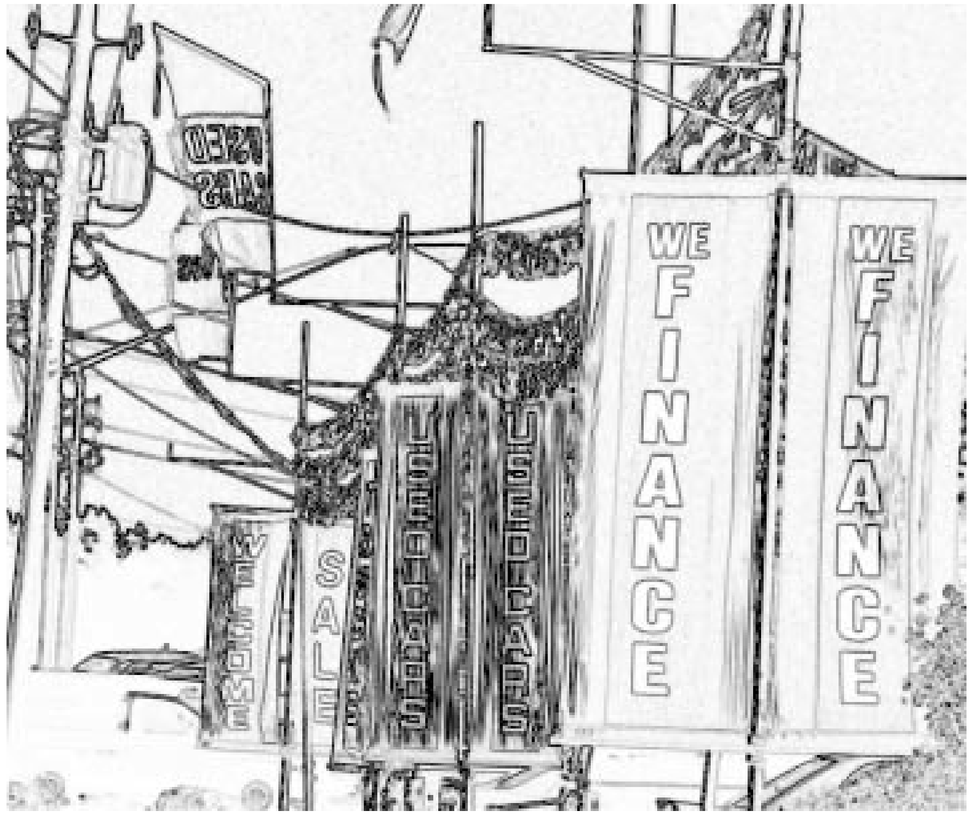
Auto Dealers Sell More than Cars....



Excessive Charges Cost Millions!

A report of the Southwest Regional Office of Consumers Union

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Auto dealers sell a lot more than cars, but avoid most of these extras! Consumers Union looked at credit insurance, theft protection plans and extended warranties and found that dealers make a killing while consumers enjoy minimal benefit. This report, focusing on credit insurance, is the first of two that address the extras you may be offered before you leave the dealer financing office.

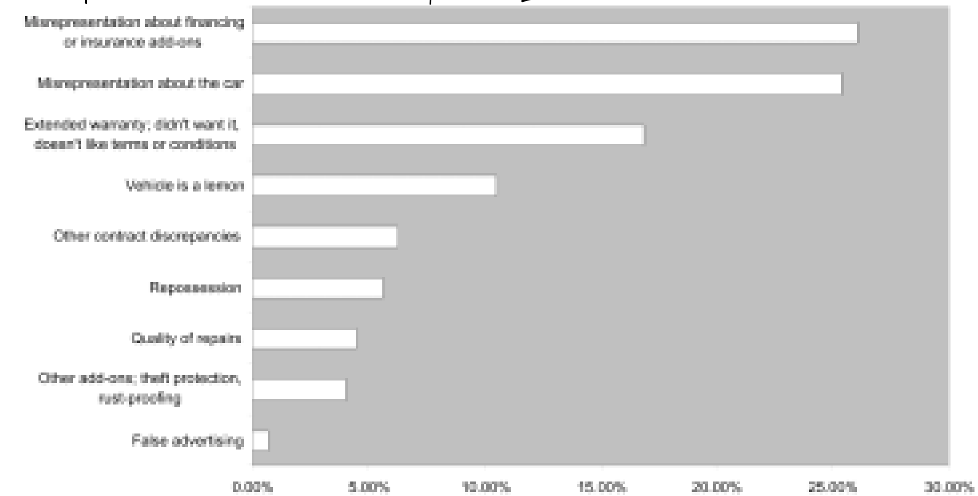
The Consumers Union Study

Consumers Union reviewed 404 consumer complaints filed between 1999 and 2001with the Texas Attorney General's office against new and used auto dealers; credit complaints filed with the Office of the Consumer Credit Commissioner (OCCC) and the Texas Department of Insurance; statewide insurance data from 1997 to 2001 and credit insurance rate filings. Our review reveals on-going problems at the point of sale and demonstrates that dealers enjoy extravagant returns on the few minutes of time they invest over the financing desk.

