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Bank Holding Companies' Participation in Credit Insurance Underwriting

by Paul R. Watro

Banking organizations have responded to the growing demand for financial services by expanding the number of services that they offer. Commercial banks can offer nonbanking products and services through bank holding companies (BHCs). The resulting organizations can utilize existing facilities and resources more effectively and gain entry into potentially profitable areas; at the same time, the public benefits through price, product, and service competition.

The Bank Holding Company Act of 1956, amended in 1970, authorizes bank holding company expansion into nonbanking activities. The Board of Governors of the Federal Reserve System decides which nonbanking activities are permissible. A permissible activity must be so closely related to banking as to be a "proper incident thereto," and the activity must be expected to produce benefits to the public that outweigh possible adverse effects. The Federal Reserve has approved a number of such nonbanking activities, including finance, mortgage, leasing, and trust companies; data-processing services; investment or financial advising; management consulting; sale of travelers' checks; and underwriting credit insurance. The Federal Reserve does not permit activities such as property management, land developments, and travel agencies.

The Federal Reserve approves applications to engage in underwriting credit insurance only if net public benefits are expected to occur; these benefits normally are shown by a commitment to reduce credit insurance rates. Despite this requirement, underwriting credit life and credit accident and health insurance is a popular nonbanking activity for BHCs. This *Economic Commentary* examines the public and corporate benefits associated with credit insurance underwriting by BHCs in the Federal Reserve Fourth District.[1]

1. The Federal Reserve Fourth District includes all of Ohio, the eastern part of Kentucky, the western part of Pennsylvania, and the northern panhandle of West Virginia. Only the Fourth District BHCs headquartered in Ohio and Pennsylvania currently operate credit insurance underwriting subsidiaries.

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The Market for Credit Insurance

Credit life and credit accident and health insurance are designed to facilitate repayment of a loan in the event of the death or disability of the borrower. Credit life is usually available for either single or joint coverage. Credit disability insurance is retroactive, typically after a 14-day waiting period provided that the insured debtor is disabled for more than 14 days. Credit insurance is offered by a variety of underwriters and typically is sold by banks and other lenders in conjunction with a loan.

The individual states regulate the price of credit insurance by setting *prima facie*, or maximum allowable, rates; these rates vary widely among states. In the Fourth District states *prima facie* rates currently range from $0.50 to $0.75 per $100 of debt per annum for credit life insurance; rates for credit accident and health insurance range from $2.13 to $2.69 per $100 of debt per annum.[2] However, statutory rate ceilings are not always binding, because underwriters may apply for and receive approval of upward rate deviations. Various states, including Pennsylvania, have approved rates above the statutory rate ceilings for individual insurance companies based on the company's loss experience in the previous two or three years. These approved rates effectively act as the *prima facie* rates for the individual company when selling credit insurance.

The Federal Reserve permits a BHC to underwrite credit insurance only in connection with credit extended by a BHC subsidiary.[3] Underwriting differs from merely selling the insurance, notably in assuming the risk of loss. Underwriting this risk may be done either *directly* as an underwriter or *indirectly* as a reinsurer. A reinsurer bears the underwriting risks of the credit insurance and receives the residual of premiums after fees and claims are paid. All of the 14 BHCs that now underwrite credit insurance in the Fourth District are *reinsurers*. As intermediaries, reinsurers have contractual arrangements with direct insurers who are authorized to underwrite and sell insurance to the public in the state where the BHC lending subsidiaries operate. A direct insurer issues policies, collects premiums, pays claims, and prepares tax and other required reports. The direct insurer charges a fee for these services that generally depends on the premium volume.

Public Benefits

Banks and other lenders often sell credit insurance at the maximum permitted rates. To ensure that tangible benefits accrue to the public, the Federal Reserve has established rate-reduction guidelines in considering applications for BHC subsidiaries to underwrite credit insurance (see table 1). These reductions are calculated from the insurance rates actually being charged by the BHC's lending subsidiaries at the time of application rather than from *prima facie* rates. The rate reduction necessary (but not sufficient) for approval of underwriting credit life insurance varies directly with the current rates being charged.[4] For example, a $1.00 rate per $100 of debt requires a 15 percent reduction, whereas a $0.50 rate per $100 of debt requires a 2 percent reduction. The Federal Reserve's guidelines generally call for a 5 percent rate reduction for the underwriting of credit accident and health insurance.

Rate reductions on credit life and disability insurance must be maintained over time. When a state lowers its *prima facie*

2. Credit life insurance rates are for single-decreasing-term coverage; credit accident and health insurance rates are for 14-day retroactive coverage.

3. However, BHCs cannot underwrite level-term credit insurance in connection with installment loans, joint credit insurance (unless both insurers are co-signers or co-makers), or credit insurance in connection with loans secured by first mortgages.

4. Of course, some BHCs have opted for higher rate reductions. In addition, financial, managerial, and competitive factors also were analyzed and considered consistent with approval in these applications.

