INSURANCE ACTIVITIES OF BANKS AND BANK HOLDING COMPANIES: A SURVEY OF CURRENT ISSUES AND REGULATIONS

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I. INTRODUCTION

Prior to the 1970 Amendments to the Bank Holding Company Act,[1] little controversy attended the insurance activities of banking organizations. In the past decade, however, many aspects of the federal regulations concerning insurance activities of banks and bank holding companies[2] (hereafter

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1. Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, 84 Stat. 1760 (amending 12 U.S.C. §§ 1841-1849 (1964)).

2. The definition of a bank holding company is found at 12 U.S.C. § 1841 (1976) as follows:

> (a)(1) Except as provided in paragraph (5) of this subsection, "bank holding company" means any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of this chapter.
>
> (2) Any company has control over a bank or over any company if—
>
> (A) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting

"BHCs") have been challenged by the Association of Independent Insurance Agents for the reason that the proposed activity did not produce "net benefits"[3] to the public.

These challenges mounted by various independent insurance agents and their associations were premised on the language of the Bank Holding Company Act,[4] which in general prohibits a bank or BHC from acquiring control or ownership of any voting shares of any company not a bank or BHC, or from engaging in activities other than those permitted under subsection (c)(8) of section 1843 of the Act.[5] This subsection allows the acquiring of the shares of any company the activities of which the Federal Reserve Board has determined to be "closely related to banking or managing or controlling banks as to be a proper incident thereto."[6] The subsection has been interpreted to include two distinct tests,[7] the first involving an assessment of whether the activity is closely related to banking, and if so, whether the activity is a proper incident to banking, that is, whether the activity is likely to produce "net benefits" to the public.[8]

Despite the numerous protested applications and challenges to Federal Reserve Board rulings, both the board and the courts have permitted BHC subsidiaries to engage in certain insurance activities after finding that the proposed activity was "closely related to banking."[9] This in turn has led to an expansion of insurance activities engaged in by BHCs and their subsidiaries under the present law. The efforts of those independent insurance agents seeking statutory change have culminated in legislation currently

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securities of the bank or company;

(B) the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or

(C) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.

3. *See* text accompanying notes 7-8 *infra*.

4. 12 U.S.C. §§ 1841-1849 (1976).

5. *Id.* § 1843 (a). *See id.* § 1843(c)(8).

6. *Id.* § 1843 (c)(8). This subsection also provides in pertinent part:

> In determining whether a particular activity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.

7. Association of Bank Travel Bureaus, Inc. v. Board of Governors of the Fed. Reserve Sys. 568 F.2d 549 (7th Cir. 1978).

8. *Id.*

9. For a recent decision discussing what activities constitute acts "closely related to banking," see Bank Americard Corp. v. Board of Governors of the Fed. Reserve Sys. 491 F.2d 985 (9th Cir. 1974) (leasing of computer equipment not closely related to banking). For a complete list of permitted non-bank activities, see 12 C.F.R. § 225.4 (1980). For a list of those activities in which a BHC may not engage, see Regulation Y at 12 C.F.R. § 225.126 (1980).

pending before Congress (H.R. 2255) which, if enacted, would radically change the existing regulatory framework and would limit the ability of banks and BHCs to underwrite and sell a variety of products. This survey article will discuss the current role of federal banking law and regulation with respect to the underwriting and retailing of insurance by banks and BHCs and the potential impact of the legislation currently awaiting Congressional approval.

II. Regulatory Framework

On the federal level, all insurance activities of banks and BHCs are regulated by the BHC Act,[10] the National Banking Act,[11] and the Federal Reserve Act.[12] Regulations and interpretations to implement the provisions of these statutes are issued and enforced by the Comptroller of the Currency and the Board of Governors of the Federal Reserve System[13] (hereafter "the Board").

In addition to federal regulation, statutes and regulations of the several states have a major impact on the level and type of insurance activity permitted for banks and BHCs. Power to regulate the underwriting of insurance was delegated to the states by the McCarran-Ferguson Act,[14] and the states primarily exercise this power through the enactment of statutes which establish retail rates and through licensing rules and procedures including capital requirements.

These capitalization rules can attract or discourage the operation of underwriting in any state. For example, the low capitalization requirements of Arizona[15] attract many underwriting subsidiaries of BHCs who are solely engaged in credit life, accident and health insurance. On the other hand, relatively low maximum permissible rates will tend to discourage such activity.

With regard to insurance agency activities, federal regulations prevail for national banks, state member banks and BHCs, except where state laws are more restrictive.[16] Therefore, a more restrictive state law would prohibit all banks and BHCs from engaging in the specified activity while a less restrictive state law would enable state chartered non-member banks to per-

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10. 12 U.S.C. §§ 1841-1849 (1976).
11. *Id.* §§ 21-215 (1976).
12. *Id.* §§ 221-522 (1976).
13. *Id.* § 1844(b) (1976).
14. 15 U.S.C. §§ 1011-1015 (1976).
15. Newly organized stock life insurance companies must have minimum capital of $300,000 and an initial free surplus of $150,000. Ariz. Rev. Stat. Ann. § 20-210 (West 1975). By contrast, New York requires newly organized stock life insurance companies to have $2 million in paid-in capital and $4 million paid-in initial surplus. N.Y. Ins. Law § 191 (McKinney 1966 & Supp. 1979-80).
16. 12 U.S.C. § 1846 (1976).

