

FEDERAL RESERVE BANK  
OF NEW YORK

[ Circular No. 7357  
March 13, 1974 ]

**INTERPRETATION OF MARGIN REGULATIONS G AND U**  
**Questions and Answers on Insurance Premium Funding Programs**

*To All Banks and Regulation G Registrants  
in the Second Federal Reserve District:*

Enclosed is an excerpt from the *Federal Register* of March 11, containing the text of an interpretation of margin Regulations G and U, adopted February 27 by the Board of Governors of the Federal Reserve System. The interpretation is in the form of questions and answers, and relates to the applicability of margin requirements to credit extended in connection with insurance premium funding programs.

Additional copies of the enclosure will be furnished upon request.

Alfred Hayes,  
*President.*

# Board of Governors of the Federal Reserve System

## INTERPRETATION OF REGULATIONS G AND U

### Title 12—Banks and Banking

#### CHAPTER II—FEDERAL RESERVE SYSTEM SUBCHAPTER A—BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[Regs. G & U]

#### PART 207—SECURITIES CREDIT BY PERSONS OTHER THAN BANKS; BROKERS OR DEALERS

#### PART 221—CREDIT BY BANKS FOR THE PURPOSE OF PURCHASING OR CARRYING MARGIN STOCKS

##### Credit in Connection With Insurance Premium Funding Programs

#### § 207.108 Applicability of Margin Requirements to Credit in connection with Insurance Premium Funding Programs.

(a) The Board has been asked numerous questions regarding purpose credit in connection with insurance premium funding programs. The inquiries are included in a set of guidelines in the format of questions and answers which follow. A glossary of terms customarily used in connection with insurance premium funding credit activities is included in the guidelines. Under a typical insurance premium funding program, a borrower acquires mutual fund shares for cash, or takes fund shares which he already owns, and then uses the loan value (currently 40 percent as set by the Board) to buy insurance. Usually, a funding company (the issuer) will sell both the fund shares and the insurance through either independent broker/dealers or subsidiaries or affiliates of the issuer. A typical plan may run for 10 or 15 years with annual insurance premiums due. To illustrate, assuming an annual insurance premium of \$300, the participant is required to put up mutual fund shares equivalent to 250 percent of the premium or \$750 ( $750 \times 40$  percent loan value equals \$300 the amount of the insurance premium which is also the amount of the credit extended).

(b) These guidelines also (1) clarify an earlier 1969 Board interpretation to show that the public offering price of mutual fund shares (which includes the front load, or sales commission) may be used as a measure of their current market value when the shares serve as collateral on a purpose credit throughout the day of the purchase of the fund shares, and (2) relax a 1965 Board position in connection with accepting purpose statements by mail. It is the Board's view that when it is clearly established that a purpose statement supports a purpose credit then such statement executed by the borrower may be accepted by mail, provided it is received and also executed by the lender before the credit is extended.

#### § 221.122 Applicability of Margin Requirements to Credit in connection with Insurance Premium Funding Programs.

For text of this interpretation, see § 207.108 of this subchapter.

Questions and answers in connection with the credit provisions in § 207.4(f) Regulation G, and § 221.3(x) Regulation U, as they apply to the combined purchase of mutual fund shares and insurance (usually referred to as "insurance premium funding program" and sometimes referred to herein as "program") February 1974 Board of Governors of the Federal Reserve System.

1. Q: At what price may mutual fund shares be valued when they serve as collateral for an extension of credit in connection with an insurance premium funding program?

A: The fund shares may be valued at no higher than the public offering price throughout the day of purchase of the fund shares. At any other time, the fund shares may be valued at no higher than the redemption price.

2. Q: A program provides for an annual insurance premium of \$300 and interest charged in advance in the amount of \$24 for a total extension of credit of \$324. What is the collateral requirement?

A: \$810. The collateral requirement may be determined (and proved) by applying the following formula:

Extension of credit  $\times$  collateral requirement percentage = collateral requirement  $\times$  maximum loan value = extension of credit

$$\text{or} \\ \$324 \times 250\% = \$810 \times 40\% = \$324$$

(the 250% collateral requirement percentage is determined by the 40% special maximum loan value)

3. (a) Q: Using the example in question number 2, assume that fund shares are purchased on the same day the credit of \$324 is extended. On what basis may the fund shares be valued?

A: The fund shares may be valued at no higher than the public offering price. Accordingly, the customer would purchase fund shares with a public offering price of at least \$810.

(b) Q: Assume instead that under the program arrangements the fund shares are already in or are deposited in the account. The shares may have been purchased prior to the actual date of the extension of credit, either in a lump amount, say a month or so earlier, or as might apply in a monthly investment plan. On what basis may the fund shares be valued?