Short Findings

- About half of the issues consumers brought to the Attorney General related to the car, and about half related to the financing, insurance and extras. Consumers either didn't want these extras, were told they had to buy them to get a better interest rate, or couldn't use them when they needed them.
- Since the legislature created a 30 percent "rate band" around the rate set by the Commissioner of Insurance, most companies in the market have asked for and received a 30 percent rate hike.
- Credit insurers now overcharge consumers about $125 million dollars a year for single premium credit life and disability insurance added to auto, personal property and other credit contracts.
- Auto dealers (and others who sell products on credit) sold more credit

Complaint Issues Identified by Consumers to the AG



life insurance than credit disability to these customers, even though the paid benefits to consumers for credit life are actually lower in relation to the cost of the product.

- Policies are sometimes sold to people who do not qualify for them. The most common complaint about these policies filed at the Texas Department of Insurance involves "rescission," the practice of underwriting the coverage after a claim is filed and finding that the consumer didn't qualify for it in the first place. The company refunds the initial premium rather than pay the claim.
- Although these are low value products sold at a high price, some consumers think they have to buy the product in order to qualify for credit or get the car they want, according to their complaints.

Auto Dealer Complaints

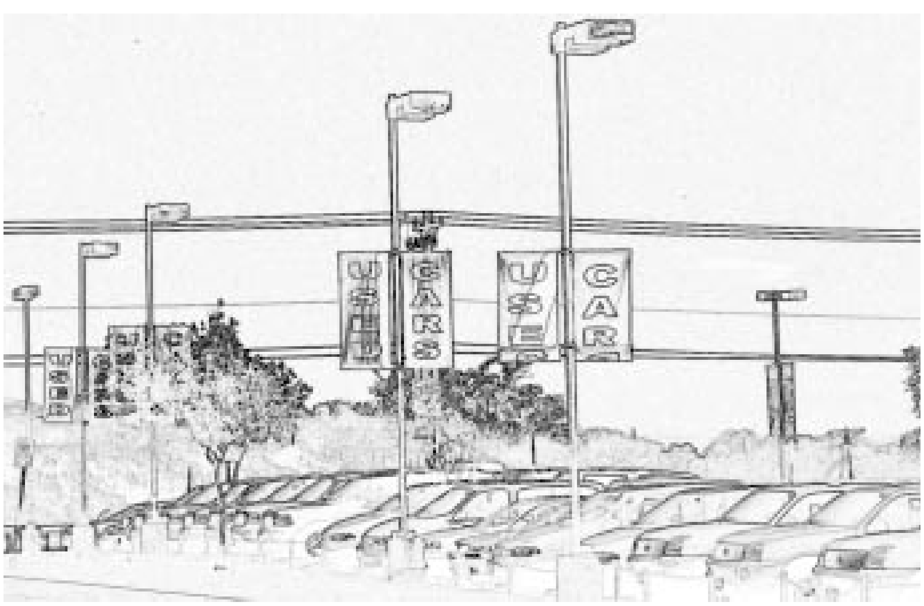
Nearly every year, auto dealers turn up on the top ten list of businesses against which consumers file Attorney General complaints. Consumers Union SWRO looked at 404 complaints filed with the Texas Attorney General to determine the nature of the problems that consumers report, and we found that about half of complaints deal with financing and insurance. While the quality of a car is a shared responsibility between the dealer and the manufacturer, the problems with insurance and other add-ons generally point directly back to the dealership and the hard-sell tactics used to press these low value products on unwary buyers. The products are regulated at the state level and state policymakers should consider new consumer protection laws to put money back in buyer's pockets.