form functions prohibited to member banks (inclusive of national banks) and BHCs.[17] In the past decade many states have taken advantage of this feature of federal law to enact laws that restrict or prohibit operation or ownership of insurance agencies by banks and BHCs.[18]

III. History

Prior to 1956, multi-bank BHCs[18.1] were free to sell insurance without much federal regulation and many did so as part of the financial services offered to their customers. National banks historically have been able to offer certain insurance services in towns with less than 5,000 population, and in other places if the activity was a proper incident to the business of banking.[19] With the passage of the Bank Holding Company Act of 1956,[20] the Federal Reserve Board somewhat narrowed the scope of insurance agency activities of BHCs that were considered acceptable, but at the same time generally approved applications under section 4(c)(8)[21] of the Act as long as

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17. *See* BT Managers, Inc. v. Lewis, 461 F. Supp. 1187 (S.D. Fla. 1978) (holding that federal law does not dispossess the states of whatever regulatory authority they exercised over banks and BHCs prior to passage of the federal statutes). *See also* Commerce Nat'l Bank v. Board of Governors of the Fed. Reserve Sys. 451 F.2d 86 (8th Cir. 1971).

18. As of year-end 1979, the following states had some type of restrictions or prohibitions on insurance agency activities by BHCs: Arkansas, Ark. Stat. Ann. § 66-2810(2) (1966 & Supp. 1979); California, Cal. Ins. Code §§ 770.1-771 (West 1972 & Supp. 1980); Colorado, Colo. Rev. Stat. § 10-2-217 (1973 & Supp. 1979); Connecticut, Conn. Gen. Stat. Ann. § 38-76c (West 1969 & Supp. 1980); Florida, Fla. Stat. Ann. § 626.988 (West 1972 & Supp. 1980); Georgia, Ga. Code Ann. § 56-322 (1977 & Supp. 1980); Illinois, Ill. Ann. Stat. ch. 73, § 1065.53 (Smith-Hurd 1975 & Supp. 1980-81); Massachusetts, Mass. Gen. Laws Ann. ch. 175, § 174E (West 1972 & Supp. 1980); Mississippi, Miss. Code Ann. § 83-17-227 (1973 & Supp. 1979); Missouri, Mo. Ann. Stat. § 362.940 (Vernon 1968 & Supp. 1980); Nebraska, Neb. Rev. Stat. § 44-392 (1978); Nevada, Nev. Rev. Stat. § 110 (1979); New Jersey, N.J. Stat. Ann. § 17B:22-8 (West 1963 & Supp. 1980); New Mexico, N.M. Stat. Ann. § 59-5-58 (1978 & Supp. 1980); New York, N.Y. Ins. Law § 7-b (McKinney & Supp. 1979-80); Oregon, Or. Rev. Stat. § 708.100 (1979); Pennsylvania, Pa. Stat. Ann. tit. 7, § 6003 (Purdon 1971 & Supp. 1980-81); Rhode Island, R.I. Gen. Laws § 27-3-46 (1979 & Supp. 1979); Tennessee, Tenn. Code Ann. § 57-721 (1980); Vermont, Vt. Stat. Ann. tit. 8, § 4811(a); and Virginia, Va. Code Ann. § 6.1-58.2 (1976 & Supp. 1980). However, a recent court decision in New Jersey has overturned that state's restrictive statute. ADA Financial Serv. Corp. v. New Jersey, 416 A.2d 908 (Super. Ct. App. Div. 1979).

18.1. The 1956 BHC Act covered only multi-bank organizations. One-bank holding companies were brought under the scope of the Act by the 1970 Amendments.

19. 12 U.S.C.A. § 92 (West 1945) (initially adopted at 39 Stat. 753 (1916)). This section, like its predecessor statute, allows national banks to engage in insurance business in locations not exceeding 5,000 inhabitants. The purpose of this enactment was to allay fears that banks in such localities could not survive unless an additional source of income was provided to improve the banks' stability and profitability. *See* Georgia Ass'n of Indep. Ins. Agents v. Board of Governors of the Fed. Reserve Sys. 533 F.2d 224 (5th Cir. 1976).

20. 12 U.S.C. §§ 1841-1849 (1958) (amended 1966, 1970).

21. Section 4(c)(8) of the Bank Holding Company Act of 1956 is codified as 12 U.S.C. § 1843(c)(8) (1976). The language was section 4(c)(6) in the 1956 Act, but a 1966 amendment resulted in renumbering.

the application was not for a general insurance agency whose functions included unlimited activities in areas unrelated to the lending function of the parent organizations.[22] Board actions during this period were in large part responsible for establishing the basic policy that insurance activities of BHCs should be "closely related" to banking.[23] Under the 1970 Amendments,[24] the Board essentially confirmed the policy it had established between 1956 and 1970 with the adoption of Regulation Y,[25] first published in August 1971. The portion of this regulation relating to insurance was protested and the Board held formal hearings on the protest in 1973.[26] After reviewing the records and the findings of an administrative law judge, the Board issued the final regulation in July 1974.[27] The final regulation was challenged by various parties, but a decision by the Court of Appeals for the Fifth Circuit upheld the Board on most points.[28] The Supreme Court refused to grant the consolidated petition for certiorari.[29]

IV. Pending Legislation

Legislation[30] which has passed the House of Representatives, and is now awaiting action on the Senate floor,[31] would cause a radical change in the regulatory framework for the insurance activities of BHCs at the federal level. This bill would essentially prohibit all insurance activities of BHCs by amending section 4(c)(8) of the BHC Act[32] to state that such activities are not closely related to banking. The bill does, however, create the following six exemptions to this general prohibition.

