Moreover, the risk to the insurer is decreased or eliminated because premiums are high enough to pay a refund even when the experience is bad. As a result, to the extent the "experience refund" is reduced by high losses, the creditor becomes the risk bearer or insurer. The named insurer maintains his income, and most of the losses are paid from the creditor's refund. The retrospective rating system also affords compensation to the creditor even though he is the policy holder. Unlike the agent's commission, the refund is calculated and paid at the end of the fiscal year.<sup>28</sup> However, the insurance sale,

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<sup>23</sup> KEDZIE 122-23. This causes the premium to vary from month to month according to the creditor's outstanding debt. *Id.* at 122.

<sup>24</sup> KRS § 304.841 (1962); 3 KY. ADMIN. REC. I-CL&C-5 (1955). Selection of contribution or non-contribution by the creditor depends upon why he is providing coverage: to protect his asset, the debt, and provide service for his customer, or to provide liability insurance to protect the debtor.

<sup>25</sup> KRS § 304.932 (1962).

<sup>26</sup> See KEDZIE 96-111 where these practices are explained in detail.

<sup>27</sup> KRS § 304.865 (1962).

<sup>28</sup> The fiscal period is limited to one year in Kentucky, KRS § 304.933(6) (1962). KRS § 304.865 (1962) prohibits any refund to the creditor of any cost of coverage over the aggregate contributed by the creditor on regular group life insurance. Any excess shall be applied for the sole benefit of the debtors. There is no such limitation on group credit life insurance.

whether individual or group coverage, is in effect an additional income-producing transaction tied in with the credit transaction.<sup>29</sup> under any method of compensation, the creditor gains a reward in addition to security for his credit.

#### ABUSES

The sale of credit life insurance is highly susceptible to abuse since it is sold to a captive market,<sup>30</sup> the prospective debtor being "captured" by his need to secure credit. Even if there is a choice of creditors, the prospective debtor has no bargaining power; he must accept whatever terms are offered.<sup>31</sup> He can ill afford to criticize a requirement that he buy credit life insurance under the terms offered by the creditor. Nor will he be permitted to supply his own insurance, since this would prevent the creditor from realizing a financial gain by supplying the insurance. Since he may be able to pledge full security for the debt, the prospective debtor often does not want or need the insurance, but he is still required to buy it.

It is in the area of small loans that the greatest abuses are found. The debtor often is without hard collateral to secure the loan in the way a chattel mortgage secures a vendor's credit. Credit life insurance may be required in Kentucky as an express condition of the loan by small loan and industrial loan companies, and insurance companies lending money.<sup>32</sup> Other types of creditors, not specifically allowed to require insurance, may, either expressly or by "suggestion," coerce or intimidate the debtor into buying insurance as a condition precedent to the extension of credit. His superior bargaining position increases the temptation for the unethical creditor to refuse credit unless the debtor becomes a party to a scheme which will yield the creditor an extra source of profit in addition to the interest charged for the credit.

The disparity of bargaining positions also leads to more subtle forms of coercive selling. The insurance may be added to the debtor's total obligation without his knowledge.<sup>33</sup> Thus, he would be unaware of his coverage or ensuing rights in case any premium refund is due

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<sup>29</sup> At least one banker admitted to a Kentucky government official that he made \$50,000 last year on the sale of credit life.

<sup>30</sup> Congress found this condition in investigating the need for credit life regulation in the District of Columbia. H.R. REP. No. 2168, 87th Cong., 2d Sess. 2 (1962).

<sup>31</sup> See KEDZIE 40-42; SOUTH CAROLINA REPORT 23; H.R. R5§. No. 1782, 86th Cong., 2d Sess. 2 (1960).

<sup>32</sup> KRS §§ 288.560, 291.480, 360.030 (1962).

<sup>33</sup> Noted in President Johnson's speech to Congress regarding the Truth-In-Lending Act of 1967 as reported in U.S. INVESTOR (April, 1967).

him.<sup>34</sup> Moreover, where the creditor's retrospective rate credit depends upon his loss experience, claims on the policy may be strictly construed against the debtor's estate. A typical excuse for nonpayment is that the debtor's pre-existing condition which caused his death bars payment.

Excessive coverage may be sold on the debt initially by insuring for more than the debt, or a level term policy may be issued.<sup>35</sup> Usually the creditor has advanced the premium and the debtor must pay interest rates on this additional debt.<sup>36</sup> Pyramiding the insurance policies and thus multiplying the premium cost is another abuse which is difficult to detect. Often loans are refinanced or renewed, the old debt being paid off by the greater new loan.<sup>37</sup> The insurance policy on the old debt is cancelled, and a new policy is issued. Pyramiding occurs when the unearned insurance premium on the old debt is not refunded and the creditor charges a full premium for the policy issued on the new loan. Pyramiding is found in states which do not require refund of all unearned charges upon cancellation of a loan. Also, under a group policy, when there is no secondary beneficiary, any over-insurance at the death of the debtor is paid to the creditor even though the debtor paid the premium.

A startling example of debtor captivity and the abuse of credit life insurance is shown by the experience of Mr. Cecil G. Husky of North Carolina.<sup>38</sup> Mr. Huskey attempted to secure a large loan for his home building business, Huski-Built, Inc. After having been turned down by several financial concerns, he secured a \$33,000 bank loan for his corporation. As collateral, Huski-Built, Inc. was required to put up \$67,000 worth of first mortgages it held on houses previously sold, and Mr. and Mrs. Huskey were required to personally guarantee repayment of the loan, although the corporation's financial statement

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<sup>34</sup> This turns credit life into creditor asset insurance rather than a debtor liability surety, with the debtor paying for the creditor's protection. KEDZIE 7. For methods, See H. BLACK, BUY NOW, PAY LATER 182 (1962). This practice is prohibited by 2 KY. ADMIN. REG. I-CL&C-5 (1955).

<sup>35</sup> Where coverage is excessive, there is no insurable interest; the excessive coverage becomes a wager in violation of usury laws and is prohibited by KRS § 304.841 (1962); 3 KY. ADMIN. REG. I-CL&C-8 (1955).