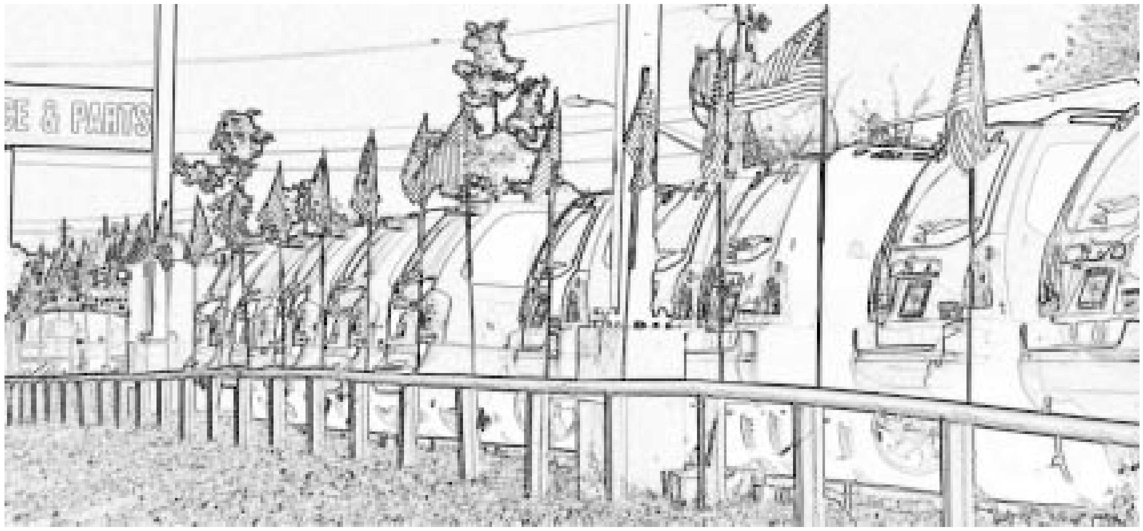
In the first of two reports, Consumers Union SWRO examines the cost and benefit of credit insurance add-ons to dealer financing. In the second report, we will address extended warranty and theft protection—products that resemble insurance but are exempt from even the minimal insurance laws that regulate credit insurance products.

What is credit insurance?

Credit insurance pays your lender if you die, become temporarily disabled or unemployed, or your car is wrecked or stolen. Consumers purchased 81 percent of the credit life and accident and health insurance in force by paying a single premium added on to a loan contract. Nearly all (97 percent) of the credit insurance sold by auto, truck, furniture and other dealers is financed in this way.[1]

Credit insurance is big business in Texas and can mean big profits to those selling or underwriting it. Of the 404 people who wrote to the Attorney General about a problem with their auto dealer, about 23 percent had purchased credit life and 12 percent bought credit disability, adding hundreds and sometimes thousands of dollars to their auto loan. In 2001, Texas insurers earned $263 million in premium for the most common class of credit insurance sold by auto dealers.[2]





Dealers make good money because people don’t shop for credit insurance. Instead, they shop for a new or used car, and get the credit insurance as part of the final loan package. Therefore, insurance companies must compete to become the company chosen by an auto dealer for offer to its consumers. Credit insurance companies pay hefty commissions to auto dealers to encourage them to sell their brand of insurance and to push credit insurance to auto buyers.

Of the $263 million in earned premiums, only $112 million covered claims (42%) while $96.4 million (36%) paid commission and compensation. The remaining $56.2 million (21%) covered other expenses or was invested as profit.[3] This ratio of premiums to claims incurred is among the lowest of all types of insurance. By comparison, auto and homeowners policies pay out more than 80 cents on the dollar in claims.[4]

This framework for buying and selling, where the salesperson benefits directly from higher prices (with higher commissions) and consumers exert little downward pressure on price, is called reverse competition. In hearings, spokespeople for the credit insurance industry admitted that reverse competition drives up the cost of credit insurance to consumers.

“Q: So I take it, the answer to my question then is yes, that creditors benefit by higher commissions from higher rates.

A: Well, your question said they would. I would say they could.

Q: Generally they do, though, don’t they?

A: Generally they do, yes.”[5]

In a 1992 study, the industry’s key expert determined that reverse competition inflates insurance company costs by six percent, but the Texas Insurance Commissioner notes that the effect of reverse competition on consumers could be significantly greater.[6] In fact, Consumers Union believes that the overcharges to consumers in 2001 were far higher than this, and overcharges since September 1, 2001, have gone through the roof.