A: The fund shares may be valued at no higher than the redemption price. Accordingly, the customer would have to deposit in his account, if the shares are not already in the account, fund shares with a net asset value of at least \$810.

4. Q: Is the addition of interest to the outstanding debt in a program treated as a new extension of credit which must be margined?

A: The margin regulations do not require that interest added to a debt be treated as a new extension of credit if the amount of the credit is not otherwise increased. By contrast, interest charged in advance on new debt forms part of the new credit.

The following illustrates the first few years of a 10-year program commencing July 1, 1970 that provides for annual insurance premium loans of \$300 each with interest at the rate of 8% per annum.

In Illustration A, interest is charged in advance, whereas in Illustration B, interest is added at the end of each year. The illustrations do not include service charges, custodial fees or administration fees which would, of course, be considered in an actual program.

5. Q: Using Illustration A in answer to question number 4 wherein interest is charged in advance, assume mutual fund shares with a redemption value in the amount of \$1,050 were in the account and collateralized an extension of credit as of July 1, 1971 in the amount of \$349.92. What is the amount of excess collateral based on initial margin requirements, if any, which could be applied against the July 1, 1971 extension of credit in the amount of \$324?

A: \$175.20. Proof:

$\$349.92 \times 250\% = \$874.80 \times 40\% =$	\$349.92
Redemption value of fund shares..	\$1,050.00
Amount that would be needed to maintain initial collateral requirements .....	874.80

Excess collateral based on initial requirements .....	175.20
This excess collateral could support new credit in the amount of ( $\$175.20 \times$ maximum loan value 40%) .....	70.80

6. Q: Same as question number 5 except that the mutual fund shares in the account have a redemption value of \$700.00 on July 1, 1971. What is the amount, if any, of the excess collateral based on initial margin requirements?

A: There is no excess collateral in the account. In fact, the account is in a so-called restricted status in the amount of \$174.80.

Proof:

$$\$349.92 \times 250\% = \$874.80 - \$700.00 = \$174.80$$

7. (a) Q: Same as question number 6. Assume the program prospectus requires, for maintenance purposes, that fund shares pledged as collateral must always have a redemption value at least equal to 150% of debt. On July 1, 1971 with a debt of \$349.92 and fund shares with a redemption value of \$700.00, did the customer's account have any excess collateral based on maintenance requirements?

A: Yes. The account had excess collateral based on maintenance requirements in the amount of \$175.12.

Proof:

$$\begin{aligned} \$349.92 \times 150\% &= \$524.88 \\ \$700.00 - \$524.88 &= \$175.12 \end{aligned}$$

(b) Q: May the excess collateral based on maintenance requirements in the amount of \$175.12 be applied to margin the July 1, 1971 extension of credit in the amount of \$324?

A: No. Only excess collateral based on initial margin requirements may be applied against a new extension of credit.

8. (a) Q: Using Illustration A in the answer to question number 4 wherein interest is charged in advance, assume mutual fund shares with a redemption value of \$2,000.00 were in the account and collateralized the extension of credit as of July 1, 1971 in the amount of \$349.92. What is the amount of excess collateral based on initial margin requirements, if any, which could be applied against the July 1, 1971 extension of credit?

A: \$1,125.20. Proof:

$$\begin{aligned} \$349.92 \times 250\% - \$874.80 \times 40\% &= \$349.92 \\ \$2,000.00 - \$874.80 &= \$1,125.20. \end{aligned}$$

(b) Q: Would this excess collateral based on initial margin requirements be sufficient to margin the July 1, 1971 extension of credit in the amount of \$324?

A: Yes. The collateral requirement on the new extension of credit would be \$810 ( $\$324 \times 250\% = \$810 \times 40\% = \$324$ ) and would leave excess collateral based on initial margin requirements in the amount of \$315.20 ( $\$1,125.20 - \$810.00 = \$315.20$ ).

ILLUSTRATION A.—Interest charged in advance

Date		Annual extension of credit	Total debt
July 1, 1970	Insurance premium— Interest (\$300×8%)	\$300.00 24.00	
	Collateral with a value of \$810 is required for this amount based on initial margin requirements		\$324.00
July 1, 1971	Interest on total prior debt (\$324×8%)		25.92
	Make computation to determine whether there is any excess collateral, based on initial margin requirements and valued at redemption price of fund shares, on this amount. (No additional collateral required even though the account is in a so-called restricted status but above program's minimum collateral requirements.)		349.92
	New extension of credit: Insurance premium— Interest thereon	300.00 24.00	
	Collateral with a value of \$810 is required for this amount based on initial margin requirements; any excess collateral based on initial margin requirements may be applied toward this collateral requirement.		324.00
July 1, 1972	Total		673.92
	Interest on total prior debt (\$673.92×8%)		53.91
	Make computation to determine whether there is any excess collateral, based on initial margin requirements and valued at redemption price of fund shares, on this amount. (No additional collateral required even though account may be in a so-called restricted status, but above program's minimum collateral requirements.)		727.83
	New extension of credit: Insurance premium— Interest thereon	300.00 24.00	
	Collateral with a value of \$810 is required for this amount based on initial margin requirements; any excess collateral based on initial margin requirements may be applied toward this collateral requirement.		324.00
	Total		1,051.83