<sup>36</sup> The Kentucky Insurance Commissioner suggests that it is illegal under KRS § 304.841 (1962) to insure beyond the amount of the debt, even to cover finance charges. KY. REPORT 15.

<sup>37</sup> Insurance charges pyramided four times amounted to \$678 on a debt of \$2870. *In Re Branch*, [1966-1967 Transfer Binder] BANKER. L. REP. ¶61,943, at 71, 481 (E. D. Tenn. 1966). This practice is prohibited in most states; See, e.g., 3 KY. ADMIN. REG. I-CL&C-4 (1955). See also KEDZIE 2 for a list of other abuses.

<sup>38</sup> Mr. Huskey testified before the Senate Antitrust Subcommittee in May, 1967. *Hearings Before the Antitrust and Monopoly Subcomm. Of the Senate Comm. on the Judiciary*, 96th Cong., 1st Sess. 1 (1967) [hereinafter cited as *Huskey's Statement*].



showed total assets four times as large as the amount owed the bank.

As Mr. Huskey's business grew so did his need for operating capital. As a prerequisite to granting the next nine loans, Huski-Built, Inc. was required to buy credit life insurance at a high premium rate. The insurance covered Huski-Built's customers whose mortgages had been placed with the bank as security.<sup>39</sup> The coverage was for the amount and term of the mortgages, which greatly exceeded the amount and term of the loans. Huski-Built, Inc. had to pay ten years of premiums in advance and was not allowed to furnish its own insurance. No receipts or policies were ever issued by the bank, the bank was the beneficiary of the policies, and no refund of unused premiums was ever made when loans were prematurely repaid.

There was a total debt repayment of \$249,571. Of this debt, \$28,820 were charges for unneeded, unwanted credit life insurance.<sup>40</sup> The bank's explanation of the insurance requirement was that: "We want to make money, too."<sup>41</sup> Mr. Huskey, in explaining his submission to the demands, stated that:

when one gets caught on a treadmill of need and necessity, you don't have much choice but to go along with the imposed requirements whatever they are. This is what happened to us. . . . You concede to the unnecessary terms and unnecessary expense because you *need* the money.<sup>42</sup>

This type of experience is found in consumer goods credit transactions as well as lender transactions.

The greatest single abuse and the incentive for all other abuses is the high premium rate charged for credit life insurance. The creditor's share is the largest single increment of this premium.<sup>43</sup> How important is the tie-in sale of credit life to the creditor? Two of the largest independent consumer credit companies, Commercial Credit Corporation and Associates Investment Company, whose basic business is lending, report that in 1966 more than fifty per cent of their net income was derived from insurance operations.<sup>44</sup> Kentucky statistics show that in 1955, \$9,423,420 in premiums was earned on the sale of credit life insurance, of which approximately forty-six per cent, or \$4,234,773, was repaid as benefits to debtors.<sup>45</sup> Nationally, credit life returned, in the form of benefits, fifty-three per cent of all premiums

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<sup>39</sup> The policies were not issued on the life of Mr. Huskey, although he was the personal guarantor of the loan and the key man in the corporation. *Id.*

<sup>40</sup> See page 676 *infra*.

<sup>41</sup> The bank and its officers owned 100% of the insurance company. *Huskey's Statement* 3.

<sup>42</sup> *Huskey's Statement* 5.

<sup>43</sup> Doss, *Rate Regulation in Consumer Credit Insurance*, 1967 *INS. L. J.* 9 (1967).

<sup>44</sup> *KY. REPORT* 26.

<sup>45</sup> *Id.* at 4.

Date Loan	Term	Amount	Amount Applied to Insurance	Field Loss Recovered by Huski-Bilt	Monthly Premiums Paid at 5% Rate	Monthly Premiums Paid at 6% Rate	Monthly Premiums Paid at 6 1/2% Rate	Monthly Premiums Paid at 7% Rate	Total Interest Paid by Huski-Bilt (\$)	Total Interest Paid by Other Lenders	Total Interest Paid by All Lenders	Rate of Interest Paid by Huski-Bilt (%)
1- 9-61	4yrs.	\$ 33,000.00	-0-	\$33,000.00	\$ 775.02	\$ 852.50	\$ 77.48	\$4,200.96	\$ 7,920.00	-0-	\$ 7,920.00	11% + --
5- 2-61	4yrs.	25,319.00	-\$4,283.28	21,036.00	494.00	632.97	138.97	2,676.00	9,346.56	4,283.28	13,629.84	30% + --
8- 7-61	4yrs.	23,365.00	4,860.42	18,504.58	434.74	584.13	149.39	2,362.94	9,533.66	4,860.42	14,394.08	36% + --
8-28-61	4yrs.	23,657.00	4,324.96	19,332.04	456.41	591.44	135.03	2,574.64	9,056.08	4,324.96	13,381.04	30% + --
10-24-61	5yrs.	27,263.28	2,246.69	25,016.59	483.66	567.96	84.30	4,003.01	9,061.01	2,246.69	11,307.70	22% --
3- 8-62	5yrs.	34,060.30	2,135.00	31,925.30	617.22	709.58	92.36	5,107.90	10,649.50	2,135.00	12,784.50	15% + --
5- 5-62	5yrs.	29,546.00	2,080.00	27,466.00	531.02	615.53	84.51	4,395.20	9,465.80	2,080.00	11,545.80	14% + --
7-13-62	5yrs.	61,925.67	5,540.00	56,385.67	1,090.35	1,290.11	199.76	9,035.33	21,020.93	5,540.00	26,560.93	17% + --
9- 7-62	5yrs.	62,780.61	3,350.00	59,430.61	1,148.99	1,303.20	154.21	9,508.79	19,061.39	3,350.00	22,411.39	12% + --
2- 4-63	6yrs.	249,571.02	28,820.35	221,350.67	3,668.45	4,506.15	837.70	42,777.87	103,092.27	28,820.35	131,912.62	18% + --

° Calculated on net loan proceeds (col. 5).  
 (1) 6% interest + excess over 6% (48 X monthly excess).  
 (2) Huski-Bilt's Loan costs as amortized rate on net loan.  
 (3) Total insurance previously paid and included in consolidated loan.