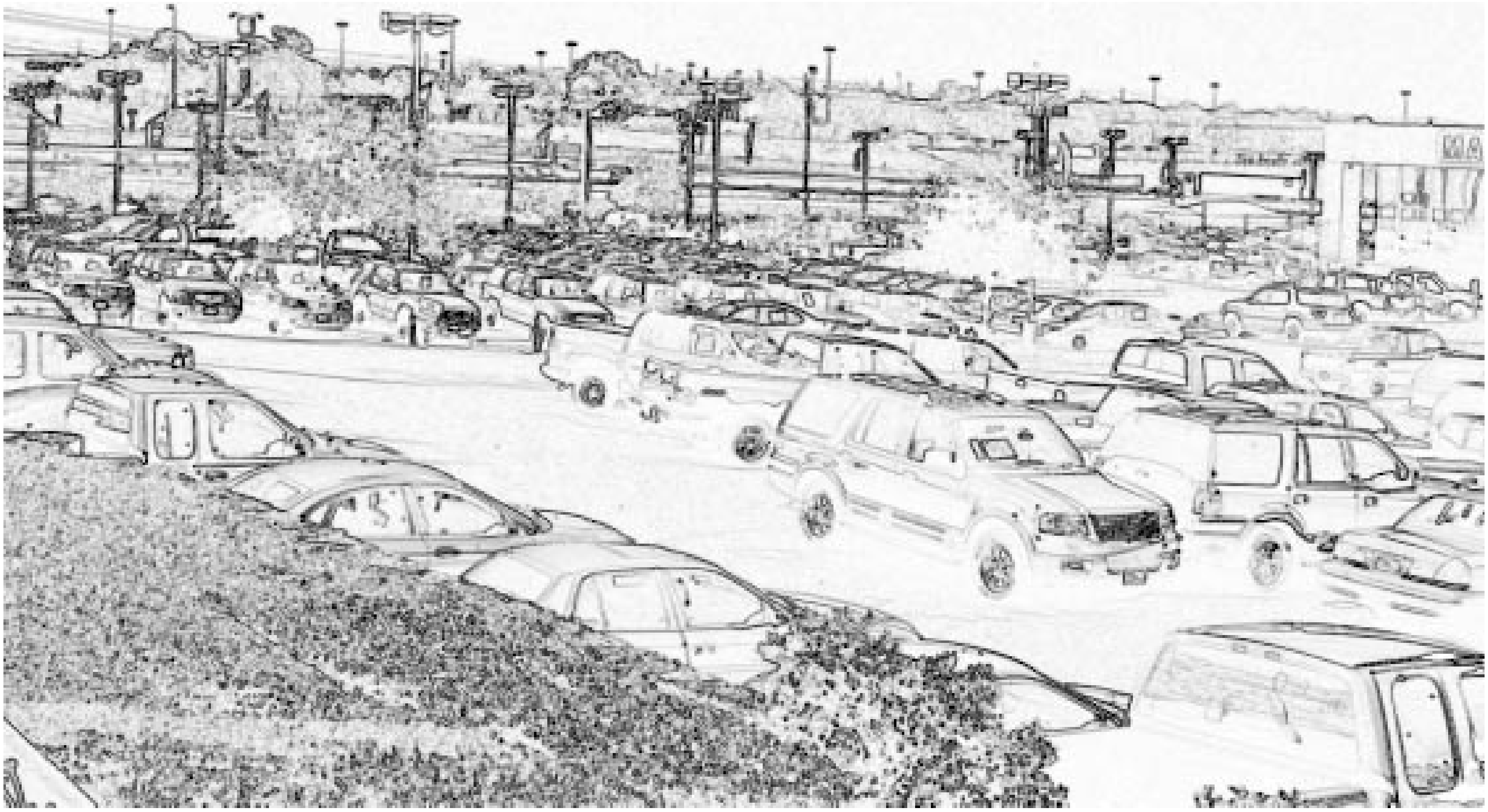
Making a Bad Thing Worse

The Texas Department of Insurance in 2000 lowered the rate for credit life insurance an average of 21 percent based on expert testimony and state premium and loss data.[7] The new rates were designed to produce a product with some value to the end buyer—estimated at about 50 cents in claims payments for every premium dollar for credit life and 60 cents for disability.[8]

In fact, this rate resulted in an actual return to consumers of 49 cents for single premium credit disability and only 37 cents for single premium credit life in 2001. The difference between the state recommended loss ratios and the actual benefits of 37 and 49 cents on the premium dollar represent *an excess premium charge of $59 million* for the insurers and dealers.[9]

The industry, however, believes that consumers should get less than 30 cents of the premium dollar in insurance benefits—and argued for permission to use a much higher rate than allowed by the commissioner. Says Gary Fagg, the industry’s primary witness at the rate hearing, in his manual, *Money on the Table*, “the insurers need about 30 cents/$1.00/year to provide for claims, general operating costs, premium taxes and profit. The rest goes for compensation to the dealership and general agents.”[10]