Table 1 Rate Reduction Guidelines[a]

Prima facie or current rate per $100 per annum	Reduced rate per $100 per annum	Percentage reduction
$1.00	$0.85	15.0
0.90	0.80	11.1
0.80	0.74	7.5
0.70	0.66	5.7
0.60	0.58	3.3
0.50	0.49	2.0

a. Acceptable rate reductions for single-decreasing-term credit life insurance are calculated according to the following formula:

$$RR = BR \left[\frac{1 - (BR)^3}{6.66666} \right]$$

where RR = reduced rate
BR = current rate unless the insurance is new, in which case the *prima facie* rate is used.

The same percentage is used for reductions for level term and joint credit life as for single-decreasing-term credit life insurance. Reductions for credit accident and health insurance generally have been 5 percent, regardless of the current or *prima facie* rates.

SOURCE: Federal Reserve System Letters BHC-129 and BHC-170.

rates, the insurance underwriting subsidiary is required to reduce its rates below the new *prima facie* rates by 5 percent for credit disability insurance and by the amount specified in the Federal Reserve's sliding-scale schedule for credit life insurance. *Prima facie* rates do not change very often. However, when a state changes its statutory rates, or when an individual underwriter receives permission from the state's insurance department to raise its rates, the BHC must submit a revised rate schedule for Federal Reserve approval. These new rates must continue to show public benefits commensurate with those provided at the time of approval of their application to engage in such activities. While not regulating insurance rates, the Federal Reserve ensures that benefits will accrue to the public over time.

The Federal Reserve System has approved 15 BHC applications in the Fourth District since the advent of credit insurance underwriting by BHCs in 1972.[5] All 15 BHCs cited proposed rate reductions as their primary public benefit, averaging 3.8 percent for credit life insurance and 5 percent for credit accident and health insurance. Based on these rate reductions and actual and estimated premiums written, savings to the buyers of credit life and credit accident and health insurance totaled around $2 million for the years 1978 through 1981. The greatest annual savings occurred in 1981. Future years should bring substantially larger savings, as several BHCs have received authority to underwrite credit insurance in the last two years.

These savings understate public benefits of BHC credit insurance underwriting, as they do not include any estimate of the value of increased policy benefits or other public benefits cited in insurance underwriting applications. The benefits could include the availability of certain types of credit insurance from subsidiaries that previously did not offer it; more efficient and timely claims processing; elimination or liberalization of policy exclusions; and better service from other underwriters because of additional competition.

BHC Benefits

A potentially high return on a relatively small investment provides the financial incentive for BHCs to enter the credit insurance business. Most underwriting subsidiaries are incorporated in the state of Arizona, where reinsurers can be established for as little as $90,000 in capital and surplus.[6]

5. One BHC received approval in 1974 but has never actually engaged in the underwriting of credit insurance. Another BHC currently has a pending reinsurance application.

6. The capital and surplus requirement will increase to $105,000 on July 1, 1982, and an additional $15,000 each year until July 1, 1985, when it will be $150,000.

The financial performance of the credit underwriting subsidiaries of Fourth District BHCs has been excellent. These companies have strong capital bases and high earnings (see table 2). Capital funds (including capital, surplus, and retained earnings) accounted for 43 percent of total assets for the 1978–81 period. Most of the assets were government securities and other relatively liquid investments. More importantly, the companies earned a 30 percent return on capital over the four-year period.

Although the earnings generated by the credit insurance subsidiaries are quite small compared with total earnings of the BHCs, their marginal per-dollar contributions are substantial (see table 3). The subsidiaries earned a rate of return on capital nearly three times higher and a return on assets nearly 15 times higher than the returns earned by the BHCs as a whole over the 1978–81 period. Rates of return for individual subsidiaries in all cases were above those of the BHCs, ranging up to 23 times the BHC return on capital and up to 116 times the BHC return on assets. Such marginal gains indeed have enhanced the overall profitability of the BHCs.

Earnings varied over the period examined, as shown in table 2. While the companies collectively experienced the greatest return on capital in 1979, earnings have declined since then. Less demand for credit insurance (presumably resulting from weaker consumer loan demand) and relatively higher insurance claims have contributed to a slower stream of income. This impact was cushioned somewhat by higher investment returns resulting from

Table 2 Performance Ratios[a]

Ratio	1981	1980	1979	1978	Total
Capital/assets					
Average	49.4	44.3	35.3	40.7	43.2
Range	31.4–73.8	26.1–64.9	12.4–61.9	31.3–56.6	25.3–64.7
Net income/capital					
Average	24.6	34.6	36.8	26.7	30.4
Range	11.3–58.9	14.0–62.0	16.4–71.5	20.3–25.2	14.9–59.8
Premium income/ total income					
Average	81.6	83.5	89.0[b]	86.7	82.7
Range	65.0–88.0	72.6–99.8	77.7–92.9[b]	82.4–90.0	69.8–92.9
Interest and other income/total income					
Average	18.4	16.5	11.0	13.3	17.3
Range	12.0–35.0	0.2–27.4	7.1–22.3	10.0–27.6	7.1–30.2
Credit life premiums/ total premiums					
Average	57.8[c]	76.7[c]	76.4[b]	78.1[d]	71.3[c]
Range	18.7–100.0[c]	48.3–100.0[c]	69.0–93.0[b]	72.8–98.5[d]	60.0–100.0[c]
Sample[e]	9	9	7	5	9

a. Performance ratios are expressed in percentages. The term *capital* includes capital, surplus, and retained earnings.
b. Based on six observations.
c. Based on seven observations.
d. Based on four observations.
e. Sample included credit insurance underwriting subsidiaries of the Federal Reserve Fourth District BHCs that operated for the full year and for which data were available.