LOANS OBTAINED BY HUSKI-BILT, INC.  
 from  
 FIRST-CITIZENS BANK & TRUST CO.

collected.<sup>46</sup> This percentage would have returned \$4,994,412 to Kentucky debtors. Hence, Kentucky debtors received thirteen per cent, or \$759,639, less return benefits than their counterparts across the nation. There is no way to determine how this profit was shared between the creditor and the insurer, because there are no such statistics.

Studies have shown that approximately \$.30 per \$100 indebtedness per annum is returned to beneficiaries,<sup>47</sup> premiums charged above \$.30 being divided among administrative costs, taxes, and profits. The rate offered by creditor groups in Kentucky ranges from \$.37½ per 100 per annum with a loss ratio of 85.1 per cent (General Motors Acceptance Corporation, to a high of \$1.25 per \$100 per annum with a loss ratio of 24.7 per cent (Investor's Heritage Life Insurance Company, and State Capital Life Insurance Company.)<sup>48</sup> At present, most credit life insurers in Kentucky are using the \$1.00 per \$100 per annum rate on decreasing term insurance.<sup>49</sup> Policies may differ in rates, but offer comparable coverage. However, the debtor is in no position to shop for the cheapest insurance since he usually has no real choice of creditors.<sup>50</sup> Often it is impossible to compare rates and coverage offered by different creditors, because the policies are presented in a complex and ambiguous way.<sup>51</sup>

The high rates are caused by a phenomenon, peculiar to credit life insurance, called reverse competition. Ordinarily, market pressures force sellers to charge competitive prices for a standardized product like insurance. However, in the credit life marketplace the buyer is not free to shop for a lower price since he is required to buy the insurance sold by his creditor, regardless of the price. In order to maximize his profits on the credit transaction, the creditor sells to the debtor the policy of the insurer who pays the greatest commission or kickback. The insurer must maintain his normal profit in order to stay in business while he competes for the creditor's business. Therefore,

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<sup>46</sup> *Id.* at 18.

<sup>47</sup> II NAIC PROCEEDINGS 508 (1964); See also Statement of James H. Hunt, Commissioner of Banking and Insurance of Vermont, delivered to the Senate Antitrust Subcommittee May, 1967. *Hearings Before the Antitrust and Monopoly Subcomm. of the Senate Comm. on the Judiciary*, 90th Cong., 1st Sess. I (1967) [hereinafter cited as *Hunt's Statement*].

<sup>48</sup> KY. REPORT 14.

<sup>49</sup> From a survey of the rates required to be filed by 3 KY. ADMIN. REG. I-CL&C-4 (1955). However, under his statutory authority the Insurance Commissioner has limited the amount small loan companies may charge to \$.75 per \$100 per annum. See KRS § 238.560 (1962) and KY. REPORT 11.

<sup>50</sup> See text at notes 32-34 *supra*. This inequality of bargaining power is the basis for all interest regulatory statutes.

<sup>51</sup> Noted in President Johnson's speech to Congress regarding the Truth-In-Lending Act of 1967 as reported in U. S. INVESTOR (April, 1967).

to withstand the creditor's demand for a greater profit share the premium is raised.<sup>52</sup> The more complete the debtor's captivity, the higher rate the creditor can charge, and likewise the more profit he can demand from the insurer. Thus, the real competitive pressure is between the insurer and the creditor for the profit, with the debtor exerting no influence.<sup>53</sup> Only financially strong and ethical insurance companies can withstand this reverse competition and charge reasonable rates.

Although insurers generally make a profit on credit life, some cannot withstand the profit demands of creditors. South Carolina found that many insurers, superficially profitable, were in fact and law insolvent, primarily because huge kickbacks to lenders on group credit life policies had exhausted their surpluses and lowered their capital below minimum reserves required by law.<sup>54</sup> However, the creditors who deal with such insurers make such large profits on insurance sales that they would suffer no severe economic loss if the insurer were to fail financially. Any loss of debt collection, due to the insurer's insolvency, would be absorbed by the past excessive profits earned by the creditor. The only real losers are the regular life policy holders of insurers who sell both types of policies. The result of this abuse is to undercut and destroy public faith in insurance in general.

It has been shown that creditors profit from the tie-in sale of credit life insurance through commissions and retrospective credits for favorable group underwriting experience. But why should the enterprising creditor be satisfied with only a percentage of this windfall when he can secure all the profit by owning or controlling the insurance company? Such a course is not without difficulty since it is expensive and time-consuming to establish a company in all the states in which a creditor might operate, and it also takes a certain expertise to operate an insurance business, even a specialty credit life company. However, the same result can be accomplished by reinsurance.<sup>55</sup>

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<sup>52</sup> See H.R. REP. No. 2168, 87th Cong., 2d Sess. 5 (1962); KEDZIE 40, 163-64; KY. REPORT 24; *Hunt's Statement* 6; SOUTH CAROLINA REPORT 10, 23. The regional manager of a national insurance company reported to his home office that "[i]n most cases the insurance company is getting a net retention of 10% of the gross premium and allowing their [*sic*] broker to get whatever he can as additional retention." Statement of Charles W. Gambrell, Chief Insurance Commissioner, State of South Carolina. *Hearings Before the Antitrust and Monopoly Subcomm. of the Senate Comm. on the Judiciary*, 90th Cong., 1st Sess. 17 (1967) [hereinafter cited as *Gambrell's Statement*].

<sup>53</sup> KANSAS HEARINGS 4-5; *Hunt's Statement* 6; SOUTH CAROLINA REPORT 22.

<sup>54</sup> SOUTH CAROLINA REPORT 21.