Unhappy with the new lower rates, the industry asked the Legislature in 2001 for a different rating system and got it. Starting on September 1, 2001, insurers no longer had to charge the rate set by the Commissioner. Instead they could charge up to 30 percent more than the Commissioner’s rate simply by filing their new rate with the Department. According to research first conducted by the Center for Economic Justice, most of the companies selling credit insurance in this state increased their rates



the maximum amount (30 percent) under the new law. Thirty of them filed for a rate increase within weeks of the September 1 effective date and began charging more immediately.[11]

TDI asked insurers to provide the reason why they needed a higher rate. Most companies simply stated that they needed to charge more "to remain competitive" or to maintain "a level playing field" in the industry. Some pointed more directly to the competition for dealers through higher commissions. One company stated that "acquisition costs are not sufficiently incorporated into the Texas rate making process," while another multi-company group asked for money to support "higher acquisition expenses," which are primarily the commissions to the dealers.[12]

Using 2001 as our baseline estimate of market volume for credit life and credit disability, we estimate that **credit insurers now overcharge consumers $125 million** dollars per year on single premium credit life and disability insurance.[13] That estimate is conservative, because we base it on the assumption that credit life and disability insurance sales have not increased due to the higher commission levels.

Based on interest rates charged for a 48 month auto loan by auto finance companies in the past year (a very low interest rate year for auto lending), we estimate that **consumers paid an additional $2.7 million in extra interest** in the past 12 months on the excessive credit insurance cost. The higher charges for credit insurance, assuming a modest increase in claims costs, will produce a loss ratio for credit life of only 30 cents on the premium dollar—exactly what the industry prefers to charge and the worst value for Texas consumers allowed in many years.

Reverse competition drives prices up; companies compete for dealerships by paying higher and higher commissions and this expense is then recouped by increasing charges to consumers. For every dollar that a car buyer spent on credit life and disability insurance in 2001, over a third covered commission expenses (mostly to dealers).[14] This was actually an improvement from previous years (1997 to 1999) when about 42% of every dollar went to commissions.[15] We now expect that dealer commissions have returned to their earlier levels or higher.

Credit Insurance Benefits

Reverse competition has the effect of pushing the market to sell the lowest value policy at the highest possible rate in order to leave the maximum amount of money available to split between the insurance company and the dealer. Among auto dealers, we found credit life insurance to be the most commonly sold policy even though it offers the least benefit to consumers.

From the entire sample of 404 complaints, 94 people reported purchasing credit life insurance while only 49 people reported purchasing credit disability. Because not all consumers report complete information, Consumers Union collected actual retail installment contracts from 163 Attorney General complaint files. The number of credit life insurance policies sold to consumers in this sample (60 policies) was almost twice the number of credit disability policies (34 policies). Although they probably sold fewer policies, Texas insurers paid out more in claims on credit disability than they paid on credit life overall.[16]

Insurers encourage auto dealers to emphasize credit life over credit disability sales because there's more money to split in commissions with the dealer. "The loss ratios on disability insurance usually exceed the loss ratios on life insurance," says Gary Fagg. "To reflect this fact, insurers have begun to vary the compensation percentage on the two products. The primary rationale is that the life insurance products remains more profitable than the disability products, so it should be stressed."[17]

But most people who qualify for credit life insurance (people in good health) can also qualify for low cost term life that will pay a benefit far in excess of the benefit in any credit program. For example, a middle-age, non-smoker in good health can purchase $100,000 worth of term life over 48 months for less than $500. If she dies, her car as well as other major outstanding debts can be paid off to help her family. Auto finance contracts show that consumers paid an average of $510 plus interest for credit life policies with a benefit of only $21,000. [18]

People who do not qualify for coverage: Benefit denied

Credit insurance is easy to buy. It involves no complex underwriting or medical testing. It is often already written into the loan contract. Purchasers of credit insurance affirm that they fall within the age restrictions (generally under 65) and are in good health. This may lead some consumers to believe that coverage is guaranteed, even if they actually do have medical conditions. Pressure to pull down high commissions leads some dealers to oversell the product, or fail to explain what it means to be in "good health."

For example, a husband and wife purchased a car at Cavendar Toyota in San Antonio and had the car specially fitted with a handicap adjustment to the steering wheel for her, according to their letter to TDI. Very sick with cancer, she had already lost the use of one arm due to her surgeries for the disease. "My wife was offered an insurance, and we let the agent know that she was under chemo and she was still under a doctor's care but that she was feeling fine," her husband wrote. "We were up front with the agent about my wife's condition. We asked him if they could still insure her and he said that it would not be a problem."[19] Of course, it was a problem.

