

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. 10,087]
[October 15, 1986]

AMENDMENT TO REGULATION Y
Permissible Insurance Activities for Bank Holding Companies

To All Depository Institutions, Foreign Banking Organizations, and Bank Holding Companies in the Second Federal Reserve District, and Others Concerned:

The following statement has been issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has adopted a comprehensive revision to provisions of Regulation Y that deal with permissible insurance activities for bank holding companies.

As part of this revision the Board eliminated a 1972 requirement that bank holding companies engaging in credit life, accident and health insurance underwriting provide rate reductions or increased policy benefits.

The requirement stipulated that premiums must be charged below mandated State rates, on a sliding scale 2 to 15 percent lower than the State-allowed maximum.

The Board determined that this requirement put bank holding companies at a disadvantage with respect to other providers of this insurance underwriting. The Board also determined that other adequate safeguards exist to deal with the possibility of adverse effects on the public.

The general revision of the insurance provisions of Regulation Y was originally proposed in March 1984 to reflect amendments to the Bank Holding Company Act contained in the Garn-St Germain Depository Institutions Act of 1982.

In clarifying the scope of insurance activities that are closely related to banking and permissible for bank holding companies under the Garn-St Germain Act, the Board further defined seven specific exemptions contained in the Act.

These exemptions generally allow bank holding companies to sell credit-related life, accident and health insurance, and involuntary unemployment insurance; to sell property insurance on collateral securing loans of \$10,000 or less (\$25,000 for manufactured homes) through finance company subsidiaries; to act as general insurance agents in towns under 5,000 population or where the bank holding company has less than \$50 million in assets; to continue to sell and expand in certain instances insurance agency activities authorized on or before May 1, 1982; and to act as a managing general agent for group insurance for the holding company.

Enclosed is the text of the amendment, effective November 7, 1986, which has been reprinted from the *Federal Register* of October 9. Questions regarding the amendment may be directed to our Domestic Banking Applications Division (Tel. No. 212-720-5861).

E. GERALD CORRIGAN,
President.

BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

AMENDMENT TO REGULATION Y

(effective November 7, 1986)

FEDERAL RESERVE SYSTEM

12 CFR Part 225

[Regulation Y; Docket Nos. R-0491 and R-0511]

Bank Holding Companies and Change in Bank Control; Permissible Insurance Activities For Bank Holding Companies

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rulemaking.

SUMMARY: The Board has adopted, with some modifications, a proposed revision of its Regulation Y dealing with permissible insurance activities, 12 CFR 225.25(b)(8). The Board proposed this revision (49 FR 9215, March 12, 1984) in order to reflect amendments to section 4(c)(8) of the Bank Holding Company Act (12 U.S.C. 1843(c)(8)) ("the BHC Act") contained in Title VI of the Garn-St Germain Depository Institutions Act of 1982 (Pub. L. 97-320 601; 96 Stat. 1469, 1536-38 (1982)) ("the Garn-St Germain Act"). This regulation seeks to clarify the scope of insurance activities the Board finds to be closely related to banking and permissible for bank holding companies under the Garn-St Germain Act. This revised regulation will replace in a single revised § 225.25(b)(8) (12 CFR 225.25(b)(8)), the current provisions of 225.25(b)(8) dealing with permissible insurance agency activities, and 225.25(b)(9) dealing with insurance underwriting activities.

In addition, on November 18, 1983 (48 FR 53125), the Board invited public comment on a proposal to eliminate the condition contained in note 7 to § 225.25(b)(9) of Regulation Y (12 CFR 225.25(b)(9), n. 7) requiring a showing of positive public benefits, generally in the form of rate reductions, by those bank holding companies applying to engage in the underwriting of credit life, credit accident and health, and involuntary unemployment insurance. The Board in adopting the amended insurance regulation has decided to eliminate this rate reduction requirement.

EFFECTIVE DATE: November 7, 1986.

FOR FURTHER INFORMATION CONTACT: Sidney M. Sussan, Assistant Director, Division of Banking Supervision and Regulation (202/452-2638), James E. Scott, Senior Counsel, Legal Division (202/452-3513) or Michael J. O'Rourke, Senior Attorney, Legal Division (202/452-3288), or for users of Telecommunications Device for the Deaf, Earnestine Hill or Dorothea Thompson, (202/452-3244), Board of Governors of the Federal Reserve System, Washington, DC 20551.