<sup>55</sup> A reinsurance transaction is a transaction in which the company accepting the risk cedes a part of that risk to another insurance company. In consideration

(Continued on next page)

In the reinsurance scheme the creditor forms a subsidiary specialty company in one state, often Arizona because of its minimal capital and surplus requirements. This company need not apply for permission to do business in any other state. Instead, the creditor, in his capacity as the Arizona company, enters into a reinsurance contract with an established company licensed in the other states in which he does business. This company "fronts" for the real insurer, the Arizona captive company. The fronting company directly underwrites all the policies sold by the creditor in that state and reinsures them with the creditor's subsidiary company. In return, the fronting company usually receives a service fee, which varies according to the relative strength of the creditor and fronting insurer, plus any premium tax due. Typically, the fronting company's only administrative duties are to record an "in an out" entry in its books, with the creditor and his captive company handling the other necessary administrative duties.

Three basic kinds of fronting situations have been found by the Kentucky Department of Insurance.<sup>56</sup> "Territorial fronting," the most common, operates as described above, *i.e.*, a licensed Kentucky insurer reinsures with a creditor's captive insurance company licensed only in another state. "Financial fronting" is employed when the surplus of the captive company is so limited that it cannot post reserves for all the business the creditor controls. A fronting company with strong surplus issues the policy, posts on its records the necessary statutory reserves to protect the policy, and then assigns the policy to the captive company. Both companies are licensed in the same state, but only the issuing or fronting company must post the reserve. This permits the captive company to receive the profits earned from the policies without becoming technically insolvent by exceeding reserve requirements.<sup>57</sup> The third fronting situation, "premium tax avoidance," is similar to "territorial fronting" and occurs when a domestic insurer, who pays little or no premium tax, fronts for a foreign insurer, who under state law would have to pay a higher tax to the domiciliary state.<sup>58</sup>

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(Footnote continued from preceding page)  
for the acceptance of the risk, the reinsurer receives a premium from the company which originally accepted the risk, just as the original company received a premium from the insured for the acceptance of the same risk. S. ACKERMAN, *INSURANCE* 707 (3d ed. 1948).

<sup>56</sup> KY. REPORT 27.

<sup>57</sup> Financial fronting was explained in a letter from American United Life Insurance Co., a fronting company, to the Kentucky Department of Insurance. Letter from American United Life Insurance Company to the Kentucky Department of Insurance, April 21, 1967.

<sup>58</sup> The average state tax on regular life insurance in 1966 was 4.2% of the total premium dollar.

In a fronting situation, very little profit is taken by the named insurer, with the bulk of the premium going to the creditor directly as sales commissions, or indirectly as profits from his subsidiary insurance company.<sup>59</sup> Thus, the creditor can easily increase his insurance sales profits by raising his rates, and at the same time he can allocate his income between himself and his captive insurer in order to secure the best income tax advantage. He may take no profit as a creditor-agent, sending all profit instead to the captive insurance company, which holds it as earned surplus. Later, upon liquidation of the insurance company, the creditor will pay only a capital gains tax on the stock which has swelled in value from lucrative profits received through credit life sales.

Notwithstanding these financial manipulations, the fronting company does not care about the harsh terms of the policy or the subsequent poor service given to the policyholder by the subsidiary company. The fronting company, whose customer is the creditor, is unconcerned that the debtor relying on its good name is misled.

#### REGULATION

Little attempt was made to regulate credit life insurance until after World War II. Then in *United States v. Southeastern Underwriters Association*,<sup>60</sup> the United States Supreme Court held that insurance was interstate commerce subject to federal regulation. However, since there had traditionally been little or no federal regulation of insurance, Congress promptly passed the McCarran-Ferguson Act.<sup>61</sup> The policy of this Act was that the public interest required that the states be allowed to continue regulating and taxing the business of insurance. The Act did apply federal antitrust and trade regulation legislation "to the business of insurance to the extent that such business is not regulated by State law."<sup>62</sup> The courts, however, were left to determine exactly what regulation by state law entailed.

The states made no concerted effort to regulate credit life insurance until after the 1953 Senate Antitrust Subcommittee hearings con-

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<sup>59</sup> Some large insurance companies are professional fronting organizations, assigning their entire business to creditors' captive insurers. Kentucky has no statutes or regulations preventing such a practice.

<sup>60</sup> 322 U.S. 533 (1944).

<sup>61</sup> 15 U.S.C. §§ 1011-15 (1945).

<sup>62</sup> *Id.* at § 1011. "Nothing contained in this chapter shall render the said Sherman Act inapplicable to any agreement to boycott, coerce, intimidate or any act of boycott, coercion, intimidation." *Id.* at § 1013(b). The Act does not give insurance companies federal antitrust immunity from price-fixing conspiracies effectuated by boycott, coercion, or intimidation. *California League of Independent Insurance Producers v. Aetna Cas. & Sur. Co.*, 179 F. Supp. 65 (N.D. Cal. 1959).

cerning credit life insurance sales in Kansas. The Subcommittee, after finding great abuse in selling practices and rate making, threatened that the federal government "will not forever accept 'attempts' at regulation as a substitute for regulation of the business of insurance by the states. The patience of the Federal Government with those who would abuse the good name of insurance may come to an end."<sup>63</sup>

The National Association of Insurance Commissioners, [hereinafter referred to as NAIC],<sup>64</sup> spurred by the hearings, promulgated a model credit insurance bill. The Model Bill deals with such abuses as coercion in selling insurance provided by the creditor, lack of disclosure, pyramiding or excessive coverage, and failure to make refunds of unearned insurance premiums and benefits.<sup>65</sup> Although traditionally there had never been rate regulation of life insurance,<sup>66</sup> the NAIC, feeling that it was necessary to protect the debtor because of the lack of bargaining power and reverse competition,<sup>67</sup> advocated such regulation of credit life in 1959. Several methods of rate regulation were available, but there was no uniform agreement among the members of the NAIC on which approach was the most desirable.<sup>68</sup> It finally adopted a provision for the Model Bill, allowing state insurance commissioners to disapprove for sale any policy form in which the loss payoff benefits were not "reasonable" in relation to the premiums.<sup>69</sup> The Model Bill language was interpreted by various states who adopted it as giving the commissioner no authority to set rates per se, but only the power to reject an individual policy rate if it seemed excessive.<sup>70</sup>

Because of the varied loss experience of companies in the credit life field, it was thought difficult to determine a uniform rate which would produce a "reasonable" rate of return. Claims were made that there was a lack of credit life actuarial experience by which to

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<sup>63</sup> KANSAS HEARING 14. Subsequent to the hearings Kansas enacted small loan and sales finance acts and an insurance code for the regulation of certain trade practices. KAN. STAT. ANN. § 16-413 (1955); KAN. STAT. ANN. § 16-507 (1958).