Credit insurance companies underwrite their policies *after* consumers file a claim. In this case, she died of her cancer and her husband filed for coverage on the car. The dealer stated that no health conditions were revealed to him, and the insurance company denied the claim, applying only a small premium refund to the loan balance. This process is called rescission and is common in credit insurance.

Some consumers allege that they were never shown the "good health" statement at all. When her husband died, after a long bout with cancer, a widow pulled out his credit insurance application, filed along with the other car finance materials. She noticed that he had never circled the answers to any of the health questions. She filed a claim with Service Life Insurance Company, which

promptly denied it based on a different version of the application in its own files—one where all the questions were answered as if her husband had been in "good health." She wrote to the Texas Department of Insurance.

"He never saw the insurance form....He was given numerous documents by the sales agent and told to "...sign here..." as the salesman pointed to a spot on the form." Ultimately, the company elected to pay the amount owed on her husband's car. "Is there a commission paid to the sales representative and the dealership for insurance sales," she asked the claims manager. "Does this commission "cloud" fair representation of contractual substance to the buyer?"[20] We fear, it frequently does.

Most consumers allege that when they inquired of the salesperson whether certain conditions or illnesses would disqualify them, the dealer tells them its "not a problem." When the consumer then says he or she is in "good health" and a pre-existing illness is later found, it appears to be the consumer trying to defraud the insurance company.

A widow wrote to TDI after American National rescinded her husband's credit life on a Dodge Ram. "My husband read the document and told Mr. Gray that he was under a doctor's care. Mr. Gray said, "no problem."" Her husband died of a heart attack two months later, and the insurer rescinded the policy. The claims adjuster "talked about fraud, meaning that if my husband had taken out this policy knowing he wasn't qualified. I tried explaining the conversation he had with Mr. Gray which said he was qualified. ...She barraged me and insinuated that I knew my husband had committed fraud." American National and the dealer denied these allegations.[21]

Many types of insurance exclude coverage for certain conditions or refuse to insure people with health problems. But rescission is somewhat different. Although it seems like a claims denial to the consumer, it is, in fact, post-claims underwriting. US Life Credit Life includes the following notice on its form: "The truthfulness of the representations (listed above) will not be investigated by us until a claim is filed...".[22]

The company reviews the medical records of the deceased after a claim is filed, and if the deceased had any condition that might have caused an insurance underwriter to refuse the coverage initially—even conditions completely unrelated to the reason the person died—then they will essentially return the policy to the consumer with a full premium refund as if it had never been approved in the first place.

After her husband died of a heart attack, a McAllen widow filed a claim with Service Life. The company asked for all his medical records, and found a copy of a Hepatitis C test conducted after he and his coworkers at a medical facility were exposed on the job. At that time, he had contracted the virus and subsequently received routine liver enzyme tests each year. But none of this related to his death, and his medical records apparently did not point to prior knowledge of his heart condition. Nevertheless, the insurance company rescinded the policy and applied the small premium refund to the amount owed on the car.[23] In a similar case, the insurer rescinded a policy due to a long-standing diagnosis of epilepsy, although it was unrelated to the cause of death—a cancer undiagnosed at the time the consumer bought the car.[24]

From our review of complaints at TDI, it is very clear that many consumers do not understand that their insurance policy may be invalidated if they file a claim within the first two years. Rescission is the single biggest source of complaint to the Texas Department of Insurance—accounting for about half of all reasons for complaint about credit insurance.[25]

After his wife's death, one consumer wrote, "It states that I'm in good health and not seeing a doctor. If that was the case, no one would be able to get the insurance."[26] That could be true, and the credit insurance sales process would be much improved if insurers were required to underwrite polices *before* consumers file a claim—so that those who qualified actually knew they had coverage and those who didn't qualify could not be charged.

Why some people buy these products

Many borrowers, particularly unsophisticated ones, are likely to be overwhelmed at the financing stage of their car purchase—anxious about securing a loan, they are not thinking about the credit insurance, or they might think it will help to secure the loan if they agree to the credit insurance. Although creditors do not *require* credit insurance for credit approval or to get a better interest rate, consumers frequently complained they were told this very thing.

> "Is there a commission paid to the sales representative and the dealership for insurance sales," one consumer asked the claims manager. "Does this commission "cloud" fair representation of contractual substance to the buyer?"[20] We fear, it can.

