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Statement by

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Board of Governors of the Federal Reserve System

before the

Subcommittee on Commerce, Consumer Protection and Competitiveness

of the

Committee on Energy and Commerce

U.S. House of Representatives

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Mr. Chairman, members of the Committee, I am pleased to be here today to present the Federal Reserve Board's position on the insurance provisions of H.R. 5094, the Depository Institutions Act of 1988. During consideration of the bill by the House Banking Committee, the Board recommended deletion of the insurance provisions as unnecessarily restrictive of competition to the detriment of consumers. The Board maintains that view, with the exception that it supports the bill's intent to authorize bank holding companies to offer financial guaranty insurance. My remarks will amplify on these general statements.

## The Need for Financial Restructuring Legislation

The Board has strongly supported Congressional efforts to enact legislation to update the nation's banking statutes and to create a framework which will allow depository institutions to adapt to the changes in technology and competition which are transforming our financial markets. We are encouraged by efforts undertaken first in the Senate, and now in the House, to begin the process of modernizing the financial system by establishing appropriate structural arrangements for bank holding companies to conduct securities activities. Important goals of these efforts include the promotion of competition and consumer service by broadening the array of financial services providers and enhancing the flexibility and safety of banking organizations and the banking system generally.

To the extent that the bill's insurance provisions are measured against these standards, they fall short. Rather than offering consumers a broader choice of products and financial services providers, the insurance title restricts the number of market participants and opportunities for price competition and constructive product innovation. Rather than allowing depository institutions to develop a more flexible line of products and enhance consumer choices, the provisions impose unnecessary additional barriers to bank participation in insurance agency activities. Importantly, these new restrictions would be imposed in a manner that focuses not on questions of risk, but on ownership, and in so doing would arbitrarily cut back the already limited insurance agency powers of bank holding companies as well as their subsidiary banks.

<u>Bank Holding Company Experience With Insurance Activities</u>

The Board has consistently supported the provision of insurance agency activities by banks and bank holding companies. Acting under the provisions of the Bank Holding Company Act, the Board has authorized the careful expansion of insurance agency activities for bank holding companies. In the original 1956 Act, Congress recognized the appropriateness and benefits of permitting bank holding companies to sell insurance by authorizing, in the Act itself, holding company participation in activities of a financial or insurance nature. Pursuant to this standard, the Board from 1956 to 1970 approved a variety of insurance agency activities for holding companies, including operating general insurance agencies, as well as selling credit-related life, accident and health insurance, the development of which, I might add, was pioneered by banks.

After the 1970 amendments added the closely related to banking standard to the Bank Holding Company Act, the Board continued to authorize insurance agency activities for bank holding companies, including particularly the sale of credit-related property and casualty insurance. In authorizing this activity, the Board determined that its conduct by bank holding companies could be expected to produce public benefits in the form of increased competition and customer convenience that outweighed potential adverse effects. As I will discuss below, the Board also adopted various precautions to guard against the potential for conflicts of interest in the combination of banking and insurance.

The Board's decision with respect to the sale of credit-related property and casualty insurance was challenged, and, in a series of court cases, upheld by the federal courts as an appropriate activity for bank holding companies under the closely related to banking standard and as meeting the safety and soundness, conflict of interest and other prudential standards in the Act.

Subsequently, in 1982, Congress amended the Bank Holding Company Act to prohibit bank holding companies generally from engaging in insurance activities subject to seven exceptions. This statute thereby prohibited bank holding companies from operating general insurance agencies or selling credit-related property and casualty insurance, except in small towns or by small holding companies or where the bank holding company had been authorized to do so before the new statute's enactment.

## Risk and Conflict of Interests Concerns

Nevertheless, over the more than 30 years since passage of the Bank Holding Company Act, bank holding companies either directly or through bank subsidiaries have become substantial providers of insurance agency products. Based upon this record, the Board's view has been that increased bank participation in insurance agency activities may be expected to enhance consumer convenience, lower the cost of insurance, and promote product innovation. Significantly, the Board has found no evidence that these activities have adversely affected bank safety and soundness or the banking system generally, or created the potential for conflicts of interest or other adverse effects. Today's highly competitive market for consumer credit, the Bank Holding Company Act's prohibitions against the tying of bank and nonbank products, such as insurance, and Board regulations requiring disclosure when insurance is sold by lenders, substantially mitigate concerns regarding the potential for tying of insurance purchases to credit decisions. I might add that as a result of the Bank Holding Company Act's anti-tying provisions, bank customers are offered more protection in this area than customers of their nonbank competitors, such as finance companies, which are not subject to these tying prohibitions and, of course, may sell all types of insurance.

In light of these safeguards, the Board does not believe that a general prohibition on the conduct of insurance by bank holding companies and their subsidiaries is necessary or warranted.

Board Reservations Regarding Title III of H.R. 5094

The insurance provisions of H.R. 5094 further limit the already limited insurance agency activities permitted under the 1982 Garn-St Germain Act in two principal respects: First, the bill extends the Garn-St Germain Act to state bank subsidiaries of bank holding companies. Under the bill, state banks may not engage in state authorized insurance activities if they are acquired by an out-of-state bank holding company. Further, state banks owned by in-state bank holding companies must limit their insurance activities to persons present in the state. Second, the bill eliminates insurance agency activities protected by the grandfather provisions of the 1982 Act if the bank holding company providing the insurance is acquired by another bank holding company.

