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Statement by

J. Charles Partee

Member, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

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My purpose in appearing before you today is to describe the recent Board staff study of possible tie-ins between the granting of credit and the sale of insurance by bank holding companies and other lenders. I would like also to discuss some related issues that have been raised concerning permissible insurance activities for banking organizations. The appendix attached to my statement describes the study methodology in more detail and attempts to address some of the critical comments that have been made about it.

The Board staff study of tying has received considerable attention. It has been used--and abused--by those seeking either to expand or limit bank and bank holding company insurance activities. The debate has at times become quite heated and both sides have tended to overstate what they interpret the study results to show. Those seeking to expand bank and bank holding company activities argue that the study indicates there are no problems. Those seeking to limit these activities assert that the results are contradictory and meaningless. Some commentators have even charged that the study was biased in order to favor banking organizations.

In view of the current debate and the role that the Board staff study seems to be playing, I'd like to note for the record that we are not here to defend the credit insurance industry or lenders who offer insurance. Certainly there are aspects of their activities that concern me very much. For example, I am distressed about the relatively high charges for credit insurance that seem to persist in the face of low payout rates when compared to other insurance.

It is also not our role to protect the independent insurance agents who have waged a long campaign in both the courts and state legislatures to limit entry by new competitors into their business. I believe that full competition, so long as it is fair and equitable, is the best way to assure that consumers will receive good service at the lowest price.

My purpose today is simply to report objectively my reading of the results of the Board staff study. By way of background, the Board in its 1975 Annual Report expressed concern that some consumer borrowers were being required to purchase credit life and disability insurance as a condition of obtaining loans. Senator Proxmire subsequently voiced this same concern and requested the Board to undertake this study of the sale of insurance by banks and bank holding companies in accordance with the anti-tying provisions of Section 106 of the Bank Holding Company Act.

The study attempts to accomplish two tasks. First, it provides an analytical framework to evaluate whether or not tying is taking place. Second, it reports the results of two special surveys that were conducted. One was a survey of individual consumer borrowers. It focused on borrower experience and attitudes toward credit life and disability insurance in connection with recent loans that were still outstanding. The other survey was addressed to a small group of bank holding companies in order to gather information on their policies, procedures and organizational patterns in selling insurance.

Of particular interest was information on their activities in the property and casualty insurance area. The sample selection and all survey questions were coordinated with and approved by the staff of the Senate Banking Committee.

The survey of consumers focused on those borrowers having outstanding closed-end credit balances with banks, finance companies, retailers or credit unions where the original balance had been $200 or more. Of these, 62 per cent of the borrowers had credit insurance. Retailers and banks had the lowest penetration rates, with about 40 per cent and 61-1/2 per cent respectively; finance companies had the highest at 75 per cent. The supporting evidence from the survey, however, suggested it was unlikely that these insurance coverage rates reflected either explicit coercion (which seemed to be virtually nonexistent) or involuntary tying. For example, relatively few consumers felt that insurance was strongly recommended or required. Among those who did, it was not possible to determine from the data whether insurance costs had in all cases been included in the annual percentage rate on the loan, as required by law.

Only a small portion of the consumers in the survey viewed credit insurance as a "bad service." Most regarded it as desirable, and more importantly, felt it was priced "about right" or even "inexpensive" for what they got, and indicated that they would recommend it to others. Finally, in response to an open ended question about whether they had ever been treated unfairly in connection with a credit transaction, about one-fourth of the respondents cited instances which they considered unfair; none of these cited instances involved reports of coercion or tying in the sale of insurance. This survey result is consistent with the staff's search of the Board's complaint files, since no valid complaint of illegal tying could be found to have been filed by a consumer or business under Section 106 or otherwise back to at least 1970.

With respect to the survey of bank holding companies, few if any firm generalizations can be made about the reported penetration rates because of the character of the responses to the survey. The median reported penetration rates on credit-related property and casualty insurance clustered well below the 40 per cent rate, whether categorized by type of loan or by type of credit originating subsidiary. These penetration rates are lower than I would expect to see if tying were a widespread practice, and are consistent with respondents' reported policies and procedures which our staff does not judge to be conducive to tying. Higher penetration rates were reported for credit life and disability insurance than for property and casualty insurance, but even these varied widely by lender group, type of loan and location of company. Again, the reported patterns of conduct did not seem consistent with extensive tying. Most institutions reported that the insurance solicitation was made after the loan was approved but before the monthly payment was determined.

