Is Creditor Insurance an Effective Risk Management Tool?

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Introduction

This article explores the effectiveness of creditor insurance as a means of managing creditor risk, ie, its effectiveness in helping borrowers to maintain their debt repayments, in the face of adversities such as periods of unemployment or sickness.

The article begins with a brief summary of the European mortgage market. It then outlines the risks facing mortgage borrowers across Europe and beyond, drawing upon the results of recent research commissioned by Cardif, and undertaken by TNS Sofres, into consumers' attitudes to and behaviour when protecting their financial commitments. Attention then turns briefly to an examination of the European creditor insurance market before focusing in on the UK market and, in particular, Mortgage Payment Protection Insurance (MPPI). Finally, some thoughts are presented as to what the future might hold for creditor insurance.

European Mortgage Market

According to European Mortgage Federation statistics, the European mortgage market has more than doubled in size over the last ten years. In 1993 the total stock of outstanding residential mortgage loans was under 2 trillion euros. By the end of 2003 the figure had risen to 4.2 trillion euros.

A few high level statistics relating to the European mortgage market are set out below.

- Hungary has the highest and Germany the lowest level of home-ownership.
- Mortgage debt now represents around two thirds of total household debt in Europe.
- The average mortgage debt in Europe is around 45% of GDP. In Poland, Greece, and Spain, mortgage debt in terms of GDP increased more than 100%, followed by Portugal, Ireland, and Italy, with more than 80%.
- The most indebted countries are the Netherlands and Denmark.

There is something of a north-south divide, largely historical and cultural, with greater use of debt in the north. The situation is, however, changing, with the southern European mortgage markets exhibiting higher growth rates than those in the north.

Creditor Risk – A European Perspective

Although there is a great deal of integration across Europe, each country also has its own laws, economic arrangements, culture, and personality. This heterogeneity makes the prospect of a single market in mortgages a very long way off indeed, not least in the light of recent referenda on the EU constitution, political posturing by Europe's leaders about the European budget and, indeed, the future of the EU itself.

These differences were evident in the results of independent research commissioned by Cardif and undertaken by TNS Sofres during March 2005 (Cardif, 2005). The research's conclusions are drawn from an international survey of consumers' behaviours and expectations regarding the protection of their financial commitments. The survey, which took place during January and February 2005, consisted of 14,000 telephone or web based interviews with consumers in 14 different countries[1].

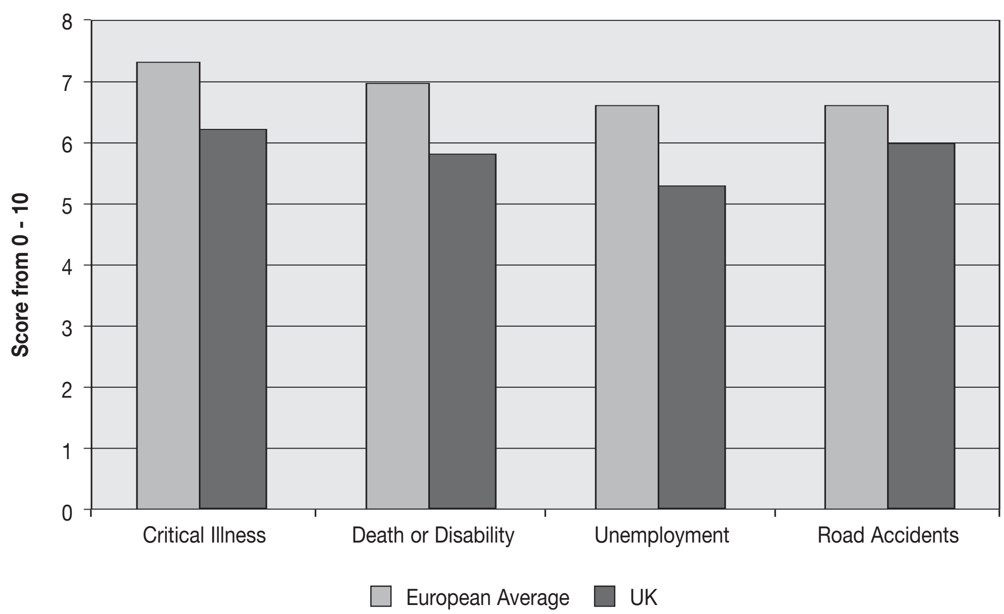
Chart 1 presents survey results that sought to identify the extent of consumers' anxiety with respect to a number of eventualities. Compared to the European average, consumers in the UK seem slightly less concerned with adverse events.