SUPPLEMENTARY INFORMATION: In the Garn-St Germain Act amending section 4(c)(8) of the BHC Act (12 U.S.C. 1843(c)(8)(A)-(G)), Congress has determined that insurance agency and underwriting activities are not closely related to banking and thus not generally permissible for bank holding companies under section 4(c)(8) of the BHC Act, except as contained in exemptions A through G of the statute. Moreover, the language of section 4(c)(8) lists the exemptions A through G as exceptions to the "closely related to banking" test, but not to the "proper incident" or public benefits test. See, for example, the Conference Report accompanying the Garn Act, S. Rep. No. 641, 97th Cong., 2d Sess. 91 (1982), which states "... thus [the Garn-St Germain Act] establishes that the sale of insurance does not, except for the activities subject to the exceptions, meet the 'closely related' test of section 4(c)(8) of the Bank Holding Company Act." The Board must still decide the public benefits issues, however, on a case-by-case basis. The Board has consistently interpreted the insurance exemptions in section 4(c)(8) as defining certain insurance activities for which bank holding companies may apply and which the Board may approve on a case-by-case basis. See, e.g., dissenting views of Representative Patterson, H.R. Rep. No. 84, 96th Cong., 2d Sess. 15-16 (1980).

The Board's revised insurance regulation, § 225.25(b)(8) of Regulation Y, 12 CFR 225.25(b)(8), contains subsections (i) through (vii) which

correspond to exemptions (A) through (G) of section 4(c)(8). Since certain of these exemptions deal with underwriting as well as agency activities, the Board has decided, for the purpose of clarity, to define both types of permissible activities in a single insurance provision, 12 CFR 225.25(b)(8). The present §§ 225.25 (b)(8) and (b)(9) will be deleted.

The following commentary is intended to describe and clarify the insurance activities permissible for bank holding companies under each provision of the amended regulation.

1. Activities Permissible Under Exemption A of the Garn Act

In paragraph (b)(8)(i) of § 225.25, the Board has determined that the following activities are permissible for bank holding companies:

(i) *Credit Insurance.* Acting as principal, agent, or broker for insurance (including home mortgage redemption insurance) that is: (A) directly related to an extension of credit by the bank holding company or any of its subsidiaries; and (B) limited to assuring the repayment of the outstanding balance due on the extension of credit⁷ in the event of the death, disability, or involuntary unemployment of the debtor.

⁷ "Extension of credit" includes direct loans to borrowers, loans purchased from other lenders, and leases of real or personal property so long as the leases are nonoperating and full payout leases that meet the requirements of paragraph (b)(5) of this section.

Defining an Extension of Credit

The Board has permitted insurance activities by a bank holding company only with respect to its own extensions of credit and those of its subsidiaries, rather than extensions of credit by unaffiliated bank holding companies. Although some commenters argued that exemption A permits insurance activities with respect to extensions of credit by any bank holding company, the Board believes Congress intended to continue the Board's practice of permitting the sale and underwriting of insurance by a particular bank holding

For this Regulation to be complete, retain:

- 1) Regulation Y pamphlet, revised effective February 3, 1984.
- 2) Amendment effective May 15, 1985.
- 3) This slip sheet.

[Enc. Cir. No. 10,087]

company only with respect to extensions of credit by that company. To decide otherwise would permit bank holding companies to engage in insurance activities in conjunction with extensions of credit by unaffiliated banks only if they are subsidiaries of a holding company rather than independent institutions.

Paragraph (i) of the revised regulation defines an "extension of credit" to include direct loans to borrowers, the purchase of loans from other lenders, and the lease of real or personal property so long as the leases meet all the criteria contained in § 225.25(b)(5) of Regulation Y (12 CFR 225.25(b)(5)), which defines leases that are "the functional equivalent of an extension of credit." This list is not intended to be exhaustive and the Board will decide on a case-by-case basis whether there are additional instruments that may qualify as extensions of credit for purposes of the sale and underwriting of insurance.

Defining an "Outstanding Balance Due"

Paragraph (i) limits the insurance coverage to the "outstanding balance due" on an extension of credit. As used in the regulation, the term "outstanding balance due" includes principal and interest and reasonable administrative fees outstanding on a loan as well as the balance of payments due in a lease transaction. It does not include the residual value of the leased item since the lessor owns the leased item and the lessee is not obligated to purchase the item by paying the residual value.

A bank holding company may sell or underwrite various kinds of life, disability, and unemployment insurance related to an extension of credit, provided the face amounts of such policies do not exceed the "balance due" on the underlying loans or leases. The insurance may provide for total repayment of the extension of credit upon the death of the borrower or for periodic payments on the extension of credit when the borrower is temporarily disabled or unemployed. Such single or periodic payments may not exceed the balance on the loan and thus provide for additional general life or accident coverage.

