FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 81-98
May 12, 1981

POLICY STATEMENT

Disposition of Income From the
Sale of Credit Life Insurance

TO ALL MEMBER BANKS,
BANK HOLDING COMPANIES,
AND OTHERS CONCERNED IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

The Board of Governors of the Federal Reserve System has adopted a policy statement that generally prohibits individuals associated with a state member bank from personally profiting from credit life insurance sales and requires that income from this activity be credited to the state member bank. The effective date of the statement is May 1, 1981.

Printed on the following pages is the text of a press release issued April 28, 1981, by the Board of Governors of the Federal Reserve System, the policy statement, and a copy of the material which was submitted for publication in the Federal Register. These pages more fully explain the Board's action.

Any questions regarding the policy statement should be directed to Earl Anderson, Ext. 6275 or S. T. Schulze, Ext. 6665, of our Bank Supervision and Regulations Department.

Sincerely yours,

William H. Wallace

First Vice President

Banks and others are encouraged to use the following incoming WATS numbers in contacting this Bank: 1-800-442-7140 (intrastate) and 1-800-527-9200 (interstate). For calls placed locally, please use 651 plus the extension referred to above.

FEDERAL RESERVE press release

For immediate release April 28, 1981

The Federal Reserve Board has adopted a policy statement generally prohibiting employees, officers, directors or others associated with a State member bank from profiting personally from the sale of life insurance in connection with loans made by the bank.

The policy adopted by the Board -- effective May 1, 1981 -- calls for such income to be credited to the bank, or, alternatively, to a bank holding company or other affiliate of the bank, so long as the bank receives reasonable compensation for its role in selling the insurance.

The policy permits State member banks to allow their employees and officers to participate in the income under a bonus or incentive plan not to exceed more than 5 percent of the recipient's annual salary. The policy statement calls for compliance within two years unless there is a further delay for clearly demonstrated hardship.

The policy statement was recommended to the Board, and to the other Federal regulators of financial institutions represented on the Council, by the Federal Financial Institutions Examination Council.

The policy statement is attached. The full text of the Board's notice in this matter may be obtained from the Federal Reserve Board or from the Federal Reserve Banks.

Attachment

POLICY STATEMENT

ON THE DISPOSITION OF INCOME FROM

THE SALE OF CREDIT LIFE INSURANCE

May 1, 1981

For the purposes of helping to preserve the safety and soundness of financial institutions, the Board of Governors of the Federal Reserve System, establishes the policies set forth below on the disposition of income[1/] from the sale of credit life, health and accident, and mortgage life insurance ("credit life insurance") related to loans made by state member banks.

1. Individual employees, officers, directors and principal shareholders of a state member bank should not personally profit by retaining commissions or other income from the sale of credit life insurance to the institution's loan customers. However, employees and officers may participate in a bonus or incentive plan under which payments based in whole or in part on credit life insurance sales are made in cash or in kind out of the state member bank's funds in an amount not exceeding in any one year 5% of the recipient's annual salary. Such payments may not be made to employees and officers more frequently than quarterly.

2. As an accounting and operations matter, income derived from credit life insurance sales to loan customers should be credited to the income accounts of the state member bank and not to the state member bank's individual employees, officers, directors, or principal shareholders, their interests, or other affiliates. However, such income may be credited to an affiliate operating under the Bank Holding Company Act or in the case of an individual shareholder, to a trust for the benefit of all shareholders, provided that the state member bank receives reasonable compensation in recognition of the role played by its personnel, premises and good will in credit life insurance sales.[2/]

3. Where state insurance laws or other legal considerations preclude a financial institution from using a particular procedure for selling credit life insurance or from disposing of the income in a particular manner, a state member bank that wishes to provide this service to its loan customers shall seek and utilize an alternative method that complies with 1 and 2 above.

4. The proper method for the distribution to shareholders of income derived from credit life insurance is through a declaration of dividends in conformity with law, rule, regulation and prudent financial practices.

5. State member banks should be in compliance with 1 and 2 above within two years following publication in the <u>Federal Register</u> of this policy statement. Modifications beyond that time will be granted only where a clear hardship exists and satisfactory assurance is provided that compliance with 1 and 2 above will be achieved within an appropriate time period.

1/ "Income" includes commissions and experience rating credits; it does not refer to that portion of the premium required to cover the underwriting risk.

2/ As a general rule, "reasonable compensation" means an amount equivalent to at least 20% of the affiliate's net income attributable to the financial institution's credit life insurance sales.

FEDERAL RESERVE SYSTEM

Policy Statement on the Disposition
of Income From the Sale of Credit
Life Insurance
[Docket No. R-068]

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Policy Statement.