<sup>64</sup> The NAIC is a voluntary cooperative organization of state insurance officials which gives advisory opinions for the regulation of the insurance industry.

<sup>65</sup> For contents of the Act, see B. CURRAN, TRENDS IN CONSUMER CREDIT LEGISLATION 330 (1965).

<sup>66</sup> 44 C.J.S. *Insurance* § 65 (1945).

<sup>67</sup> Congress also found rate regulation necessary when considering a credit life bill for the District of Columbia. S. REP. NO. 1519, 86th Cong., 2d Sess. 3 (1960).

<sup>68</sup> See notes 95, 96, and 97 *supra* for the various methods.

<sup>69</sup> I NAIC PROCEEDINGS 128 (1959). This same test was later adopted by Kentucky in relation to credit life on small loans. KRS § 288.560 (1962).

<sup>70</sup> Letter Opinion from the Attorney General to the Department of Insurance, dated May 11, 1960.

accurately determine loss experience.<sup>71</sup> In response to the need for some guideline for rate regulation, the NAIC recommended that "a rate for credit life . . . producing a loss ratio of under 50% should be considered excessive."<sup>72</sup> Using this loss ratio "bench mark," the insurer must show statistically that at least fifty per cent of its premiums were returned in claim payments.<sup>73</sup> In other words, if a rate of \$.75 per \$100 per annum is charged, the insurer must show a claim payment of at least \$.37½. However, there would appear to be no satisfactory reason why the purchaser of credit life should pay the extreme rate of fifty per cent of his purchase dollar toward the overhead and profit of the seller.<sup>74</sup> Few monopolists can boast of such a return.

In 1950, following the passage of the McCarran-Ferguson Act, Kentucky enacted general insurance laws designed to regulate insurance trade practices by defining and prohibiting practices constituting unfair methods of competition or deception.<sup>75</sup> Rate regulation was not authorized, however, and the statutes failed to deal with many of the unique problems of credit life sales. In 1954 and 1955, Kentucky Commissioner of Insurance S. H. Gobbel issued Insurance Regulations I-CL&C-1 through I-CL&C-8 governing the sale of credit life. These Regulations included the requirement that rates be filed with the Commissioner, although they did not authorize him to reject prospective rates. Due to opposition, legislation proposed in 1958, which would have allowed the Commissioner to reject rates, was never introduced in the General Assembly.<sup>76</sup> In 1959, Regulation I-CL&C-10, issued by Commissioner Thurman, stated that a rate was prima facie reasonable if it produced a loss ratio of not less than fifty per cent on individual policies and seventy per cent on group policies. In 1960, however, newly appointed Commissioner Hockensmith issued Regulation I-CL&C-11 which superseded I-CL&C-10. It provided that the benefits must be reasonable in relation to the premium charged and that a fifty per cent loss ratio or claim payment for group and

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<sup>71</sup> There appears no reason why regular life insurance actuarial experience could not have been used.

<sup>72</sup> I NAIC PROCEEDINGS 176 (1960).

<sup>73</sup> Under this test, since the average credit life claim payment is \$.30 per \$100 per annum, no premium over \$.60 should be charged. *Hunt's Statement* 19.

<sup>74</sup> Life Insurance actuaries know that loss ratios can run as high as 80% in credit insurance and still allow the creditor to receive a modest dividend and the insurer to make a profit. Aetna Life is a company which achieves such a loss ratio. *Hunt's Statement* 20. Of the average life insurance dollar, \$.783 goes for current and future obligations to policy holders, \$.096 for office expenses, \$.073 for agents' commissions, and \$.040 for taxes. INSTITUTE OF LIFE INSURANCE, *supra* note 3, at 52.

<sup>75</sup> KRS §§ 304.924-45 (1962).

<sup>76</sup> KY. REPORT 7.



individual coverage was prima facia reasonable. This was the same test that the NAIC had proposed. Shortly thereafter this regulation was revoked because the Attorney General issued a ruling that the Commissioner had no statutory authority to regulate rates.<sup>77</sup>

No rate regulatory authority has since been given to the Commissioner except by the Consumer Loan Act of 1960, which directed the Commissioner to reject all rates used by the small loan companies covered by the Act which are not "reasonable in relation to the death benefit required."<sup>78</sup> Pursuant to that authority a bulletin was issued by the Commissioner proclaiming that \$.75 per \$100 per annum was prima facia reasonable.<sup>79</sup> That rate is still in effect.

Various political pressure groups have consistently prevented passage of rate regulation legislation in Kentucky for all creditor groups except small loan companies. However, the record of regulation promulgated does show the efforts of Insurance Commissioners to exercise such power.<sup>80</sup> In 1967, the Insurance Department issued a report on credit insurance in which it charged that some creditor-agents were receiving "advance and contingent *commissions* in excess of \$.75 per \$100 per annum . . . which amount in many states is the maximum *premium* rate allowed."<sup>81</sup> The Report, after stating that the "overall loss experience record does not speak well of the credit life and accident and health industry in this State,"<sup>82</sup> indicated that the Department planned to again sponsor the Model Bill. This would include the provision granting the Commissioner power to reject rates if the benefits provided are not reasonable in comparison with the premiums charged.<sup>83</sup>

If the Kentucky Legislature fails again to enact a credit insurance bill, the Commissioner may be able to declare that rates exceeding a specified rate standard amount to "unfair competition" under KRS 304.945, and to maintain that issuance of a desist order by him in respect thereto would be in the public interest.<sup>84</sup> If the Kentucky Court of Appeals will accept such an interpretation, thus giving the Commissioner indirect rate regulating authority over all credit life, excessive profit taking can be controlled. It is doubtful that the

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<sup>77</sup> Letter Opinion from the Attorney General to the Department of Insurance, dated May 11, 1960.