A Humble, Texas consumer wrote to the Office of Consumer Credit Commissioner, "Mike stated that he could get us a rate of 8.59% from Ford Motor Credit, but we would have to purchase life insurance to get that rate. Otherwise, he could get us a rate of 10.59%."[27]

"I was told that credit life insurance needed to be added on since this was a cosign arrangement," alleged a consumer from Round Rock. "My complaint here is I may have been misled into buying something I would have otherwise declined."[28] A San Antonio consumer reported that the dealer claimed "without the warranty and the credit life he could not guarantee that the loan would pass."[29]

A south Texas consumer reported to the Department of Insurance that, "it was related to me that I must purchase credit life insurance in order for Ford Motor Credit to finance my vehicle purchase. Later, I read in the contract that it was not a requirement of Ford Motor Credit to purchase said insurance."[30] Dealers deny these allegations.

A North Star Dodge customer wrote to the Department of Insurance to get a refund of his credit insurance premium. "He lied to us, stating that the insurance was included in our loan but needed my signature for beneficiary purposes. He held back the contract...giving us a "purchase order" instead. Three weeks later when the contract arrived was when we became aware that we had been charged $538.85 for insurance we would never have bought."

In response, North Star Dodge described the use of a prewritten contract with all the numbers already worked out. "Before the customer signs any paperwork, all numbers are explained," wrote the finance manager. "Again, the customer is told that you sign here for Credit life and last sign here for terms of the contract. If the customer has said that he did not want credit insurance, it would have been removed and another contract would have been signed."[31]

This tactic is in-line with other types of credit insurance sales; "(O)n average, sales representatives spend approximately five to 10 minutes, taking application information and providing a payment quote (often—but not always—with credit insurance premium included)."[32] By quoting payments with add-ons such as credit insurance already included, buyers are less likely to question what the add-ons truly cost them.

Consider one consumer who financed a $14,000 vehicle at 18% for 48 months and purchased credit life and disability for $278 and $684 respectively. At this interest rate, the monthly payment increases by $6.08, but over the life of the loan, $365 in interest charges accrue on this insurance charge alone—38 percent of the price of the insurance. In our sample, the average amount of credit insurance purchased was $498, financed for 5 years at 11.13% interest; generating $154 in interest charges.

This charge is rolled into the financing, even if the consumer wants to pay cash. One Dallas area consumer actually wrote a separate check for the insurance and extended warranty, clearly marked, because she thought she might change her mind. The dealer "had taken the check, which was clearly intended to purchase the warranty and credit life insurance, and applied it as a downpayment," she told the Attorney General. "This was clearly not my intention. I did not want the extended warranty and credit life charges to be financed into my payment."[33]

Auto dealers increasingly rely on credit insurance as well as other add-ons to flesh out their bottom lines. The gross margin auto dealers earn on each unit sold—the difference between what the dealer makes on the vehicle minus what he/she pays for the vehicle—has been steadily declining since 1999, according to the industry. According to the National Auto Dealers association, these declines are the result of "a supercompetitive market which makes the profits generated by finance, insurance and service contracts increasingly important" to the dealer's bottom line.[34]

Recommendations

- The legislature should eliminate the new 30 percent rate "band" for credit life and credit disability policies. Since all insurers leapt to the top of the band, and competition in this market actually drives up rates, the rate band has resulted in a de facto windfall of more than $125 million to credit insurance companies and auto dealers.
- Require credit insurance companies to underwrite the consumer's policy before a claim is filed. Those who actually qualify for coverage will know that the benefits are in place, and those who do not qualify won't be surprised to find they have no benefits at claim time.

Notes

[1] Texas Department of Insurance, Credit Data Call 1997 – 1999, Experience and Expense Summary.

[2] National Association of Insurance Commissioners, Credit Insurance Experience Exhibit, Part 2A, Parts 1A and 1B for 2001.

[3] Ibid.

[4] Texas Exhibit of Premiums and Losses, Homeowners Multiple Peril and Total Private Passenger Automobile Liability and Physical Damage, 2001, downloaded from www.tdi.state.tx.us.

[5] Center for Economic Justice, Comment Before the Credit Insurance Working Group, October 5, 1999, page 3.

[6] Official Order of the Commissioner of Insurance of the State of Texas, Docket No. 454-98-1807.G, February 23, 2000, Findings of Fact Nos. 37-40.

[7] Texas Department of Insurance Public Information Office, "Montemayor Slashes Credit Insurance Rates," October 29, 1999.

