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## PREFACE

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### IT'S A LENDING PRODUCT!

In the early 1900s, the concept of an individual's borrowing money for the purchase of a consumer product secured solely by the individual's future earning power was introduced and accepted. Installment debt repaid in monthly installments became the standard. After World War II, the demand for consumer products increased explosively. Consumers began to borrow money routinely to purchase automobiles, modern appliances, and other consumer products, creating what is now known as consumer debt. In the 1960s, open-end debt became significant with the introduction of credit cards and retailer charge cards, which allowed the cardholder to borrow for any purpose, up to a pre-approved limit. Home equity debt grew in importance as a component of consumer debt after the Tax Reform Act of 1986.

For today's consumer, borrowing is easy and convenient. The use of consumer debt to purchase products and services permeates every facet of daily life. Consumer debt in the United States exceeds \$2 trillion. About 17 million new vehicles are purchased annually, the vast majority of which are financed. People borrow to buy boats, vacations, college tuition, clothes, and even groceries.

The borrower's earning power is the *collateral* for consumer debt. The system works well for borrowers when they borrow responsibly, remain employed, and do not experience life-altering events that affect their ability to repay their debts. Life doesn't always work out as planned, and it is not always fair. Unexpected events happen that affect a person's ability to repay debt. Lenders loan money with the anticipation that the loan will be repaid in full with interest. Borrowers and lenders benefit from the ability to protect the collateral of consumer debt via debt protection products.

Recognition of the risk to the borrower and the lender led to the creation and marketing of a number of protection products in conjunction with consumer debt. This book is devoted to a family of lending products, collectively referred to as *debt protection products*, which are designed to provide financial protection to borrowers who experience one of the life-altering events for which protection is provided.

Debt protection products are two-party agreements between the lender and the borrower. They are fee-based lending products in which the lender agrees to cancel, suspend, or waive debt, or otherwise modify the terms of the lending agreement when certain protected events occur to the borrower. Even today, over and over, the question is asked, "Isn't this

insurance?” This book contains information describing the basic elements of debt protection products and what distinguishes them from insurance products.

A vast number of hours have been spent debating whether a debt protection product is a lending product or an insurance product. Many years ago, Congress delegated the regulation of insurance to the individual states. However, *insurance* is defined in many different ways among the 50 states. For state-regulated lenders, this results in a complex set of interwoven and tangled paths to determine the answer regarding lending product versus insurance product.

Federal lending laws trump state lending laws, and have the power to protect, within certain limits, a national lender from intrusion by state laws, including insurance laws, when the lender is doing the business of lending. For a national bank, federal credit union, or federal thrift, the answer throughout the U. S. is simple; it’s a lending product.

For other lenders, the short answer is that, with proper modifications to the contractual document, it can be either; but the long answer is a lot of what this book is about. Ultimately, the *lending product versus insurance* question is settled by a law passed by Congress or a state body, a regulatory fiat issued by the authoritative regulator, a ruling by a state attorney general, or a court ruling. Finding the definitive regulatory pronouncement for a particular lender and a particular lending product can be a challenge. In some situations, a thorough search results in a finding of regulatory silence; that is often the most challenging situation.

There are some theoretical concepts that differentiate the two approaches. Unquestionably, a debt protection product transfers risk from the borrower to the lender, but not all contracts or contractual provisions that transfer risk are insurance.

One critical difference is the word **PAY**. There is no indemnification to the borrower, and no money is paid to the borrower; debt is canceled, suspended, or waived. If the contract defines the benefits to the borrower without using the word *pay*, then there are strong arguments that the contract is a lending contract and not an insurance contract. The basic right to enter into a contract includes the right of the parties to agree to waive payment or performance under certain circumstances. A lender has the fundamental right to tell a borrower that a debt or debt payment is canceled, suspended, or waived.

The second critical element is that the lender can always fulfill its obligation to the borrower under a debt protection product. No solvency risk exists that the lender will not have the money available to fulfill its promise; the borrower already has the money. Even if the lender’s vault is empty, the lender can honor the terms of the agreement by cancelling or suspending debt; the borrower already has the money. Insurance collects premiums from many consumers and promises to pay those consumers who have claims. Strong regulation is needed to assure that the insurer will have the money to PAY the benefits it has promised. The ability to fulfill the financial promises under a two-party debt protection product does not need that aspect of regulation.

Other aspects of the debt protection product arrangement may need regulation. In many cases, the appropriate lending laws, lending regulations, and lending regulators already exist. **Debt protection products are regulated products, but they are regulated as lending products.**

While numerous articles and short papers have been written about these products, there is no comprehensive material published on debt protection products to explain the origin and

history of these products, nor is there any sort of practical guide to aid lenders in the design and construction of debt protection product solutions.

This book addresses that void and serves as a practical guide to enable industry professionals at all knowledge and experience levels to learn and better understand how to construct, price, and manage debt protection products. This book is written with the lender in mind, but administrators, regulators, insurers, and others who are interested in these products will benefit from reading this book.

The early chapters describe the basic components for designing, building, and managing a debt protection product program. Subsequent chapters illustrate how these building blocks are used to develop debt protection product solutions for a variety of lending situations. Information is provided so readers will be able to understand the differences between debt cancellation, debt suspension, and debt suspension with interest accruing; to learn how to construct the debt protection product addendum; and to identify the elements of the contractual liability insurance policy or the administrative services agreement. Detailed information is included on the topics of pricing, program management, and the management of risk. There is some redundancy throughout this book, but only where the redundancy is required in order to provide the reader with a comprehensive understanding of the specific topic or lending situation being described, since many readers will be focused on only one lending category.

Debt protection products emerged in the 1980s, and the products' environment changed continually during the 1990s and early 2000s. By 2003, the environment stabilized, but debt protection product solutions that exist five years from now may not resemble the solutions available today. Undoubtedly, new applications for debt protection products will be found, and new lending products will emerge. Evolution will continue.

There are many appearances of the words *generally*, *typically*, and *in most cases* in this book. The consumer lending environment is so diverse that almost every sentence could have started with one of these words.

Finally, this work product was not completed alone. The co-author biography section and the Acknowledgements provide more information about those who contributed to this publication. We thank the many professionals within the industry who contributed their valuable time, knowledge, commentary, and encouragement to complete this work.

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“It is not the strongest of the species that survives, or the most intelligent. It is the one that is most adaptable to change.” - Charles Darwin



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