<sup>78</sup> KRS § 288.560 (1962).

<sup>79</sup> Ky. REPORT 11.

<sup>80</sup> *Id.* at 5-9.

<sup>81</sup> *Id.* at 37.

<sup>82</sup> *Id.* at 36.

<sup>83</sup> *Id.* at 38.

<sup>84</sup> KRS § 304.945 (1962) gives the Commissioner power to curtail in the public interest undefined practices or business conduct which is unfair or deceptive.

Court will interpret this statute as giving such authority, however, since this important power is usually expressly authorized. Securing a private agreement on a reasonable rate standard from creditor groups not covered by the Consumer Loan Act might provide an alternate control.<sup>85</sup> Such an agreement may, however, be a Kentucky unfair trade practice resulting in "unreasonable restraint of, or monopoly in, the business of insurance."<sup>86</sup> Absent the McCarran-Ferguson Act, it would surely constitute price fixing in violation of the Sherman Act, which prohibits any conspiracy in restraint of interstate commerce.<sup>87</sup> Even under this Act, Senate Antitrust Subcommittee Chairman Hart has stated, "to the extent that . . . rates . . . are tied to insurance practices, the antitrust laws apply only when they are not regulated by the states."<sup>88</sup> Thus, if the Kentucky Commissioner is a party to a rate agreement, some color of state regulation might exist. Such agreements would give the Commissioner some influence over rates, if not rate-setting authority.

A national survey shows that thirty-four states currently have some form of broad credit life insurance law, most of them patterned after the Model Bill.<sup>89</sup> Six others, including Kentucky, have similar insurance department regulations.<sup>90</sup> Thirty-three of the states with laws have one of five forms of rate regulation. The first is the maximum premium rate standard, which seventeen states have adopted.<sup>91</sup> The rate standard is the easiest rate control to administer because it is

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<sup>85</sup> Canada uses this procedure with success. SUPERINTENDENT OF INSURANCE (CANADA), MEMORANDUM FOR LICENSEES UNDER THE SMALL LOAN ACT. RE GROUP INSURANCE ON THE LIVES OF BORROWERS (1959).

<sup>86</sup> KRS § 304.926 (1962).

<sup>87</sup> The illegality of price fixing does not depend upon a showing of reasonableness since it is conclusively presumed to be unreasonable. *U.S. v. McKesson & Robbins, Inc.*, 351 U.S. 305 (1956); *U.S. v. Socony-Vacuum Oil Co.*, 310 U.S. 150 (1940). It matters not that the debtor would benefit from the rate. Combinations fixing maximum prices are no less subject to the Sherman Act than those fixing minimum prices. *Kiefer-Stewart Co. v. Joseph E. Seagram & Sons*, 340 U.S. 211 (1951). The question to be decided by the current congressional hearings is whether Public Law 15 is "wise, prudent, and makes good long-term sense." WASHINGTON INSURANCE NEWSLETTER (May, 1967). Congress has said that it is "the legal sanctions afforded combinations of competitors to set rates in concert which represent the most serious threat to the naturally competitive structure of the market." S. REP. No. 831, 87th Cong., 1st Sess. 4 (1961).

<sup>88</sup> WASHINGTON INSURANCE NEWSLETTER (May, 1967).

<sup>89</sup> Alaska, Arizona, Arkansas, California, Connecticut, District of Columbia, Florida, Georgia, Idaho, Illinois, Indiana, Maine, Michigan, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oregon, Pennsylvania, Puerto Rico, Rhode Island, South Dakota, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming.

<sup>90</sup> Alabama, Iowa, Kansas, Kentucky, North Carolina, Tennessee.

<sup>91</sup> Arkansas, California, Connecticut, Illinois, Indiana, Maine, Michigan, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, Ohio, Pennsylvania, Puerto Rico, Texas. The rates range from \$.44 to \$.90 per \$100 per annum.

more exact.<sup>92</sup> The insurance department need only prevent insurers from charging more than the maximum rate. New York and New Jersey have established rate standards on a decremental scale, decreasing with the size of the creditor.<sup>93</sup>

The second method is the percentage loss ratio "bench mark," the NAIC test, which fifteen states have adopted.<sup>94</sup> Generally fifty per cent is the accepted loss ratio. However, there is a question of whether the loss ratio should be determined from each insurer's own experience or the national experience of all insurers. If it is determined individually, excessive fragmentation in rates from insurer to insurer will result. Debtors will pay different rates for the same coverage depending on which insurer the creditor uses. The better view is that the cost should not vary with the individual insurer,<sup>95</sup> since there is sufficient national mortality experience to establish a uniform cost for credit life.<sup>96</sup> The rate then would be objectively determined from data, uninfluenced by the personal judgment of each commissioner on each policy.

The third method of rate regulation<sup>97</sup> is a combination of the rate standard and the "bench mark" loss ratio. A reasonable rate is set, such as \$.75 per \$100 per annum, subject to revision upward upon statistical showing by the insurer of a loss ratio higher than the "bench mark." This combination provides the simplicity of the rate standard and the flexibility of the loss ratio. The fourth method, adopted by one state,<sup>98</sup> is to give the insurance commissioner broad authority to approve all rates. However, most states do not want such power to reside in a politically controlled appointee. The fifth method is to place a percentage limitation on creditors' commissions. This supposedly will prevent creditors' profit demands from pushing rates upward. This method of control has been effectively circum-

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<sup>92</sup> Kentucky Commissioner Woodall stated in a personal interview that he favors a rate standard of \$.75 per hundred per annum, the same as required of small loan companies.