Exemption (A) BHCs could continue to underwrite and sell credit life, credit disability and mortgage redemption insurance.[33]

Exemption (B) Finance company subsidiaries of BHCs could continue to act as agents (but could not underwrite) with respect to declining balance

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22. *See, e.g.*, In re Northwest Bancorporation, 45 Fed. Res. Bull. 963, 968-70 (1959).
23. *See* text accompanying notes 6-8 *supra*.
24. Pub. L. No. 91-607, § 101, 84 Stat. 1760 (amending 12 U.S.C. §§ 1841-1849 (1964)).
25. 12 C.F.R. § 225.4(a)(9) (1980).
26. S. Rep. No. 923, 96th Cong., 2d Sess. 3 (1980).
27. 39 Fed. Reg. 24220 (1974).
28. Alabama Ass'n of Ins. Agents v. Board of Governors of the Fed. Reserve Sys., 533 F.2d 224 (5th Cir. 1976), *modified*, 558 F.2d 729 (1977), *cert. denied*, 435 U.S. 904 (1978).
29. 435 U.S. 904 (1978).
30. H.R. 2255, 96th Cong., 2d Sess. (1980). This bill passed the House on June 12, 1980. 126 Cong. Rec. H4913 (daily ed. June 12, 1980).
31. As reported out of Committee, the Senate version of H.R. 2255 contains language from several Senate Bills making H.R. 2255 an omnibus bill. S. Rep. No. 923, 96th Cong., 2d Sess. 1 (1980). The Senate Committee also made some changes in the six exemptions and these changes are discussed briefly in notes 33-37 *infra*.
32. 12 U.S.C. § 1843(c)(8) (1976).
33. H.R. Rep. No. 845, 96th Cong., 2d Sess. 4 (1980). The Senate Committee mark-up added the sale of involuntary unemployment insurance on open-end credit to this exception. S. Rep. No. 923, 96th Cong., 2d Sess. 5 (1980).

credit property insurance for property used as collateral on an extension of credit. The exemption is limited to sales of insurance in conjunction with loans of $10,000 or less (as adjusted by the Consumer Price Index).[34]

Exemption (C) BHC affiliates would be permitted to engage in any insurance agency activity in small towns (population does not exceed 5,000) where the BHC has its principal place of business. This exemption is designed to give BHC powers equivalent to those of national banks under 12 U.S.C. section 92. This exemption also applies to towns with a population greater than 5,000 if the BHC can demonstrate that the community currently has inadequate insurance agency facilities.[35]

Exemption (D) The fourth exemption is a grandfather clause. The bill permits BHCs that were lawfully engaged in insurance agency activities as of June 6, 1978, to continue to engage in those activities but does not allow these companies to expand by opening new outlets or by offering new product lines.[36]

Exemption (E) The legislation also exempts supervising agency activities of BHCs limited to the sale of fidelity and property and casualty insurance on the real and personal property used in the operation of the BHC or any of its subsidiaries and group insurance designed to protect the employees of the holding company or its subsidiaries. This exemption is limited to the self-insurance activities of BHCs and is applicable only in the unique institutional framework that exists in Texas.[37]

Exemption (F) All insurance agency activities of BHCs having "total assets"[38] of $50 million or less are exempt from the prohibition of the bill, provided that sales of life insurance or annuities can only be engaged in as provided for in exemptions A, B and C above. Once a BHC exceeds $50 million in total assets this exemption would cease to operate and the BHC would be forced to suspend insurance agency activity.[39]

The regulatory structure that would be created by this legislation is very different from current practice. First, and most importantly, the proposed bill declares insurance agency activities to be not closely related to

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34. H.R. Rep. No. 845, 96th Cong., 2d Sess. 5 (1980). The Senate Committee mark-up added an exemption for mobile home loans of finance company subsidiaries of up to $25,000. S. Rep. No. 923, 96th Cong., 2d Sess. 6 (1980).

35. H.R. Rep. No. 845, 96th Cong., 2d Sess. 5 (1980).

36. *Id.* The Senate Committee mark-up moved the grandfather date to June 12, 1980, the date of passage in the House of Representatives and liberalized the expansion rules for grandfathered activities. S. Rep. No. 923, 96th Cong., 2d Sess. 6-9 (1980).

37. H.R. Rep. No. 845, 96th Cong., 2d Sess. 6 (1980). This exception may be extended to other states by amendment on the Senate floor. S. Rep. No. 923, 96th Cong., 2d Sess. 9 (1980).

38. There is some confusion about the definition of the term "total assets," because this is a term which is not commonly used by the regulatory agencies. The legislative history of the bill would indicate that "total assets" is synonymous with the term "consolidated assets" normally used by the regulatory agencies. H.R. Rep. 845, 96th Cong., 2d Sess. (1980).