[8] Official Order of the Commissioner of Insurance of the State of Texas, Docket No. 454-98-1807.G, February 23, 2000, Findings of Fact Nos. 108-112.

[9] The excess profit estimate grows if we assume the NAIC's 60 percent loss ratio as a fair baseline. Then insurers and dealers made $43.1 million in excess profits from consumers. Difference between actual state and state adopted is $36.6 M and actual state and NAIC is $43.1 M

[10] Fagg, Gary, Money on the Table, Chapter 2, p. 10.

[11] 77th Texas Legislature, HB 2159, effective September 1, 2001. And Texas Department of Insurance, Devn 2159 Rate Filings, 11/04/02, list of specified forms. And underlying rate filings for 39 credit insurers with cover letters. Consumers Union updated the original research of the Center for Economic Justice. As of November, 2002, 39 companies were approved for a 30 percent rate increase. Thirty eight of the 39 companies applied a 30 percent increase to all classes and all lines of credit insurance. One of these companies filed for a variety of different rate increases for credit union business, including some smaller increases and one rate higher than 30 percent above the Commissioner's rate. Four additional companies filed for 30 percent rate increases but had not yet been approved.

[12] Shawn, Jim, Letter to Nancy Waidelich, Enterprise Life, September 17, 2001, p. 2. Bohannan, Patti, Letter to the Commissioner, Assurant Group, August 31, 2001.

[13] We assume that all insurers will charge 30% more than 2001 in the future, but that perhaps 2% percent of single premium business (some credit unions) might continue to be sold at the old rates. We also assume a generous 6% inflation increase on incurred claims over 2001 levels.

[14] Overall 36.39%: National Association of Insurance Commissioners, Credit Insurance Experience Exhibit, Part 2A, Parts 1A and 1B for 2001.

[15] Texas Department of Insurance, Credit Data Call 1997 – 1999, Experience and Expense Summary. During this period, commissions to dealers averaged nearly 50% while commissions to banks, credit unions, and others were typically lower.

[16] National Association of Insurance Commissioners, Credit Insurance Experience Exhibit, Part 2A, Parts 1A and 1B for 2001.

[17] Fagg, Gary. "Money on the Table." www.creditre.net. Chapter 3, page 2.

[18] Term life based on rate quotes for a 42 year old female, non-smoker, with no health problems. A former smoker in her forties with modest health conditions can purchase a $100,000 term life insurance policy and maintain it for 48 months for about $800. From our database, we selected for comparison the credit life policies with a 48 month term. Since credit life policies are sold based only on a short "good health" affidavit, there is very limited underwriting and far less rate variation due to specific health issues. Most credit policies are not available to people over 65 or those on permanent disability.

[19] Complaint to Texas Department of Insurance, Doc. ID 411285, received 4/30/99.

[20] Complaint to Texas Department of Insurance, Doc. ID 403359, received 2/25/99. Also, ID 447972, received 3/22/00; ID 439421, received 1/13/00.

[21] Complaint to Texas Department of Insurance, Doc. ID 404034, received 3/03/99.

[22] Complaint to Texas Department of Insurance, Doc. ID 455641, received 5/24/00.

[23] Complaint to Texas Department of Insurance, ID 405146, received 3/11/99. Also ID 399761, received 1/22/99.

[24] Complaint to Texas Department of Insurance, ID 403738, received 2/26/99.

[25] TDI complaint data for 117 complaints in 1999 and 102 complaints in 2000. "Rescission" is not a reason for complaint category used by TDI. We reviewed a sample of these complaints and determined that most credit insurance complaints categorized as "refund of premium," "delay in claims handling," and "denial of claim" related to the post-claims underwriting process. A significant share of the "cancellation" complaints are also about rescission, but since some are also about simple cancellation we did not include any of these in the estimate.

[26] Complaint to Texas Department of Insurance, ID 403004, received 2/22/99.

[27] Complaint to the Attorney General, File H0007 0096 201 BF.

[28] Complaint to the Attorney General, File A9912 0407.

[29] Complaint to the Attorney General, File S0108 0306.

[30] Complaint to Texas Department of Insurance, ID 442930, received 2/8/2000.

[31] Complaint to Texas Department of Insurance, ID 443927, received 2/14/2000.

[32] U.S. Bancorp Loan Line studies alternative scripts to cross sell credit insurance by phone. Journal of Retail Banking Services, Autumn 1998 v20 n3 p45(6).

[33] Complaint to the Attorney General, File D0110-0233-20.

[34] National Auto Dealer Association, NADA F&I, Service Contracts, NADA Industry Analysis Division, 2001.