The European average does, however, hide a quite large variance. Chart 2 presents the average anxiety level[2] across European countries. There, again, seems to be a clear

[1] These were Belgium, Brazil, Chile, France, Spain, Germany, Italy, Japan, the Netherlands, Poland, Portugal, Switzerland, Taiwan and the United Kingdom.

[2] The events on which respondents were asked to comment were critical illness, death or disability, unemployment, road accidents, severe events for family members, unexpected expenses, divorce or separation, change in professional status, multiple births, moving and a birth.

Chart 1 – Levels of Anxiety at European and UK Level



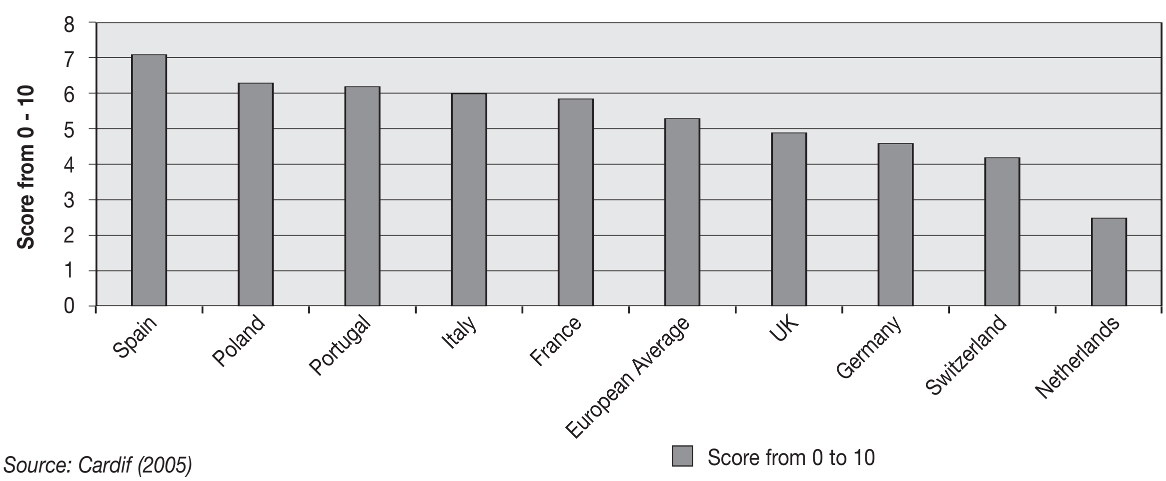
Source: Cardif (2005)

north south divide evident in the data, with southern countries being more anxious than those in the north.

The least concerned EU citizens were those consumers surveyed in the Netherlands, with an average of just 2.5, an amazingly low score compared to the European average of 5.3 and the fact that the Netherlands has one of the highest debt levels in Europe.

In terms of financial vulnerability, the research found that 36% of the working population, aged between 18-65, would find it impossible to maintain their current standard of living if they lost their job. To put this in context, it is worth mentioning that 25% of respondents had experienced difficulty with monthly instalments, although they finally overcame them.

Chart 2 – Levels of Anxiety around Europe



Source: Cardif (2005)

Creditor insurance

Estimating the size of the creditor insurance market in Europe is far from easy, as it is not often reported as a single insurance classification. In the UK, data is split between life insurance and pecuniary loss (special risks). It is also the case that product offerings differ across Europe, with different forms of coverage available, including life, disability, unemployment, critical illness, and permanent disability. For instance, in the UK, creditor policies usually consist of temporary unemployment or incapacity modules, commonly referred to as accident, sickness and unemployment (ASU). In Europe, however, products are more likely to offer life insurance and permanent disability cover.