39. H.R. Rep. No. 845, 96th Cong., 2d Sess. 6 (1980).

banking.[40] This reverses the regulatory scheme of the 1956 and 1970 Acts which gave the Board the flexibility to define closely related to banking.[41] Second, it abandons the net public benefits requirement,[42] and allows unrestricted insurance agency activity by certain BHCs, the only criteria being the size of consolidated assets.[43] It should be noted that sixty per cent of all BHCs as of year-end 1979 would fall into the less-than-$50 million category and thus qualify for the complete exemption.[44] This legislation thus represents a liberalization of powers for these exempted organizations and its passage would most likely result in an *increase* in insurance agency activity by these organizations. These organizations may expand the volume of current activities and establish new product lines that are currently prohibited by Regulation Y.[45] Grandfathered organizations with more than $50 million in total assets would be restricted to the activities they were engaged in as of June 1978 (June 1980 in Senate Bill),[46] while similarly situated organizations with less than $50 million in total assets could expand their agency activities in any way they choose.[47] Overall, when the differential effects of the proposed legislation are assessed, it is likely that total insurance activity by BHCs will increase and this increase will include growth in volume and expansion into product lines now prohibited under Regulation Y.[48]

A prediction of increased insurance activity under the bill is plausible not only because of the lifting of restrictions on BHCs with less than $50 million in assets,[49] but also because some BHCs may be able to escape the restrictions of the bill by transferring some insurance agency activity to a bank subsidiary (as opposed to a BHC subsidiary) which would be unaffected by the proposed Amendments to the Act.[50] While this loophole may

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40. S. Rep. No. 923, 96th Cong., 2d Sess. 15 (1980).

41. 12 U.S.C. § 1843(c)(8) (1976). *See* text accompanying notes 6-8 *supra*.

42. *See* text accompanying notes 6-8 *supra*. *But see* H.R. Rep. 845, 96th Cong., 2d Sess. 15-16 (1980).

43. *See* text accompanying notes 38, 39 *supra*.

44. Public information, available on request from the Board of Governors of the Federal Reserve System.

45. 12 C.F.R. § 225 (1980).

46. *See* text accompanying note 36 *supra*.

47. *See* text accompanying notes 38, 39 *supra*.

48. *See* 12 C.F.R. § 225 (1980).

49. *See* text accompanying notes 38, 39 *supra*.

50. The argument that banking organizations could escape the restrictions of H.R. 2255 by placing the insurance agency function in a bank subsidiary rather than in a BHC subsidiary has two basic elements: (1) the "bank relatedness" test of the BHC Act, 12 U.S.C. § 1843(c)(8) (1976), seems a more strict standard than the "incidental to" standard of the National Bank Act, 12 U.S.C. § 24(Seventh) (1976), and (2) passage of H.R. 2255 in its present form would not amend the National Banking Act, only the BHC Act. S. Rep. No. 923, 96th Cong., 2d Sess. 1 (1980). If the Comptroller (or state regulators for state non-member banks) determines that operation of a general insurance agency is a proper incident to banking, nothing in H.R. 2255 would prevent a banking organization from transferring its insurance agency subsidiary from the BHC to the bank and continuing to offer property and casualty insurance, because, as the

prove illusory in the face of a court challenge, the possibility of such a transfer should be noted.

V. Issues

Since the passage of the 1970 Amendments[51] to the BHC Act and the adoption of Regulation Y,[52] certain issues relating to the insurance activities of BHCs have continued to appear in contested applications that have come before the Board. Four of these issues are discussed below: (1) the limits to be placed on insurance agency activities of BHC subsidiaries,[53] (2) the tie-in question,[54] (3) the "bank relatedness" of insurance underwriting,[55] and (4) the diversion of income question.[56] The following discussion will outline the major arguments on each issue, give the current disposition of the issue and assess the potential impact of the pending legislation.

A. *Agency Powers*

Sale of insurance to the general public by BHCs or their subsidiaries is generally allowed only in connection with an extension of credit or another type of banking transaction, such as leasing, which is the functional equivalent of an extension of credit.[57] If a sufficient nexus exists to an extension of credit, the following types of insurance may be sold: credit life, health, and disability; property and casualty; mortgage life and other credit related insurance, such as performance or surety bonds. If such a policy comes up for renewal after the loan is fully repaid, present law would prohibit the sale of a renewal policy.[58] This restriction effectively limits the scope and profitability of BHC subsidiary agencies.

There are two exceptions to the requirement that insurance sales by BHC subsidiaries somehow be associated with an extension of credit: (1) the power of BHCs to operate general insurance agencies in towns of 5,000 or

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Board has held since 1970, the BHC Act allows the Board to regulate BHCs, not banks. *See One-Bank Holding Company Legislation of 1970: Hearings Before the Comm. on Banking and Currency*, 91st Cong., 2d Sess. 139 (1970) (statement of Arthur Burns, Chairman of the Board of Governors, Federal Reserve System). Therefore, the regulations imposed on banks by their primary regulator would not be overturned by H.R. 2255.

51. Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, § 191, 84 Stat. 1760 (amending 12 U.S.C. §§ 1841-1849 (1964)).

52. 12 C.F.R. § 225 (1980).

53. *See* text accompanying notes 57-67 *infra*.

54. *See* text accompanying notes 68-87 *infra*.

55. *See* text accompanying notes 88-97 *infra*.

56. *See* text accompanying notes 98-103 *infra*.

57. 12 C.F.R. § 225.4(a)(9)(ii)(a), (b) (1980).