In sum, the results of the study led the Board's staff to conclude that explicit contractual tying was virtually non-existent and that implicit tying did not appear to be a widespread problem. My reading of the study convinces me that these conclusions are appropriate. I think it is important also to emphasize that these are general conclusions. They do not imply that no abuses have taken place, but simply that problems are not widespread.

Because of the relationship between the tying concerns and a number of pending legislative proposals, you also asked for the Board's views of several additional issues. These include the appropriateness of banks and bank holding companies selling credit life and health or property and casualty insurance, the public benefits arising from these activities and the effects of permitting bank officers acting as insurance agents to direct premium income to themselves that might otherwise have gone to the bank.

The Board's view continues to be that banking organizations should be allowed to sell credit-related insurance, including property and casualty insurance. We believe that the benefits of such activity outweigh any adverse effects. In the first place, the activity of banks and bank holding companies in providing this service is procompetitive. This is an industry where additional competition would seem desirable and potentially quite productive. Second, bank sales of insurance provide a useful and convenient service to the public, including sales at locations poorly served by others. Finally, on the basis of equity, it does not seem to us that banking organizations should be singled out as prohibited sellers among financial institutions and non-regulated lenders. Prohibiting the activity for banking organizations would inconvenience at least some of the public--namely, those borrowers who would prefer to purchase their credit-related insurance from the lender and who would be forced by the prohibition to look elsewhere for the service.

The public benefits from banking organization involvement in the credit property and casualty insurance field rest entirely on the premise that better service and enhanced public convenience represent a valuable attribute. This is especially so since the insurance industry is immune from antitrust statutes. Furthermore, little retail price competition exists because rate ceilings are set by state regulatory organizations and it is the underwriters who set the insurance rates actually charged. In the case of credit life and disability insurance, I would note that holding company applicants often agree to hold premiums below state ceilings as a precondition to Board approval of their applications.

Finally, an area where the link between insurance activities and lending is of concern to the banking agencies involves situations where banking officials, during their working hours, use the facilities of the bank to sell insurance as agents acting on their own account. The effect is to divert insurance premium income that would have accrued to the banking organization had the officer been acting as an agent for the bank or holding company. On the other hand, such premium income can be viewed as an alternative form of compensation for the bank officer, supplementing what otherwise would be an unduly low rate of pay. At present the banking agencies have differing policies toward this practice. These differences need to be resolved, and we will be working to do so as a matter of interagency coordination in the period ahead.

I will be happy to try to answer any questions you may have, assisted by Mr. Robert A. Eisenbeis, the Board's Research Division Officer who was principally charged with overseeing the tie-in study.

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Appendix

The purpose of this appendix is to respond to the major criticisms that have been directed at the Board staff study of tie-ins between the granting of credit and sale of insurance. The aim is to clarify some of the misinterpretations that have arisen. In particular, four areas are addressed:

1. The methodological framework of the staff study.
2. Alternative sources of consumer credit.
3. The omission of certain studies.
4. The assertions that the conclusions are not supported by the evidence.

1. The methodological framework of the staff study.

Conceptual differences over the nature and structure of the relationship between the granting of credit and sale of insurance are at the root of the tying controversy. Lenders and those in the credit insurance industry tend to argue that because of the relatively low cost and essential social value of insurance, a large number of credit extensions with joint insurance sales are to be expected, and these joint sales are entirely voluntary. To the extent that coercion takes place, it is only in a few isolated instances. Parties on the other side of the issue assert that, because of the monopoly power of financial organizations, the structure of the sale of insurance in connection with the granting of credit is, by its very nature, inherently coercive. Therefore, they contend that all joint sales are by definition coercive, and they employ sales penetration rates as the index of coercion.

In reviewing the tying controversy, the Board staff concluded that both of these views of tying were overly simplistic. Moreover, these views were not deemed particularly helpful in generating behavioral hypotheses that could be examined through surveys. Therefore the staff sought to characterize the various types of tying and to identify the conditions under which they might exist.

A review of the relevant economics literature makes it clear that different kinds of tying may exist depending upon the types of pressures exerted on the customer by the supplier. At the one extreme are explicit contractual tying arrangements. Here the seller, through the exercise of monopoly power, is able to coerce the customer to contract formally to tie the purchase of one good--in this case insurance--to the purchase of another--credit. The Board staff labeled this "explicit" tying. At the other extreme, a joint purchase can be made that is purely voluntary, and no pressure to tie is exerted by the supplier or is perceived by the purchaser. Such purchases may in fact result from an economically rational decision by the consumer based upon both convenience and the relative cost of the goods or services.