ILLUSTRATION B.—Interest added at end of each year

Date		Total debt
July 1, 1970	Insurance premium—collateral with a value of \$750 is required for this amount based on initial margin requirements	\$300.00
July 1, 1971	Interest (\$300×8%)	24.00
	Make computation to determine whether there is any excess collateral, based on initial margin requirements and valued at redemption price of fund shares, on this amount.	324.00
	New extension of credit: Insurance premium—collateral with a value of \$750 is required for this amount based on initial margin requirements; any excess collateral based on initial margin requirements may be applied toward this collateral requirement.	300.00
	Total	624.00
July 1, 1972	Interest (\$624×8%)	49.92
	Make computation to determine whether there is any excess collateral, based on initial margin requirements and valued at redemption price of fund shares, on this amount.	673.92
	New extension of credit: Insurance premium—collateral with a value of \$750 is required for this amount based on initial margin requirements; any excess collateral based on initial margin requirements may be applied toward this collateral requirement.	300.00
	Total	973.92

(c) Q: Could the excess collateral based on initial requirements computed as of July 1, 1971, in the amount of \$315.20 be preserved and applied against a subsequent extension of credit, presumably at the time of the next anniversary of the program on July 1, 1972?

A: No. Regulations G and U do not provide for the recapture of previously computed excess collateral. The account must be refigured as of any given point in time based upon the redemption value of the mutual fund shares and the debt in the account on such date. Prior computations of the amount of excess collateral are irrelevant.

9. Q: A participant's account is in a so-called restricted status. The participant purchases mutual fund shares on a monthly investment basis in an amount intended to equal  $\frac{1}{2}$  of 250% of the amount of the annual premium. Assuming the anniversary date in his program is July 1, may he be assured that fund shares purchased between July 1, 1972 and June 30, 1973, for example,

will be sufficient to margin his July 1, 1973 extension of credit?

A: Not necessarily. Unless such fund shares purchased between July 1, 1972 and June 30, 1973 have been deposited in a separate (for Regulation U purposes) or escrow (for Regulation G purposes) account for the purpose of being deposited into the customer's loan account as collateral to margin the July 1, 1973 extension of credit, the regular loan account would include the shares purchased in a monthly investment plan. Thus, the participant may find when the account is refigured that it is in a so-called restricted status with insufficient excess collateral in the account to mark the new extension of credit. The account may be restricted for a number of reasons. The redemption value of the fund shares serving as collateral in the account may have fallen; or the fund shares purchased on a monthly investment plan might not be sufficient to margin the July 1, 1973 extension of credit. Unless the redemption value of such fund

shares purchased during the preceding 12-month period is equal to at least 250% of the new credit at the time it is extended on July 1, 1973, additional fund shares must be supplied to properly collateralize the July 1, 1973 extension of credit. (Of course, the customer would be required to supply no more than is needed to support the new extension of credit.)

## Illustration

On 7/1/73 the account stands as follows:

Redemption value of fund shares in account, including shares purchased within the latest year under monthly investment plan	\$3,500
Previous debt	2,000
New extension of credit	324
Initial collateral requirement:	
(Debt) \$2,000 × (initial collateral requirement percentage) 250%	
= (initial collateral requirement)	\$5,000
Less: Redemption value of fund shares in account	3,500

Amount of restriction—based on initial collateral requirement—\$1,500  
Therefore, additional fund shares in the amount of \$810 ( $\$324 \times 250\%$ ) must be supplied to margin a new extension of credit (net offering price may be used if fund shares are purchased on the same day as the extension of credit).

The account would then stand as follows:

Value of fund shares	\$4,310
Total debt	2,324
Initial collateral requirement \$2,324 × 250% =	5,810
Account would still be in a so-called restricted status based on initial margin requirements but Regulations would not require customer to supply additional margin.	

Maintenance collateral requirements:

\$2,324 × 150% =	\$3,486
Account would be above program maintenance requirements.	