<sup>93</sup> Recognizing that administrative costs of a group policy decrease with size, these states have limited their rates to \$.64 per \$100 per annum for the smallest creditors, reducing to \$.44 per \$100 for the largest group policies (over \$5,000,000 average outstanding debt). *Hunt's Statement* 19.

<sup>94</sup> Arizona, California, Illinois, Indiana, Maine, Michigan, Nebraska, Nevada, New Hampshire, New Mexico, Ohio, Oregon, Texas, Washington, West Virginia. The "bench mark" may be in conjunction with a rate standard. See note 99 *infra*.

<sup>95</sup> Doss, *Rate Regulation in Consumer Credit Insurance*, 1967 *INS. L.J.* 9, 24 (1967); Dunbar, *Administrative Rate Fixing on Credit Life*, 14 *PERS. FIN. L.Q. REP.* 16 (1959).

<sup>96</sup> The underlying mortality cost in credit life averages \$.30. *Hunt's Statement* 19. Approximated at \$.28 in VI NAIC PROCEEDINGS 121 (1958); and \$.30 in II NAIC PROCEEDINGS 508 (1964).

<sup>97</sup> See notes 83 & 87 *supra*.

<sup>98</sup> Wisconsin

vented through the use of captive insurance companies and fronting situations.<sup>99</sup> By owning a captive insurance company the creditor can avoid any legal regulation on the amount of commissions he can make by taking none and profiting later from his insurance company ownership.

Usury statutes may be another means of regulating credit life rates. Usury is the intentional taking or reserving, or contracting to take or reserve, either directly or indirectly, a greater sum for the use of money than the lawful interest.<sup>100</sup> Credit life may be used as an indirect usurious device because of its tie-in sale with the credit transaction.<sup>101</sup> The debtor must receive material and substantial benefits from the insurance to sustain separate and additional charges above the legal rate of interest.<sup>102</sup> Security for the debtor would be such a benefit; but the debtor must desire the security.

An intention to violate the usury law may be inferred by the courts if the sale of insurance is made as a condition precedent to extension of credit. Such an inference was made in *In re Graham*,<sup>103</sup> where an insurance premium of \$151.88 for a \$4,500 policy was deducted by the creditor from a loan of \$451.88. The case held that the contract for the loan of money and the agreement for insurance were blended together in one transaction and that the actual consideration realized exceeded the statutory rate of interest. No other evidence of usurious intent beyond the compulsory purchase of insurance was necessary to show a violation of the Kentucky usury statute.<sup>104</sup>

An intent to evade laws against usury has also been implied from the charging of exorbitant insurance premiums,<sup>105</sup> the theory being

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<sup>99</sup> Doss, *supra* note 95, at 27.

<sup>100</sup> BLACK'S LAW DICTIONARY 1714 (4th ed. 1951). The elements of usury are: (1) a loan; (2) the principal to be repaid; (3) the exaction of a greater profit than that allowed by law; (4) the intention to violate the law. The presence of these elements establishes usury irrespective of the form in which the parties put the transaction. 55 AM. JUR., *Usury* § 12 (1946).

<sup>101</sup> The creditor may be a policy holder because he has an insurable interest in the life of the debtor to the extent of the indebtedness. 44 C.J.S. *Insurance* § 208 (1945). The insurer is only incidentally connected with the credit transaction so no action for usury will lie against it. Where the credit is extended by an insurance company which issues its own credit life policy on the debt, the premium will not be considered as interest for the purpose of finding usury. KRS § 360.030 (1962). See 4 A.L.R.3d 650 (1965).

<sup>102</sup> KRS § 288.560 (1962) permits insurance charges on small loans.

<sup>103</sup> 22 F. Supp. 233 (W. D. Ky. 1938).

<sup>104</sup> The court said "I am of the opinion that the cupidity of lenders and the necessity of borrowers are so great that the courts should be diligent in searching and weeding out hidden illegal exactions in contracts of lenders of money." *Id.* at 237. See also 91 A.L.R.2d 1344 (1963).

<sup>105</sup> *Cochran v. Alabama*, 270 Ala. 440, 119 So. 2d 339 (1960); 91 A.L.R.2d 1340 (1963).

that the excess premium has no relation to the insurance security, but rather provides additional compensation for extending credit. Other factors considered by courts in determining intent to evade usury statutes are: (1) the retention of a portion of the premium as a commission, or other profit made by means of the insurance; (2) a premium in excess of the usual or fair rate, or unusual conditions imposed in the insurance provision; (3) adequate security for the credit aside from insurance, or excessive insurance; (4) failure of the creditor to give the debtor the option to provide his own insurance; (5) failure of the creditor making an insurance charge to procure a policy, or failure to pay benefits exceeding the existing debt.<sup>106</sup>

Although usurious practices may be found in credit life sales, as a practical matter usury laws offer little protection. The premium is paid at the time credit is extended. The debtor must initiate court action to recover the excessive charge, and the burden of proof is on him to show the creditor's usurious intent.<sup>107</sup> The action is at law unless the debtor can show that only equity can provide adequate remedy. Moreover, relief from usury varies from state to state. In Kentucky equitable relief is provided by statute, but recovery is limited to the excess of the rate charged over the legal rate of interest.<sup>108</sup> Even if the insurance premium is excessive by \$1.00 per \$100 per annum on a three year debt of \$1,000, recovery would be limited to \$30. This is hardly worth court action. It is evident that the traditional usury suit initiated by an individual debtor provides him little relief.

There have been a few attempts by bankruptcy referees to afford bankrupt debtors relief from excessive credit life insurance profits. In *In re Richards*<sup>109</sup> the bankruptcy referee disallowed a creditor's claim as usurious because the insurance premium exceeded the statutory limit placed on insurers. But the district court reversed the referee's decision, stating that the small loan statute specifically excludes the cost of credit life as an "interest" charge in excess of permitted charges. There was no showing that the creditor charged more than that charged by the insurer, and the Legislature had not made the creditor responsible for an unauthorized charge by the insurer. In addition, the debtor had not sustained the burden of

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<sup>106</sup> 91 A.L.R.2d 1344, 1348 (1963).