SOURCE: BHC annual reports submitted to the Federal Reserve System and the Securities and Exchange Commission.

Table 3 Earnings Comparisons

Measure	1981	1980	1979	1978	Total
Marginal capital earnings[a]					
Average	2.5	3.2	2.9	2.1	2.7
Range	1.1–4.2	1.3–23.0	1.3–7.1	1.5–2.2	1.3–6.6
Marginal asset earnings[b]					
Average	18.9	21.5	15.3	11.5	14.8
Range	10.6–22.3	12.9–116.3	11.7–30.0	9.5–14.7	12.1–55.6
Sample[c]	9	9	7	5	9

a. Marginal capital earnings measure the credit insurance subsidiary's rate of return on capital divided by the BHC's rate of return on capital. The term *capital* includes capital, surplus, and retained earnings.
b. Marginal asset earnings measure the credit insurance subsidiary's rate of return on assets divided by the BHC's rate of return on assets.
c. Sample included Federal Reserve Fourth District BHCs and their credit insurance underwriting subsidiaries that operated for the full year and for which data were available.

SOURCE: BHC annual reports submitted to the Federal Reserve System and to the Securities and Exchange Commission.

high interest rates in the last two years. The credit insurance subsidiaries still managed to earn nearly 25 percent on their capital in 1981, despite the downturn in the economy. Although earnings differed substantially among individual companies, the lowest earner generated at least 11 percent annually on capital and 15 percent for the four-year period.[7] In contrast, the highest earner derived as much as 62 percent annually and showed a 60 percent average return on capital for the two years in which it operated.

Earnings of insurance underwriting companies were enhanced by the federal government's special tax treatment allowed them as life insurance companies. While income-tax rates for these companies are the same as for other corporations, some of their income can be deferred for income-tax purposes. The most significant tax advantage is that up to 50 percent of the underwriter's gains that exceed investment income can be placed in a special surplus account called *policyholder's surplus*, which is not immediately subject to income tax.[8] These reserves not only reduce the company's taxable income but also become a source of funds for additional investments and future income.

Although premium income was the primary source of revenue, interest and other income accounted for a significant portion of the total revenue of the insurance underwriting companies. Of course, interest income varied yearly, depending on the level of interest rates. Interest and other income increased from 11 percent in 1979 to 18 percent in 1981 and accounted for about 17 percent of total income for the 1978–81 period. As with profitability, this revenue source also varied substantially among individual companies.

The vast majority of premium income originated from underwriting credit life insurance rather than credit accident and health insurance. Credit-life-insurance premiums accounted for more than 70 percent

7. Some of the earnings variations probably can be attributed to reporting and accounting differences among the reinsurance subsidiaries.

8. For details of all deferred income provisions and requirements, see the Life Insurance Tax Act of 1959. These deferrals were afforded to life insurance companies because of the special nature of their business.

of the total premiums generated by the companies in the last four years. While all credit insurance subsidiaries offered credit life insurance, one of the companies did not provide credit accident and health insurance, and several BHCs did not offer it at all of their subsidiary banks. This may reflect the underwriter's choice. A higher and less predictable incidence of claims relative to written premiums apparently has contributed to lower returns from underwriting credit accident and health insurance. Moreover, insurance companies must hold the majority of their policy reserves in life insurance reserves to maintain the tax advantage discussed earlier.

Conclusion

The entrance of BHCs into credit insurance underwriting has increased competition and lowered rates for credit insurance, thereby benefiting the public. Credit insurance buyers pay less; and, while demand may not be very rate-sensitive, lower premiums should encourage more borrowers to purchase credit life and/or credit accident and health insurance. Additional loans with credit-insurance coverage would ease the burden on a borrower's family and reduce the lender's risk of loan default in the event of a borrower's death or poor health.

The underwriting of credit insurance by BHC subsidiaries also increases the earnings of BHCs. While risks are associated with the underwriting of credit insurance, rates of return in this line of business have been extremely profitable. Every credit insurance subsidiary has earned a much higher rate of return on its investment than the BHC over the period examined. Capital outlays required to enter the business generally have been recovered within one or two years. Typically, large BHCs have established underwriting subsidiaries in the past; however, the relatively small capital requirements and potentially high rates of return may encourage other banking firms to enter into this nonbanking activity.

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