58. 12 C.F.R. § 225.4(a)(9)(ii)(c) would seem to permit sales of renewal policies but this provision of the regulation was invalidated by Alabama Ass'n of Ins. Agents v. Board of Governors of the Fed. Reserve Sys., 533 F.2d 224, 243 (5th Cir. 1976), *modified*, 558 F.2d 729 (1977), *cert. denied*, 435 U.S. 904 (1978).

less population, where the provision of these services is found to be closely related to banking,[59] and (2) the sale of insurance to the BHC itself or to its bank subsidiaries for the purpose of insuring the property, operations, and employees of such banking organizations.[60] These regulatory provisions provide only limited relief from the requirement that insurance sales be related to the extension of credit, and the Court of Appeals for the Fifth Circuit has further limited the applicability of these exceptions by holding that activities initiated under these provisions must also meet the closely related to banking test.[61] In practice, however, the imposition of the closely related to banking test has not destroyed the ability of BHCs to use these exceptions to engage in insurance agency activities. As of December 31, 1979, 476 of the 2,477 registered bank holding companies operated general insurance agencies.[62]

Under the proposed legislation, BHC subsidiaries could continue the sales of credit life, health and disability insurance as long as sales are associated with specific extensions of credit, yet sales of property and casualty insurance on collateral would be limited to finance company subsidiaries, and only for extensions of credit that do not exceed $10,000 adjusted by the consumer price index (the Senate Bill raises this limit to $25,000 for loans on mobile homes).[63] Other than the above restriction on sales of property and casualty insurance, the proposed changes may expand insurance agency activities by BHC subsidiaries. Holding companies with total assets of $50 million or less would be free of restrictions on agency activity.[64] The small town exemption in current regulations would be liberalized by removing the court-imposed closely related to banking requirement.[65] The court-imposed restraints on BHC self insurance for non-bank subsidiaries would be removed for BHCs located in Texas.[66]

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59. 12 C.F.R. § 225.4(a)(9)(iii)(a) places no bank relatedness condition on provisions of these services, but this condition is imposed by Alabama Ass'n of Ins. Agents, 558 F.2d at 731.

60. The language 12 C.F.R. § 225.4(a)(9)(i) does not limit such sales to bank subsidiaries of the holding company. This limitation was imposed by Alabama Ass'n of Ins. Agents, 533 F.2d at 241. This condition is also consistent with 12 U.S.C. § 1843(c)(1)(c) (1976).

61. 558 F.2d at 730-31. *See* notes 59, 60 *supra*.

62. Public information, available on request from the Board of Governors of the Federal Reserve System.

63. *See* text accompanying note 34 *supra*.

64. Holding companies that qualify for this exemption may only engage in the sale of life insurance as provided for in exemptions A, B and C as designated in the text accompanying notes 33-35 *supra*.

65. The Court of Appeals for the Fifth Circuit held that before the Board could implement section 225.4(a)(9)(iii)(a), it had to support that part of its regulation with further findings which would establish the requisite close relationship of banking to general insurance agency activity in small towns. Alabama Ass'n of Ins. Agents, 558 F.2d at 731. *See* notes 59, 60 *supra*.

66. There is some speculation that this exemption will be extended to all states by amendment from the Senate floor. The present language is limited to institutional arrange-

The net effect of the proposed legislation, therefore, will be to restrict the ability of subsidiaries (other than finance companies) of BHCs with total assets of $50 million or less to sell property and casualty insurance and to expand the agency powers of smaller BHCs. Grandfathered organizations could be restricted from future expansion under the House version of the bill, but the Senate Bill gives these organizations a great deal of flexibility.[67]

B. *Tie-Ins*

Tie-ins involve a multi-product firm possessing significant market power in at least one of its product markets, which is used to condition (or tie) the purchase of that product to the purchase of a second product.[68] Such a coercive joint sale is probably a violation of section 3 of the Clayton Act.[69]

Whenever a consumer purchases two or more products from a multi-product firm at the same point in time, a joint purchase has taken place. This joint purchase cannot be classified as a tie-in or tied sale unless the seller possesses some degree of power in the market for one of the products, and uses coercive tactics to induce the joint purchase. In the present context, the tying product is the extension of credit and the tied product is the sale of an insurance policy that is in some way related to the extension of credit.

The major controversy providing the impetus for restricting the insurance activities of financial institutions has historically been the joint sale of credit and insurance, the so-called tie-in issue. Tie-ins, to the extent they are coercive, represent a major abuse of market power, and this issue underlies much of the history of legislation, regulation, and litigation over the insurance activities of banks and BHCs. Much confusion exists, however, on what types of joint sales are potentially abusive.

The potential for unfair practices in the sale of credit related insurance has long been recognized, and explicit tie-ins are prohibited by section 106 of the 1970 Amendments to the BHC Act, which in turn parallels the prohibitions of the Clayton Act.[70] Tie-ins that are implicit and not contractual, yet involve some coercive intent on the part of BHC subsidiaries that sell insurance, may or may not be illegal under section 106; evidence of coer-

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ments peculiar to Texas. H.R. Rep. No. 845, 96th Cong., 2d Sess. 6 (1980).

67. *See* note 36 *supra*.

68. *See* F. Scherer, Industrial Market Structure and Economic Performance 582 (2d ed. 1980); Eisenbeis & Schweitzer, Tie-Ins Between the Granting of Credit and the Sale of Insurance by Bank Holding Companies and Other Lenders, 101 *Staff Studies*, Board of Governors of the Federal Reserve System, 7-8, (February 1979) [hereinafter cited as Eisenbeis & Schweitzer].