<sup>107</sup> *Paine v. Levy*, 142 Ky. 619, 134 S.W. 1160 (1911). See also 91 C.J.S. *Usury* § 114 (1955).

<sup>108</sup> The legal rate of interest in Kentucky is 6%. KRS § 360.010 (1962). The statute of limitations is one year from the payment of the usurious interest. KRS § 413.140 (1962).

<sup>109</sup> [1966-67 Transfer Binder] BANKR. L. R. ¶ 62,345 (S. D. Me. 1967).

proving the charge usurious. In another case, arising in Tennessee, the court upheld the referee's finding of usury.<sup>110</sup> There, the creditor

had pyramided the insurance policies and charges so as to receive four insurance premiums on the same loan. However, this form of relief is available only to bankrupts, and therefore is quite limited.

Even if the individual debtor is successful in proving that the credit life charge is usurious, such a finding will have little effect on the creditor's subsequent activities. The loss of the usury on one transaction will not teach him a lesson. An injunction has been issued in Kentucky to prevent a creditor from charging usurious rates through requiring the purchase of insurance.<sup>111</sup> However, the case is not strong precedent for the control of insurance sales since in arriving at its decision, the Court seemed more influenced by the fact that the creditor was operating a small loan business without a state license.

In devising a scheme of regulation for credit life insurance it must be recognized that laws which regulate only the creditor are not sufficient. The Kansas Hearings revealed that:

credit insurance abuses may exist because of unethical practices indulged in by both lending organizations and credit insurance companies. Where this is the case it may be necessary to enact good state loan laws side by side with good state credit life insurance laws.<sup>112</sup>

Kentucky presently has no such insurance law.

The investigating subcommittee also found that part of the inadequate control existed because agencies vested with the power to control abusive credit insurance sales were ineffective.<sup>113</sup> The Kentucky Department of Insurance has difficulty controlling the abuses because of its small staff, the difficulty of proof, and lack of adequate statutory power. The Insurance Department has statutory authority to examine the affairs and records only of insurance companies.<sup>114</sup> The only way it can investigate insurance sales records of banks, small loan companies, and other institutional creditors is to be invited by the Kentucky Department of Banking to observe its investigation.<sup>115</sup> However, the Banking Department, under pressure by creditors to prevent such an invitation, is often reluctant to cooperate with the Insurance Department. Therefore there is no effective means by

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<sup>110</sup> *In Re Branch*, [1966-67 Transfer Binder] BANKR. L.R. ¶ 61,943 (Tenn. 1966). See *In re Graham*, 22 F. Supp. 233 (D. C. Ky. 1938).

<sup>111</sup> *Grauman v. Continental Co. Inc.*, 275 Ky. 238, 121 S.W.2d 49 (1938).

<sup>112</sup> KANSAS HEARINGS 2.

<sup>113</sup> *Id.* at 9.

<sup>114</sup> KRS § 304.030 (1962).

<sup>115</sup> KRS § 287.450 (1962). The duty of the bank examiner is to see that the laws of this state have been complied with. KRS § 287.460 (1962).

which to police credit life sales. The Insurance Commissioner is himself a political appointee,<sup>116</sup> selected by the Governor to serve without a specified term. Neither his appointment nor his dismissal is confirmed by the Legislature, and he may be dismissed without cause. The office is therefore highly susceptible to political pressure.

### CONCLUSION

The principle of credit life insurance is highly desirable because of the security it affords creditors and debtors. However, as we have seen, the sale of such insurance in Kentucky and other states is greatly abused. Various selling practices are used by creditors to violate existing statutes and regulations, with the high rate of profit to be gained as an incentive. Because of the debtor's "captivity" and the phenomenon of reverse competition, rates are forced up by unethical creditors seeking unconscionable profits on their credit transactions. Although some restraint is exercised by ethical creditors and insurers who are concerned about their public image, economic pressures to compete force their participation in taking high profits. The Kentucky Department of Insurance presently has no effective means of controlling abusive selling practices and rates. Moreover, general usury law is not an effective deterrent, although credit life insurance is suspected of being a vehicle for circumventing usury statutes. Protection of the helpless debtor, the policy behind all credit transaction regulation, demands adequate governmental regulation of credit life insurance.

The vast majority of knowledgeable observers feel rate control is the only effective means of removing high sales profits. Indeed, there is some question whether the debtor should pay premiums at all since the creditor is the primary beneficiary of the policy. This is especially true when the creditor makes an unconscionable profit from the insurance sale, for after all, security is the professed purpose, not profit. If Senator Hart is correct in suggesting that absent some form of rate regulation by the states, there is no state regulation within the meaning of the McCarran-Ferguson Act,<sup>117</sup> the Federal Trade Commission or the Justice Department have the power to regulate under current federal laws. Indeed, insurance readily lends itself to federal regulation because of the desirability of universal rate control and enforcement.

However, federal regulation may neither be the fastest nor the

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<sup>116</sup> KRS § 12.040 (1962).

<sup>117</sup> WASHINGTON INSURANCE NEWSLETTER (May, 1967).

most desirable relief. Kentucky needs to take immediate steps to pass statutory rate regulation of all credit insurance. Such regulation should limit the sales profits to that earned on the sale of regular life insurance, the legislation providing either a rate standard or "bench mark" ratio. A less desirable rate control would be one similar to that regarding tie-in sales with small loans, which allows the Insurance Commissioner to reject rates not "reasonable" in relation to the benefit. However, where the Commissioner's discretion may be exercised regarding rate setting, the public's interest may be suppressed in favor of strong creditor pressure. There has never been rate control of credit life insurance in Kentucky, but because of the public interest, it is now desirable and necessary. If creditors and insurers are not abusing rates, they would have no reason to oppose reasonable rate regulation of credit life insurance.

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