10. Q: A program issuer analyzes customers' accounts a month or so prior to the anniversary date of the programs to determine whether there is any excess collateral based on initial margin requirements in the accounts and whether additional fund shares will be required to margin the forthcoming extensions of credit. Must the issuer refigure each account when the credit is extended?

A: Yes. A preliminary computation would not necessarily assure that a forthcoming extension of credit will be margined properly. For example, even though the account may appear to be margined properly and have sufficient excess collateral at the time of the preliminary analysis, a decline in the value of the fund shares before the credit is extended could cause the customer's account to become restricted, or have insufficient excess collateral in the account to margin the new extension of credit entirely. Accordingly, the analysis would have to be updated on the basis of the current market value of the fund shares in the account when the credit is extended.

If the preliminary analysis took into consideration any and all anticipated charges incidental to the account and the redemption price of the fund shares did not decline between the time of the analysis and the date of the extension of credit, of course, no further adjustment of the account would be required at that time.

11. Q: A prospectus furnished to the participant describes a program which provides for only the *annual* acquisition of insurance on credit and does not include a feature permitting insurance premiums to be paid with cash, for example (to prevent lapsing). The participant's account is in a so-called restricted status. At the time of the scheduled annual review of the program, the participant finds that he is unable to purchase sufficient fund shares to collateralize a new extension of credit based on the insurance premium for a full year. May the issuer allow the participant to renew the insurance portion of his program for less than one year, and thereby extend new credit on a quarterly or semi-annual basis, still applying the special maximum loan value set forth in the regulations on whatever fund shares may be available?

A: No. The special maximum loan value provision set forth in Regulations G and U is available only for an extension of purpose credit provided for in a program registered with the Securities and Exchange Commission under the Securities Act of 1933 (15 U.S.C. 77). Accordingly, the frequency of the extensions of credit must conform with the program.

12. Q: May an issuer accept by mail a purpose statement in connection with a program, provided the participant has properly completed that part of the statement which he is required to complete?

A: Yes. Since all credit in connection with such programs is purpose credit, a face-to-face meeting between the issuer and the participant for the purpose of accepting such statement is not essential.

#### Glossary

For the purpose of these guidelines the following terms are intended to represent

terminology commonly used in connection with insurance premium funding programs as well as Regulations G and U and have the following meanings:

**Collateral requirement**—Expressed in dollars, the collateral requirement, in the form of mutual fund shares valued at either the public offering price or the redemption price, is the sum of the amount of the extension of credit (the debt)  $\times$  the collateral requirement percentage.

**Collateral requirement percentage**—This is determined by dividing the maximum loan value percentage into 100% ( $100\% \div 40\%$  special maximum loan value = 250% collateral requirement percentage).

**Excess collateral**—The amount of collateral in an account, valued at redemption price, in excess of the minimum required to meet either initial or maintenance margin requirements.

**Initial margin requirement**—In the case of insurance premium funding credit, a customer puts up margin in the form of mutual fund shares. The amount of the requirement is determined by taking the amount of the extension of credit  $\times$  the collateral requirement percentage.

**Maintenance margin requirement**—This is the minimum value of mutual fund shares in an account, valued at redemption price, pledged to secure the extension of credit which must be maintained at all times under contract with the issuer, not because of a Board requirement. The amount of maintenance margin, sometimes referred to as minimum equity requirement, is set forth by the lender in the prospectus.

**Maximum loan value**—The maximum loan value is the maximum amount of credit which the lender may extend on mutual fund shares. A special maximum loan value of 40% is set forth in the margin regulations by the

Board of Governors of the Federal Reserve System.

**Prospectus**—This is the abbreviated form of the Registration Statement on the insurance premium funding program security required to be filed by the issuer in accordance with the Securities Act of 1933. The prospectus must be presented to each prospective participant in the program.

**Public offering price**—This represents the total cost to the investor in mutual fund shares and includes the sales commission or front load, sometimes referred to as the asked price.

**Redemption price**—This is usually the net asset value of mutual fund shares which the investor would receive if he liquidated such fund shares. (Some broker/dealers, it is understood, may impose a small service charge upon liquidation if, for example, the fund shares were not purchased through them). The actual per share value is arrived at by dividing the net assets of the fund by the total number of shares outstanding. The redemption price is sometimes referred to as the bid price.

**Restricted account**—An account in which the debt exceeds the maximum loan value of the collateral. In connection with an insurance premium funding program, it may also be defined as an account in which the collateral requirement exceeds the redemption value of the fund shares in the account.

Interprets and applies 12 CFR 207.4(f) and 12 CFR 221.3(x).

By order of the Board of Governors,  
February 27, 1974.

[SEAL]

CHESTER B. FELDBERG,  
Secretary of the Board.

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