## Insurance Agency Activities of State Banks

With regard to the insurance agency activities of state banks, the Board is opposed to the additional limitations contained in the bill for several reasons. First, as noted, the Board believes that there is no competitive or risk related rationale to justify further restrictions on the conduct of insurance agency activities by banking organizations. This is particularly the case since the bill imposes these further restrictions unevenly based solely on the ownership of the bank by a holding company.

Second, the Board believes that considerations of competitive equity weigh against further restrictions on bank holding company sales of insurance. Thrift institutions, and their holding companies, independent banks, and nonbank lenders, such as finance companies and mortgage banking concerns, have unlimited authority to operate general insurance agency activities. Moreover, a number of our nation's leading insurance underwriting companies have recently acquired federally insured commercial banks or thrifts.

Thirdly, the provisions of H.R. 5094, which restrict insurance activities on the basis of ownership by an out-of-state entity, run directly counter to both marketplace developments and policy determinations regarding the provision of banking services on an interstate basis. This decade has seen a rapid and needed movement toward full interstate banking. Currently, all but five states have enacted laws providing for acquisition of banks in these states by out-of-state holding companies. We believe it is anticompetitive and not in the best interest of consumers to require the elimination of bank insurance competitors as a penalty for the benefits of interstate banking.

Finally, the bill goes far beyond merely closing the South Dakota loophole. As drafted, the bill would require a state bank acquired by an out-of-state bank holding company to cease selling insurance even in the bank's own state. The Board sees no economic justification for this uneven treatment for state banks owned by out-of-state bank holding companies.

<u>Loss of Exemption D Rights</u>

Under Exemption D of the Garn-St Germain Act, bank holding companies may continue to engage in insurance agency activities that they conducted on the May 2, 1982 grandfather date. The exemption applies only to the particular company actively conducting insurance activities on that date. Other affiliates within the same holding company are not allowed to engage in grandfathered activities and there are geographic and product limitations imposed on an Exemption D company. The purpose of this exemption was to avoid the disruption of established customer relationships or the forced divestiture of insurance activities lawfully authorized under the BHC Act and conducted, in many cases, for a number of years.

H.R. 5094 would terminate these grandfather rights if the grandfathered company were acquired by another bank holding company. The Board believes that this termination of grandfather rights is unnecessary in view of the substantial limitations already placed on Exemption D companies. In the Board's view, the intent of Exemption D is that the grandfathered subsidiary should continue to be able to engage in the activity, even if acquired by another bank holding company, so long as the grandfathered subsidiary complies with the geographic and functional limitations in Exemption D and the insurance activity is not transferred to the acquiring company. Under these limitations, already contained in the statute, the acquisition would not add an additional insurance competitor or permit the grandfathered subsidiary to expand its activities other than as limited under Exemption D.

For example, under current law, if a California bank holding company were to acquire a Texas bank holding company with grandfathered insurance activities, these activities could not be exported to California or offered by the California holding company. With such limitations already in place, the Board sees no public policy gain in requiring the termination of the insurance activities of the Texas company with the attendant disruption in settled customer relationships, the loss of a market competitor, and the possibility of substantial financial loss.

Accordingly, the Board would strongly urge that, consistent with the intent of the 1982 Garn-St Germain Act, Exemption D not be revised as proposed.

## Financial Guaranty Insurance

The Board supports as constructive and reflecting the changes that are underway in our financial markets the provisions of the bill permitting financial guaranty insurance.

We believe, however, that as in the case of the securities powers authorized under the bill, it would be preferable for this insurance to be provided through a separate subsidiary of the bank holding company rather than by a subsidiary bank. As presently drafted, the bill would permit banks to offer this product. Unlike the operation of a general insurance agency, financial guaranty insurance is a new activity for banking organizations and poses the additional risk associated with the company acting as a principal rather than as an agent. The Board views these risks as manageable, in large part because banks have had long experience in providing similar types of financial guarantees, such as standby letters of credit. It is, however, in keeping with our general philosophy to safeguard banks and protect the federal safety net to separate nonbank activities from the bank by placing them in separate subsidiaries of the holding company rather than in the bank itself.

The approach of insulating the bank from other activities is integral to the Board's recommendation in favor of the repeal of the Glass-Steagall Act's separation of commercial and investment banking, and, as noted, it is the approach embodied in other sections of H.R. 5094 authorizing bank securities activities. We strongly recommend that such a framework be utilized for nonbanking activities such as insurance underwriting that might be authorized by the Congress.

The advantages to such an approach lie in the separation of banking activities, which are ultimately supported by federal deposit insurance and access to the Federal Reserve System's discount window, from other activities of the bank holding company. As long as there are adequate firewalls between the bank and other subsidiaries of the holding company, any financial problems of the nonbank activities are less likely to become the problems of either the bank or the banking system. Similarly, location of the new activity in a separate subsidiary, along with appropriate firewalls, helps to ensure that the protections of the federal safety net are not extended to the subsidiary's activities.

## Conclusion

To conclude, our analysis of the insurance title of the Depository Institutions Act of 1988 suggests that many of the provisions would further restrict the ability of banking organizations to compete in the provision of insurance agency products and services, thereby limiting consumer options, eliminating the prospect of decreased costs and improved services, and, in many cases, forcing bank customers to turn to other sources to meet insurance needs that banks have long satisfied. Based upon the established record of prudence and safety that bank holding companies and banks have in insurance agency activities, the existing statutory and regulatory safeguards, and concepts of competitive equity, the Board cannot support these further restrictions on bank insurance agency activities. On the contrary, it is the Board's view that insurance agency activities represent an appropriate adjunct to traditional banking activities. The Board would also support, subject to appropriate firewalls, a provision authorizing bank holding companies to offer financial guaranty insurance as well as a broader range of insurance products.