According to Finaccord's 2003 European Creditor Insurance report (Finaccord, 2003), and using the broadest definition of creditor insurance, that includes life and the permanent disability elements, the total value of the European Creditor market at the end of 2002 was 25.75 billion euros. Of this, the total for ASU type of creditor was 8.45 billion euros. This can be broken down further into 5.23 billion euros for personal loans and motor finance, 1.93 billion euros for mortgage related products and 1.29 billion euros for the credit card sector.

Mortgage Payment Protection Insurance (MPPI) in the UK

Most, if not all, mortgage lenders in the UK offer similar types of MPPI cover. There are differences in such things as excess periods, exclusions, premiums and, benefits. However, they all have essentially the same basic "ASU" insurance modules. This reflects the work undertaken since 1998 to improve the "safety net" available to home-owners, part of which was the creation of a "baseline" specification for MPPI.

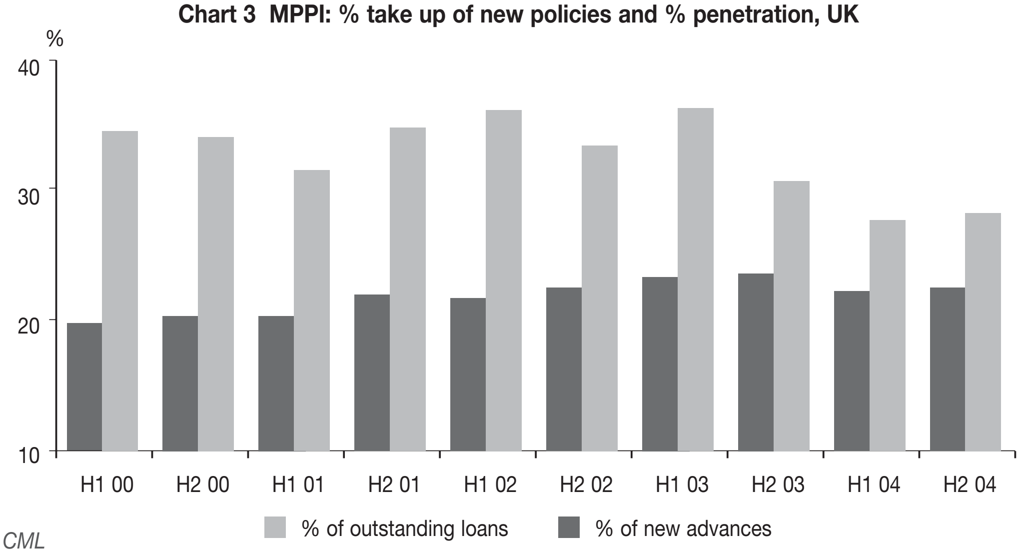
The baseline specification is part of the Sustainable Home Ownership Initiative (SusHo). The initiative, initially a partnership between the Council of Mortgage Lenders (CML), the Association of British Insurers (ABI) and a number of Government departments involved with home-ownership policy (the Office of the Deputy Prime Minister and the Department for Work and Pensions), seeks to enhance both the quality of the safety net available to home-owners and their willingness to access it. This year, the SusHo initiative's steering group has expanded to include the Association of Mortgage Intermediaries, HM Treasury and the Financial Services Authority (FSA); the statutory regulator that has overseen both the mortgage and general insurance markets since 31 October 2004 and 14 January 2005, respectively.

Establishing a baseline specification for MPPI has enhanced the quality of the policies. It sets out a minimum standard that MPPI policies must adhere to, covering, amongst other things, terms and conditions, benefits and exclusions. Intended to raise the bar, in terms of the quality of MPPI policies offered alongside first charge mortgages, the baseline was introduced in 1999 and has the support of the vast majority of mortgage lenders in the UK.

To track the progress of the SusHo initiative, insurers and lenders collect half yearly figures to show the status of MPPI and the safety net it provides mortgage borrowers.