69. 15 U.S.C. § 14 (1976).

70. *See* 12 C.F.R. § 225.4(c) (1980) (regulations promulgated pursuant to Bank Holding Company Amendments of 1970, Pub. L. No. 91-607, § 101, 84 Stat. 1760).

cive practices in the sale of insurance, however, is not in the public interest and would be a negative factor under the public benefits test of section 4(c)(8).[71] The Board has the authority to deny an application by a BHC to engage in insurance agency activities where there is a finding that the adverse consequence of the coercive tie-in activity outweighs any benefits to be gained by the public.[72] If the seller has no market power and uses no overt coercive tactics to induce the joint purchase, the only type of tie-in that can occur is the so-called "voluntary" tie-in which does not appear to be a tie-in at all.

A voluntary tie-in is said to occur when a consumer makes a joint purchase from a multi-product firm without any coercion on the part of the seller, but under the perception that the seller has power in the market for one of the products and expects the buyer to purchase both products.[73] Other commentators would go further and include within the definition of voluntary tie-ins all actual or potential joint purchases when one of the products is credit from a commercial bank,[74] reasoning that a creditor inherently possesses market power and thus is perceived by the borrower as having such power. The analysis of the voluntary tie-in phenomenon is further complicated by the fact that any definition of the concept involves assumptions about consumer perceptions that cannot be easily verified. The absence of a definitive definition of voluntary tie-ins causes many discussions of the subject to wander from point to point without direction.

In *Connecticut Bankers Association* v. *Board of Governors*,[75] the Court of Appeals for the District of Columbia indicated that voluntary tie-ins could occur if a prospective borrower of a personal finance company which is a BHC subsidiary acts on the belief that being a customer of the BHC's lead bank would be helpful or necessary in obtaining a loan from the finance company.[76] The potential for this type of voluntary tie-in would be greater when the bank has high name recognition and is in close geographic proximity to the non-bank subsidiary, and promotional activities tend to link the two entities. In its analysis, the court appears to imply that mere structural characteristics of the market in which the supplier operates may tend to give the consumer reason to ascribe market power to the potential supplier, even if the supplier in fact has no such power.[77]

In our view, the question concerns neither the type of product nor what the perception of the customer might be. Rather, the important question is

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71. *See* 12 U.S.C. 1843(c)(8) (1976).
72. *See* note 6 *supra*.
73. EISENBEIS & SCHWEITZER, *supra* note 68, at 8-14.
74. Vaugh, *The Federal Reserve Board's Tying Study: A Critical Analysis, reprinted in, Tie-Ins of the Sale of Insurance by Banks and Bank Holding Companies: Hearings Before the Comm. on Banking, Housing and Urban Affairs*, 96th Cong., 1st Sess. 306, 314 (1979).
75. No. 79-1554 (D.C. Cir., filed Feb. 7, 1980).
76. *Id.* slip op., at 24.
77. No. 79-1554 (D.C. Cir., filed Feb. 7, 1980).

whether or not the supplier has significant market power. If no market power exists, then an abusive situation cannot exist inasmuch as purchases cannot be tied consistently over a period of time, regardless of the type of product or service. If market power is perceived by the consumer, but in reality does not exist, any *involuntary* joint purchase which occurs is the result of imperfect information and should be viewed as a transitory short-term market friction which will be cured by the passage of time and dissemination of information.

Most metropolitan banking markets are not concentrated to the extent that any banking organization should be able to gain the market power necessary to successfully tie the sale of insurance to an extension of credit. Only one-third of all SMSAs[78] have banking markets that are classified as concentrated (a three-firm concentration ratio in excess of .75).[79] It is reasonable to assume that successful tying may require a more concentrated market environment than is necessary to make intramarket mergers suspect. If, for example, a .90 three-firm concentration ratio was necessary to enable a firm to successfully tie insurance sales to credit, only eight of the 277 SMSAs could accommodate such activity. By contrast, forty-two SMSAs have three-firm concentration ratios that are lower than .50.[80]

Even if a banking organization has sufficient market power to successfully tie some non-credit product to the extension of credit in one market, it would be impossible to transfer that power to another market where it has no such power. Adjacent markets across state boundaries would be particularly immune to such a transfer of market power, as the banks could not branch across it and establish a major market position. In the *Connecticut Bankers* decision, the court speculates that a bank's market power might extend beyond the home state in the mind of the consumer, when the non-bank service in question is being supplied in a bedroom community of the home market.[81]

This discussion is useful in identifying the difficulties involved in defining a voluntary tie-in and then applying the concept to policy decisions. The illusive nature of the concept makes it difficult for the Board to cite voluntary tie-ins as an adverse factor in section 4(c)(8)[82] applications. One is led,

78. SMSA is the Standard Metropolitan Statistical Area, which is any city over 50,000 population and the metropolitan area including the county in which the city is located and surrounding counties which are economically tied to it. F. SCHERER, *supra* note 68.

79. A three-firm concentration ratio is the percent of total deposits within a SMSA held by the three largest banks in the banking market. *Id.* at 56-60. For example, a ratio of .75 reveals that the three largest banks in that SMSA hold 75% of all the area deposits. The Department of Justice Guidelines on concentration are written in terms of four-firm ratios, but it is standard practice to use three-firm ratios for the commercial banking industry.