SUMMARY: The Board has adopted a policy statement that generally prohibits individuals associated with a state member bank from personally profiting from credit life insurance sales and requires that income from this activity be credited to the state member bank. The policy statement, however, permits crediting such income to bank holding companies or other affiliated organizations, if the state member bank making the loan receives "reasonable compensation" for its role in selling credit life insurance. The policy statement also allows state member banks to permit their employees and officers to participate in the income from credit life insurance sales under a bonus or incentive plan not to exceed 5 per cent of the recipient's annual salary. Finally, the policy statement requires complete compliance within two years of its effective date; however, there is provision for further extension in the case of clearly demonstrated hardship.

EFFECTIVE DATE: May 1, 1981

FOR FURTHER INFORMATION: Sandra Greene (202/452-2742), Division of Banking Supervision and Regulation, or Richard Whiting (202/452-3779), Legal Division, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

SUPPLEMENTARY INFORMATION: On January 4, 1980, on behalf of the Board and its other member agencies, the Federal Financial Institutions Examination Council published for comment a joint notice of proposed Policy Statement on Disposition of Credit Life Insurance Income (45 Federal Register 1152). The proposed policy statement addressed the longstanding financial practice whereby officers, directors and principal shareholders receive, either directly or indirectly, income derived from the sale of credit life, health or accident insurance in connection with loans made by the financial institution. The proposed policy statement stated the belief that this practice may constitute an unsafe and unsound financial practice. Accordingly, the proposed policy statement would have prohibited all insiders or affiliates of financial institutions from personally profiting from the sale of credit life insurance and would have required all such income to be credited to the financial institution's income account.

A large majority of the approximately 650 comments received opposed the policy statement as proposed. Most comments came from small state chartered banks located in the Midwest. Very few national banks submitted wholly negative comments, suggesting that they had adjusted without difficulty to a similar regulation promulgated by the Comptroller of the Currency in 1978. Few state banking associations opposed the policy statement, and no opposition came from state insurance commissioners. A number of small banks, and others applauded the policy statement. Similar sentiments of a general nature were expressed by larger banks and bank holding companies, although most bank holding companies urged a modification allowing holding company affiliates to receive credit life insurance income.

The principal criticisms of the proposed policy statement were: (1) it is unreasonable to label the insider retention of credit life income an "unsafe and unsound banking practice" when the practice is one of long standing, is approved by the bank's board and has not been the cause of many bank failures; (2) to obtain competent management in small banks, it is necessary to provide an incentive in addition to salary; (3) unless loan officers share in the credit life premiums, they will have no incentive to mention the availability of credit life to borrowers; (4) receipt of credit life income will not cause a loan officer to make an unsound loan or coerce a borrower to purchase unneeded or unwanted credit life insurance; (5) the policy statement threatens the ability of individuals to buy bank stock and controlling ownership, thereby restricting the transfer of ownership of small institutions and the maintenance of local ownership-management and encouraging acquisition of banks by multibank holding companies; and, (6) the disposition of credit life income is more properly a responsibility of the bank's board of directors.

In light of these comments, the following significant changes have been made in the policy statement recommended by the Federal Financial Institutions Examination Council on December 31, 1980, and finally adopted by the Board:

1. The policy statement has been expanded to cover income from the sale of mortgage life insurance, a form of credit life insurance sold on mortgage loans.

2. A footnote has been added to make it clear that the policy statement does not intend to govern that portion of the insurance premium required to cover the underwriting risk.

3. The policy statement's first paragraph contains a new sentence permitting limited bonuses to be paid to officers and employees for credit life insurance sales. Allowing limited bonuses responds to the comment voiced by many financial institutions that an incentive is required to motivate loan officers to sell credit life insurance, while still reducing the potential for abusive sales practices.

4. The final policy statement reaffirms that credit life income should be credited solely to the state member bank's income accounts and not to individual employees, officers, directors, principal shareholders, their interests, or other affiliates. However, an exception allows credit life income to be credited to an affiliate operating under the Bank Holding Company Act or, in the case of an individual shareholder, to a trust for the benefit of all shareholders, provided that the financial institution is paid "reasonable compensation". This latter condition recognizes both the role of the state member bank in generating credit life insurance sales and the rights of any minority stockholders to share in the benefits of such sales. As a general rule, "reasonable compensation" should amount to a minimum of 20% of the net income attributable to the state member bank's credit life insurance sales. For example, where a bank holding company operates an insurance agency selling credit life insurance to both the bank's customers and to customers of the holding company's finance company subsidiary, the minimum reasonable compensation to the bank would be 20% of the net income from credit life sales related to loans made by the bank. If management feels that less than 20% should be the appropriate measure of compensation, it may discuss the matter with its principal federal regulator.