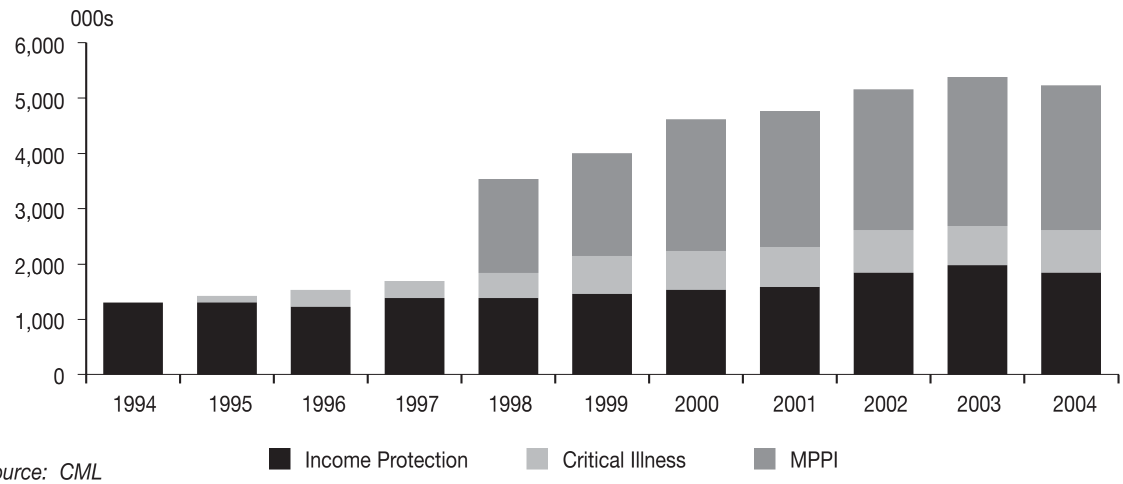
The total number of MPPI policies in force at the end of 2004 was 2.62 million, nearly 23% of the 11,512,000 mortgages outstanding. In terms of sales distribution, 73% of policies are currently sold by lenders, 7% direct to the customer by an insurance company and 21% via financial intermediaries. The average MPPI premium was £4.98 per £100 of cover and the average length of claims is 196 days for accident & sickness and 186 days for unemployment.

Chart 3 MPPI: % take up of new policies and % penetration, UK



Source: CML

Chart 4: Number of MPPI, critical illness and income protection policies



Source: CML

Turning to MPPI policies taken out with new mortgages, penetration rates are currently 28.1%, a fall from the peak of 34.8% in 2002. After some significant progress in the early years of the SusHo initiative, it is clear that the advance of MPPI sales has slowed in the last two years. This is largely due to the benign economic environment in the UK and high consumer confidence fuelled by rampant house price inflation.

It is also the case that the introduction of statutory regulation by the FSA of both mortgages and general insurance has also undoubtedly affected sales of MPPI. Lenders who offered free introductory periods have generally withdrawn or reduced them. This is because the FSA deem "free" insurance to be identical to "paid for" insurance and apply the same regulatory requirements. This has made lenders and intermediaries cautious about exposing themselves to the risk of making an inappropriate sale or providing inappropriate advice due to complacency at the point of sale with the insurance being a no cost sale to the borrower. The FSA has also expressed concerns about product "bundling" (products or multiple insurance products sold on the back of another primary product such as a mortgage or loan). This nervousness on the part of lenders to be exposed to such regulatory risk may become more evident in the next set of MPPI figures for the first half of 2005.

MPPI policies form part of a wider safety net comprising other types of insurance cover taken out to protect mortgage payments, such as critical illness and income protection. Research undertaken by the Centre for Housing Studies at the University of York, *Risk, Homeowners and Safety-Nets: MPPI and Beyond* (Ford et al, 2004), revealed that 60% of borrowers have some form of insurance cover, and that almost a third of borrowers have multiple insurance. The most prevalent combination was MPPI and Critical Illness (9%). Chart 4 shows the volume of MPPI, critical illness and income protection policies in place over the last few years.

The Reputation of MPPI

Despite the improvements made through the development of the baseline by the SusHo, it is still the case that creditor insurance in the UK has a negative image in the media and among consumer lobbying organisations. For some years now there has been a sustained campaign by parts of the media to suggest that lenders have been selling creditor insurance to borrowers primarily because of the high commissions that they receive for the sale.

