MEMORANDUM 02-2004

TO: Financial Institutions and Insurance Companies

FROM: Ken Vines, Wyoming Insurance Commissioner

Date: October 15, 2004

Re: Debt Protection Products and Contractual Liability Policies

Purpose

The purpose of this bulletin is to clarify the position of the Wyoming Department of Insurance regarding the regulation of debt protection products, also referred to as debt cancellation or debt suspension contracts in contrast with a contractual liability policy.

Debt Protection Product (DPP)

A debt protection product is a contract between a lender and borrower under which the lender may cancel, suspend or waive all or part of the contract debt upon the happening of an event that places the repayment of the debt at risk. The protected event may be death, disability or the loss of the product which was the subject of the underlying purchase agreement. The debt protection product is ancillary to the underlying debtor creditor relationship.

Contractual Liability Policy (CLP)

A contractual liability policy is a policy that insures the contractual liability of a creditor who sells a DPP to the creditor's debtor. A contractual liability policy protects the creditor's solvency in the event a number of debtor's contracts must be forgiven at any given time.

Definition of Insurance

Wyo. Stat. §26-1-102(a)(xv) defines insurance to mean "a contract in which one undertakes to indemnify another against loss, damage or liability arising from determinable hazards or fortuitous occurrences or to pay or allow a specified amount or determinable benefit in connection with ascertainable risk contingencies;."

Analysis

A debt protection product is a contract in which one party allows a determinable benefit in connection with an ascertainable risk. The elements necessary for the product to be classified as insurance are present. In its broadest interpretation the definition of insurance would include a debt protection product.

However, traditional insurance provides that if a defined contingency occurs and the insured party suffers a measurable loss, then the insurer shall cover the loss, from funds set aside from the investment of premiums from a group of similar situated parties. Under a debt protection product, the debtor receives a benefit that may have no relation to the loss and the creditor has not been required to take any steps other than cancellation of the debt.

The difference between debt protection products and traditional insurance was noted in the case of First National Bank of Eastern Arkansas v. Taylor, 907F.ed 775(8th Cir.), cert. denied, 498 U.S. 972 (1990), wherein the court stated:

> Although debt cancellation contracts may…transfer some risk from the borrower to the bank, contracts do not require the bank to take an investment risk or to make payment to the borrower's estate. The debt is simply extinguished. Thus, the primary and traditional concern behind state insurance regulation – the prevention of insolvency – is not of concern to a borrower who opts for a debt cancellation contract.

970 F.2d at 780.

To aid in determining when a contract is insurance this office in previous memorandum dated October 14, 1987 and July 25, 1988, adopted a five element test for insurance.

1. An insurable interest
2. A risk of loss
3. Assumption of risk by the insurer
4. Distribution of the risk over a group of persons with similar risks
5. Premium paid for the assumption of the risk

With a debt protection product the creditor does not assume the obligation or the position of the debtor. As previously stated, the creditor is not required to accumulate reserves in order to fulfill an assumed obligation of the debtor. The creditor simply cancels a contract obligation. It would be illogical to say that every time one party to a contract who met with a hardship and was allowed to buy out his obligation, that the parties had created a contract of insurance.

The United State Supreme Court in Union Labor Life Ins. Co. v. Pereno, 458 W.S. 119, 129 (1982) set forth three criteria in determining whether "the business of insurance" was being undertaken:

> [F]irst, whether the practice has the effect of transferring or spreading a policyholder's risk; second, whether the practice is an integral part of the policy relationship between the insurer and the insured; and third, whether the practice is limited to entities within the insurance industry.

Applying these criteria, a two-party debt protection product is not insurance. The debt protection product is not an integral part of the relationship between the debtor and creditor, the loan is the integral business relationship piece. The practice of offering debt protection products is widely accepted within the banking and other financial institutions industry.

In contrast with a DPP a contractual liability policy is a contract between a creditor and a third party. The third party assumes the responsibility to pay the creditor the amount of the debtor's relief on the loan upon the happening of a fortuitous event to the debtor. The contractual liability policy is the integral basis for the relationship between the creditor and the third party, ie. an insurer.

Department of Insurance Position

In summary, debt protection products between a debtor and creditor are not insurance contracts. They fail both the state and federal tests because such products do not require the accumulation of assets to protect the consumer, are not contingent upon the solvency or insolvency of the creditor, lack the element of assumption of risk and is ancillary to the primary loan agreement. If a second contract involves a third party to underwrite, indemnify or assure any risk associated with the debt protection product then the product will be viewed as a contractual liability policy which is viewed as an insurance product subject to the Wyoming Insurance Code.

Questions regarding this memorandum should be directed to James Mitchell, Staff Attorney.