80. Public information, available on request from the Board of Governors of the Federal Reserve System.

81. No. 79-1554, slip op. at 24 (D.C. Cir., filed Feb. 7, 1980).

82. *See* 12 U.S.C. § 1843(c)(8) (1976).

therefore, to formulate a policy where involuntary tie-ins (those tie-ins that are explicit or where the seller engages in coercive activities to induce the joint purchase) would be either illegal or at least considered a negative factor in the "public benefits" test. Voluntary tie-ins would be presumed to have a neutral impact on section 4(c)(8) applications, except where the applicant has considerable market power (as measured by concentration or some other measure of market power) at the location of the proposed activity. The likelihood of involuntary tie-ins becoming an adverse factor is greater in rural banking markets (which tend to be more concentrated than urban markets), and in those SMSAs where banking resources are highly concentrated.

The proposed legislation should have little impact on the tie-in question. Sales of credit life and disability insurance are given a complete exemption,[83] which would eliminate even the slight possibility of a tie-in of property and casualty insurance with an extension of credit by a relatively large BHC, that is, one with assets in excess of $50 million. Under the provisions of H.R. 2255,[84] the smaller non-urban banking markets which are served by the smaller BHCs (those with assets of less than $50 million)[85] would be unaffected. These are the markets where significant market power is more likely to exist and where most participants would be exempted from the restrictions of H.R. 2255.[86] Similarly, most lending transactions of finance company subsidiaries of BHCs, where voluntary tie-ins are more likely to occur, are also exempted.[87]

C. *Underwriting Powers*

The Board has authorized BHC subsidiaries to engage in credit life, accident and health insurance underwriting as a bank related activity.[88] This decision was based on the functional relationship between the extension of credit and the sale of this particular type of insurance, and the historical development of the credit insurance product. As this type of insurance is sold in relatively small amounts, its profitable sale depends on the existence of a delivery system which can provide the product at a low unit cost. Due to the small face value of these policies, an independent delivery system was not viable and was not developed by the insurance industry. Lending institutions could and did market this type of insurance, since the sales could be made at a low unit cost as a secondary function of their lending offices. The underwriting of these insurance products by banks and BHC subsidiaries was a natural outgrowth of this marketing system. Accordingly, national

83. *See* text accompanying note 33 *supra*.
84. H.R. 2255, 96th Cong., 2d Sess. (1980).
85. *See* text accompanying notes 38, 39 *supra*.
86. *See* H.R. 2255, 96th Cong., 2d Sess. (1980).
87. *See* text accompanying note 37 *supra*.
88. 12 C.F.R. § 225.4(a)(10) (1980).

banks were authorized to engage in the underwriting of credit insurance prior to the 1970 BHC Act Amendments.[89]

There are several institutional forms by which banks and BHCs can engage in insurance underwriting. Prior to the 1970 Amendments, most banks and BHCs chose to assume underwriting risks through the variable commission system rather than engaging in underwriting directly. Under this arrangement, a "first line" underwriter processes the paper work and provides the actuarial expertise for a fixed or percentage fee. The funds that remain after both the actuarial needs and the underwriters fee are covered are rebated to the financial institution as a periodic bonus for acting as the underwriters sole agent. An alternative insitutional arrangement is for the BHC to establish a reinsurance subsidiary which reinsures a relatively high proportion of the policies written by the "front line" underwriter. This device allows the BHC to generate revenue from the reinsurance business and take advantage of certain tax advantages available to the insurance industry.[90] Finally, the BHC can directly establish an underwriting subsidiary. This approach is not viable since the underwriting company would have to qualify to do business in every state in which it operates and many state capital requirements are relatively onerous.

Due to the fact that the variable agency commission arrangement tends to encourage high prices resulting from what is occasionally termed "reverse competition,"[91] the Board has required BHCs applying to engage in underwriting to commit themselves to lowering their premium rates. This policy of required price reduction satisfies the statutory mandate that the approved activity must result in a net public benefit.[92]

The underwriting of property and casualty insurance has not been treated like credit insurance. Specifically, the Board has held that underwriting of credit related property and casualty insurance (as opposed to credit life, health and disability insurance) is a distinct activity unrelated to banking.[93] This issue arose in conjunction with an application by a BHC to

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89. The Comptroller has never specifically allowed national banks to operate insurance underwriting subsidiaries, *see* [1978-1979 Transfer Binder] FED. BANKING L. REP. (CCH) ¶¶ 85,113, 85,151, 85,171, 85,174, but they are allowed to write debt cancellation contracts which amounts to underwriting credit life insurance policies. *See* 12 C.F.R. § 7.7495 (1980).

90. The basic tax advantage gained from life insurance underwriting is that 50% of the gain from operations (underwriting) can be excluded from taxable income and is not taxed until it is distributed to shareholders, while losses from underwriting operations can be deducted from taxable investment income. *See* I.R.C. §§ 801-820.

91. The "reverse competition" argument states that because creditors face no serious competition in the market for credit insurance and because creditor income from insurance sales activity is dependent on the size of the premium, creditors have an incentive to deal with underwriters whose policies have the highest premiums rather than the lowest. *See* Note, *Credit Life & Credit Accident & Sickness Insurance—Administrative Regulation of Premium Rates*, WISC. L. REV. 943 (1973).

92. *See* text accompanying notes 6-8 *supra*.