Between these two extremes a continuum of pressures could exist to achieve joint sales. These could range from situations where there is strong "implicit" pressure to tie by the supplier to the mere perception on the part of the consumer that it might be advantageous to make the purchase. The degree to which these pressures can be exerted successfully and the extent to which they are coercive depends importantly upon the market power of the seller. If consumers have few options for credit, then it is relatively easy to force the purchase of insurance. In contrast, where there are many options for credit, economic theory suggests that only a few customers can be pressured into buying insurance from the lender. Even here abuses can take place. Lack of information and full disclosure could make some customers more susceptible to high pressure sales tactics to make joint purchases. We would not, however, characterize such practices as tying but rather as "unfair and deceptive" sales techniques.

In summary, then, a precondition for joint sales potentially to constitute a tying problem is the existence of some degree of monopoly power. This may lead to supplier conduct employing either explicit or some degree of implicit pressures on the customer to agree to a tied sale. However, developing methods and techniques to measure the relationships between market power and the pressures that might be exerted on individual customers so as to identify where on the continuum of potential tied sales they may lie is a formidable research task.

To deal with this problem, the staff identified a series of indirect types of hypotheses about which evidence could be generated. They might--when taken together--provide some clues to aid in deciding when particular joint sales could represent a potential tying problem. For example, if tying were a widespread practice, it surely would be perceived and reflected in consumer attitudes toward credit-related insurance. First, the perception of pressures to tie would be great. Second, a high proportion of borrowers might view the service as unnecessary, undesirable, and relatively expensive for what they received even though they purchased the service. In this instance consumers would perceive being forced into purchasing a service at nonmarket rates and terms, or else there would be no point for the supplier to exert coercive pressures. Third, if a significant number of borrowers felt coerced, it would generate widespread consumer resentment that would in many cases result in formal complaints.

At the same time, if bank holding companies (or any other organizations) were engaging in tying practices, their procedures for selling insurance and granting of credit would likely be structured to facilitate tying. One would expect to find close coordination between insurance sales and lending, both in terms of the solicitation for insurance and the timing of the credit decision. Organizationally, there could be patterns in the way agents are compensated for insurance sales. If coercive sales were promoted, incentive compensation to induce greater sales penetration could be more prevalent.

Finally, high penetration rates would likely result from aggressive tying policies. It should be noted, however, that high sales penetration rates are not, in themselves, evidence of tying behavior, despite the arguments of those who believe tying is a significant problem. High penetration rates are also consistent with a high incidence of voluntary joint purchases; they become an important indicator of involuntary tying only when accompanied by other evidence of coercive sales practices and consumer perceptions of required joint purchases. By the same token, the existence of aggressive salemanship is also not unambiguous evidence, by itself, of tying behavior.

Those who criticize the staff study methodology essentially deny that any of the consumer reactions hypothesized as being related to tying are likely to be indicators of tying behavior. Thus one is left with the curious result that even though a borrower has been presumably coerced, this will generate no resentment toward the product. It may be even desired and thought to be fairly priced.[1/] Nor will the consumer be motivated to file a complaint. In other words, there is almost no evidence that would provide an indication that tying is taking place rather than a voluntary joint purchase.

2. Alternative sources of consumer credit.

As already noted, substantial monopoly power in the credit market is critical to being able to coerce consumers to purchase credit insurance. Those who believe that banking organizations engage in tying behavior point to the unique position that banks play in providing a package of deposit and credit services to consumers.

While this view of the uniqueness of commercial banks may have been true at one time, it is now clear that the more traditional distinctions are eroding rapidly. Banking organizations are being brought increasingly into greater and greater competition with other financial and nonfinancial lenders in providing consumer credit services. It is now the case that consumers have a broad range of alternative sources of credit. The attached table, for example, tabulates for the Board staff study the proportion of borrowers who obtained credit from retailers, banks finance companies and credit unions by type of loan. In total, banks had

1/ One commentator does argue that resentment may be directed instead toward the supplier. We note that in response to a broad, open-ended question on whether they had ever been treated unfairly in a credit transaction, about 25 percent of the respondents (622) cited 947 instances they considered unfair; none mentioned coersion or tying in the sale of insurance.