5. The last paragraph of the policy statement increases from one year to two years, the period within which compliance is to be achieved by the state member bank. While an additional year may not be necessary for most institutions to comply with the policy, an extra year will ensure that adequate time has been provided for virtually all institutions to be in compliance. The provision for hardship extensions beyond the initial implementation period is retained as well.

The policy statement is issued pursuant to the authority granted to the Board by section 11 of the Federal Reserve Act (12 U.S.C. § 248) and the Financial Institutions Supervisory Act of 1966 (12 U.S.C. § 1818(b)).

POLICY STATEMENT

ON THE DISPOSITION OF INCOME FROM

THE SALE OF CREDIT LIFE INSURANCE

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1/ "Income" includes commissions and experience rating credits; it does not refer to that portion of the premium required to cover the underwriting risk.

1. Individual employees, officers, directors and, principal shareholders of a state member bank should not personally profit by retaining commissions or other income from the sale of credit life insurance to the institution's loan customers. However, employees and officers may participate in a bonus or incentive plan under which payments based in whole or in part on credit life insurance sales are made in cash or in kind out of the state member bank's funds in an amount not exceeding in any one year 5% of the recipient's annual salary. Such payments may not be made to employees and officers more frequently than quarterly.

2. As an accounting and operations matter, income derived from credit life insurance sales to loan customers should be credited to the income accounts of the state member bank and not to the state member bank's individual employees, officers, directors, or principal shareholders, their interests, or other affiliates. However, such income may be credited to an affiliate operating under the Bank Holding Company Act or in the case of an individual shareholder, to a trust for the benefit of all shareholders, provided that the state member bank receives reasonable compensation in recognition of the role played by its personnel, premises and good will in credit life insurance sales.[2/]

3. Where state insurance laws or other legal considerations preclude a financial institution from using a particular procedure for selling credit life insurance or from disposing of the income in a particular manner, a state member bank that wishes to provide this service to its loan customers shall seek and utilize an alternative method that complies with 1 and 2 above.

4. The proper method for the distribution to shareholders of income derived from credit life insurance is through a declaration of dividends in conformity with law, rule, regulation and prudent financial practices.

5. State member banks should be in compliance with 1 and 2 above within two years following publication in the Federal Register of this policy statement. Modifications beyond that time will be granted only where a clear hardship exists and satisfactory assurance is provided that compliance with 1 and 2 above will be achieved within an appropriate time period.

2/ As a general rule, "reasonable compensation" means an amount equivalent to at least 20% of the affiliate's net income attributable to the financial institution's credit life insurance sales.

REGULATORY ANALYSIS OF POLICY STATEMENT

The Board has adopted a policy statement that generally prohibits individuals associated with a state member bank from personally profiting from credit life insurance sales and requires that income from this activity be credited to the state member bank. The policy statement, however, permits crediting such income to bank holding companies or other affiliated organizations if the state member bank making the loan receives "reasonable compensation" for its role in selling credit life insurance. The policy statement also allows state member banks to permit their employees and officers to participate in the income from credit life insurance sales under a bonus or incentive plan not to exceed 5 per cent of the recipient's annual salary.

The policy statement as adopted is significantly different from the proposed policy statement, which constituted the principal alternative considered by the Board. As adopted, the policy statement in effect exempts bank holding companies and their affiliates from the prohibition against receiving income from the sale of credit insurance, except that "reasonable compensation" must be paid to the state member bank. Under the policy statement as proposed there existed no such exemption. The exemption was adopted after considering all comments received and, in light of this exemption, it is likely that the effect of the policy on the majority of bank holding companies will be immaterial. The Board further believes that because the policy requires a state member bank to be reasonably compensated for its role in effecting the sale of credit life insurance, it is expected that any burden associated with adjusting operations to comply with the policy statement generally will be more than offset by benefits to the institution. Finally, the majority of individuals associated with financial institutions who currently rely on income from the sale of credit life insurance to supplement salary or dividend income are expected to have little difficulty in adjusting to the policy. Salary or dividends can often be increased by a financial institution sufficiently to replace foregone credit life insurance income. While under certain circumstances a financial institution may be unwilling or unable to replace an individual's lost insurance income with an increase in salary or dividends, and where a severe or insurmountable problem is encountered an appeal may be made to the hardship extension provision of paragraph 5. Because the policy statement pertains to the accounting of income among persons associated with state member banks, it imposes no new regulatory burden upon the general public. Consequently, as a result of the revisions made by the Board in the final policy statement, the Board believes that the burdens imposed by the policy will be minimal, while the objective of the Board in ensuring the safety and soundness of state member banks will be preserved.

By order of the Board of Governors, April 24, 1981.

(signed) Theodore E. Allison

Theodore E. Allison
Secretary of the Board

[SEAL]