93. In re NCNB Corp., 64 Fed. Res. Bull. 504 (1978).

retain ownership of a large finance company which had an underwriting subsidiary.[94]

The Board recently received an application by a BHC seeking to engage in underwriting mortgage life insurance.[95] The Board determined that the applicant had "failed to demonstrate that there is a reasonable basis for the opinion that the activity is closely related to banking."[96] This conclusion was reached since neither the historical elements nor the unique elements which were important with regard to the underwriting of credit life, health and disability were present in the case of mortgage life insurance.[97]

D. *Diversion of Income*

The Comptroller of the Currency has recently issued a regulation which forbids the diversion of income from the sale of credit life and health insurance from a National bank to any individuals connected in any way with the bank.[98] Prior to the issuance of this regulation, it was not unusual for officers or directors of a National bank to act as agents for this type of insurance, collecting commissions from sales without compensating the bank for the use of its facilities or good will. The Comptroller found this practice to be an unsound and unsafe banking practice.[99] The regulation does not cover income from the sale of other types of insurance, such as property and casualty insurance, which bank officers and directors presumably may continue to sell and for which they may receive commissions, subject to other regulations.[100]

While the regulation issued by the Comptroller appears to prohibit a practice which deprived the bank of some income rightfully belonging to it, the benefits of the regulation may not be so apparent. In many instances, bank officers received these commissions as part of their total compensation. Thus, as a result of this regulation, banks may be forced to raise salaries of affected employees to compensate them for lost income, the net result being of little or no net benefit for the bank. To the extent that customers were pressured to buy such insurance, the new policy will benefit the public inasmuch as loan officers will no longer have a financial stake in the sale of credit insurance. It is somewhat doubtful, however, that sales pressure by

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94. *Id.*

95. *See* Federal Reserve Press Release on a BankAmerica Corporation request concerning permissibility of underwriting home loan life mortgage insurance, July 7, 1980.

96. Order Concerning Permissibility of Underwriting Home Loan Life Insurance, Applicant - BankAmerica Corporation, *Federal Reserve System*, 2 (July 2, 1980). This order was not published in the *Federal Register*.

97. *Id.* at 3, 4.

98. 12 C.F.R. § 2 (1980). The Federal Financial Institution Examination Council has moved to adopt a policy statement on this subject which would be uniform for all federally examined financial institutions. 45 Fed. Reg. 1152 (1980).

99. *See* 12 C.F.R. § 2 (1980).

100. *See id.*

bank officers was widespread. In this regard, surveys have shown that improper pressure was one of the less frequent causes of consumer complaints in the consumer credit area of bank operation.[101] The office of the Comptroller of the Currency has released figures which show that at year-end 1978, there were 1,815 identifiable violations of Regulation Z[102] involving credit insurance in the national banking system, but not one of these violations involved a demonstrated tie-in.[103] This evidence tends to refute charges that sales pressure for credit life insurance is widespread in banks and BHCs.

VI. Conclusion

Many of the issues surrounding insurance agency and underwriting activities of banks and BHC non-bank subsidiaries remain unresolved after a decade of experience under the Bank Holding Company Act Amendments of 1970. However, the regulatory agencies and the courts, through regulation and case-by-case adjudication, have narrowed the focus of disputes. The flexibility of the "closely related to banking" and "net public benefits" tests has allowed the Board and the courts to establish rules that apply to all BHCs and, at the same time, rules can be fashioned to deal with unique circumstances, changed market conditions and new insurance services.

Congress ultimately has authority to change the rules by which regulatory bodies write rules and resolve disputes, but it is not at all clear that the proposed legislation will resolve the issues discussed in this paper, especially the tie-in issue.[104] First, while credit-related life and disability insurance is exempted from the general prohibition, the potential for tying is probably greater for credit-related life and disability than for other insurance products. Since there are generally fewer alternative sources for these insurance products, the situation provides those creditors who operate in concentrated credit markets additional power to force a joint purchase. Creditors do in fact report higher sales penetration rates for credit-related life and disability insurance than for other insurance products.[105] Second, the complete exemption for small BHCs may leave smaller and more concentrated banking markets unaffected. Smaller BHCs frequently are located in markets where the market power that is necessary to successfully engage in tying may be present.

The pending legislation would obviously change the traditional approach to regulation with respect to insurance activities of BHCs. It substitutes criteria based on size of consolidated assets, type of financial institu-

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101. *See* Eisenbeis & Schweitzer, *supra* note 68, at 33.

102. 12 C.F.R. § 226 (1980).

103. *Tie-Ins on the Sale of Insurance by Banks and Bank Holding Companies: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 96th Cong., 1st Sess. 172 (1979) (statement of John Heimann, Comptroller of the Currency).

104. *See* text accompanying notes 68-87 *supra*.

105. Eisenbeis & Schweitzer, *supra* note 68, at 55-56.

tion and size of transaction for the Board's authority to interpret the "closely related to banking" and "net public benefits" tests with respect to insurance activities. This change may produce a regulatory system that is less capable of dealing with issues such as tie-ins than the system it replaces because the criteria cannot be altered to deal with new insurance products or changed market conditions without an act of Congress. In addition, this change may induce other financial service industries to shift the debate over the "permissible" activities of BHCs into the political arena where traditional regulatory concerns for bank relatedness, competition and public benefits might receive less emphasis and attention.