Loans in excess of $200

(percent)*

Lender	Total	New Car	Used Car	Addition and Repair	Durables	Personal
Banks	51.2	53.2	64.5	66.7	33.0	45.2
Finance Companies	14.1	13.4	11.1	5.6	14.8	20.4
Credit Unions	21.2	28.0	17.9	16.7	14.3	21.7
Retailers	13.4	5.3	6.5	11.1	37.9	12.7
Total	99.9	99.9	100.0	100.1	100.0	100.0

*The total may not seem to 100 percent due to rounding.

about 50 percent of the consumer credit market, with the shares for individual loan categories ranging from a high of 66.7 percent to a low of 33.0 percent. Furthermore, in most consumer credit markets, especially in urban and suburban areas, a number of banking and other organizations supply consumer financial services.

3. The ommission of certain studies.

Commentators on the Board staff study state that certain studies were omitted from consideration that provided evidence of tying behavior. These included:

A. Complaints filed by consumers to the FTC outlined in the the 1974 Annual Report of the Commission to the Federal Reserve Board.

B. A 1969 Board Staff report to Senator Proxmire which surveyed Federal Reserve Banks.

With respect to the FTC report, the one documented complaint about a bank it contained was not regarded as valid by the appropriate bank regulatory agency. Furthermore, the FTC staff itself stated that "...the actual incident may have been an isolated misunderstanding between the lender and borrower." Beyond this, no analysis or other information was cited that pertained to banks and bank holding companies, which were the primary focus of the Board staff study.

The Federal Reserve staff report was a survey of Reserve Banks--not commercial banks--for their opinions concerning bank practices in the sale of credit life insurance. The staff report stated, "Most of the Federal Reserve Banks reported that no specific situations had come to their attention involving questionable practices in the sale of credit life insurance by banks, their officers or affiliated organizations in connection with loans by the banks." The report contained no analyses nor did it report any data.

4. Conclusions not supported by the evidence.

Those who believe that the study conclusions are not supported by the data tend to focus on the interpretation of essentially two types of numbers: (a) the reported penetration rates and (b) the proportion of customers who felt that insurance was "required" or "strongly recommended."

With respect to the penetration rates, it is argued that the numbers reported are biased downwards, since they are lower than those reported to the FTC by a few individual firms. Hence, these rates are said to understate the extent to which coercion is taking place.

The Board staff did not, however, use these penetration rates as indices of coercion but merely as indicators of whether they were high enough to warrant going further with an attempt to determine if tying was taking place. In describing the penetration rates, the staff concluded that they were not so high as to be suggestive of the possibility of widespread contractual tying, but they were sufficiently high to carry on with the investigation for the existence implicit tying. Eventually, they were only one element in the overall conclusion.

The interpretation of the extent to which consumer perceptions of the pressures exerted on them represent coercion is admittedly subjective. The critics of the Board staff study believe that the proportion of customers who reported that they felt the purchase of insurance was either "required" or "strongly recommended" should be interpreted as direct evidence of coercion.[1/] There are several reasons, however, why the staff chose to be much more cautious. First of all, it is not illegal to require that insurance be purchased so long as the costs are disclosed in the APR. What is illegal, is to require that insurance be purchased through the particular creditor. Unfortunately, standard survey methods do not easily allow separation of those who were "legally" required to purchase insurance from those who were not. Second, there is other evidence to suggest that "strongly recommended" response was just as consistent with the existence of salesmanship as with other interpretations. For example, almost 30 percent of the consumers did not purchase insurance.[2/] This indicates that there were an important group of people who felt no deciding pressure to purchase insurance.[3/] Moreover, over 75 percent of the respondents did not get the impression that insurance was either required or strongly recommended. This, coupled with the responses on consumer attitudes toward the product itself led the staff to conclude that implicit tying was not a widespread problem. The Board staff conclusions were based upon a weighing of the totality of the evidence from both surveys rather than on a narrow interpretation of a single number.

1/ It is noted that a consumer's perception that insurance is required may or may not be correct.

2/ The proportion without insurance by class of creditor was retailer (46%) bank (32%), finance company (16%) and credit union (20%).

3/ Furthermore, to exclude these customers from the base when evaluating the extent of pressure brought on consumers seems to the staff to be inappropriate.