This has proved to be a convenient stick to beat mortgage lenders with. Recently however, the media and national press have changed tack and are also now suggesting creditor insurance has little value and that people do not need to buy it. This is based on 'the fact' that only a few people actually claim on the insurance (in reality it can be estimated that payouts are worth around £300 million per annum, roughly the same amount as the current state scheme to support those in longer term difficulties). There is a real danger that borrowers will respond to this by not being prepared to take out the sensible insurance protection.

This is particularly true in the light of the substantial levels of personal debt in the UK, which recently passed the trillion pound mark (over 80% of which are mortgages according to the EMF). According to the Department of Trade and Industry's Over-indebtedness Monitoring Paper (DTI, 2005), published early in 2005 -

> "the growth rate of borrowing continues to outstrip that of earnings, pushing up the total debt to income

> ratio to just under 150% of annual income. Average earnings growth has remained relatively static at around 4.5%, so we can expect debt-income ratios to continue to rise in the short term"

Other research from the DTI reveals that 9% of people spend more than half their income on credit repayments and, according to an organisation called Credit Action, the average amount owed by every person in the UK is approximately £18,000. Concern regarding the growth of the debt rises when it is noted that according to research by Datamonitor consumer borrowing for each adult in the UK through credit cards, motor and retail finance deals, overdrafts and unsecured personal loans has risen to more than £4,000. This is an increase of 10%, in just one year and almost 50% since 2000.

Although the growth of debt is a worldwide issue, it has risen faster in the UK than in other countries. A Bank of England report (BoE, 2004) suggests that household debt in the UK is now 140% of aggregate income. This is above the level in most European countries and in the USA. Such debt burdens are sustainable when wages continue to rise, interest rates are stable or falling and house prices are rising. However, in the UK, mortgage costs have increased due to five increases in the Bank of England base rate over the last 18 months.

The UK economy is starting to show some telling signs that an economic downturn and all its consequences could be just around the corner and unemployment is on the rise again. The claimant count has just risen for the fourth month in succession, according to the ONS. The last time it rose for four months in a row was in December 1992. There were 2.96 million workless households in autumn 2004, representing 15.8% of all working-age households. There were 4.15 million working-age people living in workless households, representing 11.4% of the working-age population. Personal bankruptcies are up 28% in the past year and a fifth higher than they were in the early 1990s. The housing market is cooling, with gross UK lending in May 2005 of £22.3 billion, according to the latest data from the CML, a 7% fall from the £24.1 billion lent in May 2004.

Given these statistics and trends, the continuing negative comments in the UK media diminish the value of creditor insurance (including MPPI, one of the most significant parts of the existing safety net for mortgage borrowers) in the eyes of advisers and potential customers. Media comment is typically based on a combination of out of date views on the quality of the product, pricing and the fact that some claims are declined (as is bound to be with a product underwritten at the point of claim). In reality some 85% to 90% of MPPI claims are met, pricing has fallen over time and the quality increased. MPPI is just one choice in a range of options borrowers can choose to protect themselves with if they cannot work and pay the mortgage repayments. It is definitely not the only option borrowers should consider but given the high levels of unsecured debt and the low average levels of savings in the UK some form of protection does make considerable sense.

This was evident in the Cardif research cited earlier. Some 66% of mortgage borrowers were interested in an insurance to protect their repayments and around the same proportion claimed to be aware of their entitlements to state benefits in the event of difficulties. In the UK state benefits and specifically, income support for mortgage interest, provide a partial alternative to private insurance. However, most mortgage borrowers are subject to a nine month delay before state benefits kick in to pay the interest on their mortgages (at a set interest rate which may be higher or lower than the actual rate to be paid). There is also the complexity and stigma (for many people) attached to claiming state benefits, especially when they are means-tested. Private insurance will pay out much sooner and in that sense provides a more immediate safety net. In that regard MPPI provides an important option for borrowers, alongside other insurance such as Critical Illness Insurance and Income Protection. It will usually be the most affordable insurance option and, unlike other options, covers unemployment, a major concern to them.

The adage " there is no longer a job for life" is well understood in the UK, especially amongst the younger generations. No matter how well educated, proficient, or productive workers might be, they can still be the victims of globalisation, mergers, market changes, and many other factors that can cause periods of unemployment. The latest SusHo MPPI figures show that the average duration of unemployment claims were 196 days, that is between six and seven months. So the average benefit period associated with MPPI policies, 12 months (although some are 24 months), offers customers a reasonable period of time to get back into employment. In addition, the benefits can be used again for another full claim period, providing the customers re-qualify by working for a sufficient period before the second claim. Given that people who are made redundant once are more likely to be made redundant again, this is a feature of the MPPI product that cannot be understated.

Conclusions

Arguably, the UK mortgage market is the beating pulse of the UK economy. The current Government is now examining the feasibility of ownership levels rising from 70% towards perhaps 75%. This will further stretch the existing safety net, perhaps too far, if there is no significant change in attitude by consumers towards protecting their capacity to make debt repayments.

To this end, both the lending and insurance industries and the regulator's efforts to improve consumer education and awareness relating to the protection of financial commitments and understanding of borrowing and consumer credit really does need to pick up speed. There is a low level of public awareness, typified in the Financial Services Consumer Panel Annual Report, which revealed that only 14% of respondents to their research knew that the FSA existed (FSA, 2004).

Perhaps there will also be a solution to the negativity in the media regarding creditor insurance via the FSA's current investigation into the creditor insurance market, which is due to be completed later this year. Hopefully the findings will help address any problems and also dispel some of the myths that exist around the product and how it is distributed, purchased and sold. In addition, the work the FSA is undertaking regarding the financial capability of the consumer is an important adjunct to this issue. The lending industry has been working with the FSA on the creation of a borrowing 'tool' designed to help raise borrower awareness of risk and the options they may have for dealing with this (see Solomon, 2005). Better informed customers, alongside better products and processes could go some way to improving both awareness of risk and the actual safety nets in place to help borrowers when in times of difficulty.

Given the risks that exist, it can be argued it is important that the UK creditor insurance market does not go down the same route as it has in the USA. There, take up has been slashed and insurance replaced by non-insurance alternatives such as debt cancellation and debt suspension. These products have all the virtues of creditor insurance but state that they are not insurance contracts. The product benefits of these non-insurance contracts can be customised and priced at the lender's discretion. It is unclear just how the FSA would view these contracts but it could be that they would fall outside their jurisdiction. This will probably need to be decided in the law courts.

In 1999/2000 the net written premiums for all credit related coverage in the USA totalled $7.22 billion. By the end of 2003 this total declined 32% to $4.93 billion. There are already examples of these non-insurance products appearing on credit cards in the UK, so the process has already started. Creditor insurance has a vital role to play as one of the safety net options that mortgage borrowers should be aware of when considering how to protect themselves and their families. However, if non-insurance contracts do begin to replace insurance policies in the UK, will they be subject to the same level of regulatory constraint as insurance contracts?

From a European perspective, creditor insurance is still very young compared to the UK and certainly the USA. There is growth potential for the product in these countries, especially if they seek to restructure their welfare regimes along more "liberal" lines, with an emphasis on the market as the dominant means of support, with state benefits heavily means tested and targeted.

Creditor insurance was first introduced into the UK from the USA in the early 1960s and has matured into a £5.2 billion market. Whilst there is still obviously room for further growth in the UK market, the prospects for growth elsewhere in Europe are substantially higher, especially in the less developed member states, as consumers aspire to reach the same living standards of their European neighbours.

It will be slower and steadier growth in those other countries, which might be looking to rely more on the market than the state in future. This is because of the time it will take to engineer and deliver the desired welfare reforms. In addition, subject to the resolution of continuing teething problems, the EU could help speed up these welfare reforms and thus create the environment for all European borrowers to consider their options in protecting their financial commitments.

Note

Cardif Pinnacle is part of Cardif, a French insurance company, which is a member of the BNP Paribas Group. Cardif offers creditor insurance in 30 countries and is the third largest provider of creditor insurance in the world, offering products in 30 countries.

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