While ordinarily such credit-related insurance coverage would be declining term as payments reduce the balance due on an extension of credit, a bank holding company may write or sell a level term policy on non-amortizing loans. Policies written or sold pursuant to this paragraph, moreover, may be individual rather than group policies, and the premiums on such policies may be age-related. The language of exemption A requires only that the insurance guarantee repayment of the

outstanding balance due on an extension of credit and not that it be limited to traditional group credit life insurance. While recognizing that the types of insurance permitted under exemption A are "generally underwritten as group policies covering certain classes of borrowers," the Senate Report on Title VI of the Garn Act (S. Rep. No. 536, 97th Cong., 2d Sess. 38 (1982)) (hereinafter "the Senate Report") does not indicate that such a requirement is mandatory.

The Board will continue to require that insurance policies sold or written to cover the "outstanding balance due" insure only named borrowers or lessees of a particular bank holding company. Accordingly, such policies could cover both spouses jointly only if both spouses were actual borrowers or lessees under the terms of the agreement with the bank holding company. The Board limited permissible insurance activities to actual debtors even prior to passage of the Garn-St Germain Act. *Irwin Union Corp.*, 60 Fed. Res. Bull. 138 (1974); *First Bancorp*, 39 FR 7493 (1974). See also *Federal Reserve Regulatory Service*, 4-337 and 4-590.

Paragraph (i) of the amended regulation contains three significant interpretations of the term "extension of credit" in exemption A of Garn-St Germain Act. It permits the sale and underwriting of credit-related life, accident and health, and involuntary unemployment insurance: (1) With respect to lease transactions where such lease transactions are the equivalent of loans, (2) in connection with loans secured by residential first mortgages, and (3) in connection with the servicing of loans originated or purchased by the applicant bank holding company and subsequently sold.

Leases as an Extension of Credit

The amended regulation explicitly permits the sale of life, disability, and involuntary unemployment insurance with respect to a lease transaction, provided the lease is the type of non-operating, full payout lease described as permissible for bank holding companies in § 225.25(b)(5) of Regulation Y (12 CFR 225.25(b)(5)). Since the Board has determined that such leases are the "functional equivalent of an extension of credit," it believes that this type of lease is encompassed in the term "extension of credit" as it is used in exemption A of the Garn-St Germain Act. The Board also notes that it has previously authorized the sale of credit-related life and accident and health insurance in connection with leases, and it finds no evidence that Congress intended to overturn the Board's ruling.

The Board's conclusion is supported

by a number of commenters who suggest that in practice a lease and a loan are functionally and operationally equivalent. The bank holding company makes the same sort of credit analysis in each case. The bank holding company then uses this credit analysis, the prevailing interest rates, the term of the transaction, and consideration of available financing alternatives in preparing the lease or loan package. In each case the bank holding company is protected by an interest in particular property. The lease and loan both place the bank holding company's funds at risk, require a monthly payment, and generally have a diminishing outstanding balance to complete the transaction. The loan has a down payment and the lease a residual value amount.

The customers of the bank holding company often consider loans and leases as alternative forms of financing. Moreover, the lease and the loan customers of the bank holding company have similar interests they may choose to insure. In both cases, the bank holding company customer or his beneficiary retains the use of a particular piece of property under the terms of a contract without need to make additional payments under the contract at the disability or death of the customer.

The Board does not believe, as some commenters urge, that a bank holding company may engage in the sale of property and casualty insurance on the leased item. This provision of the amended regulation permits only the sale of credit related life, disability and voluntary unemployment insurance on the lease transaction.

Underwriting Credit-Related Home Mortgage Insurance

The second interpretation in paragraph (i) of the amended regulation involving the definition of "extension of credit" is the permissibility of underwriting home mortgage insurance, which insures the repayment of the unpaid balance of a residential first mortgage loan in the event of the death or disability of the mortgagor. As noted above, exemption A of the Garn-St Germain Act permits the sale and underwriting of any type of life, disability, and involuntary unemployment insurance related to an extension of credit by a bank holding company as long as the face value of the insurance policy does not exceed the "outstanding balance due" on the extension of credit. The Garn-St Germain Act does not impose any additional restrictions or limits on the type of life, disability, or involuntary

unemployment insurance that may be underwritten or sold.

The Board had previously held that the underwriting of home mortgage insurance is not closely related to banking, in part because it is more like general life insurance than credit life insurance and in part because banks have not generally underwritten such insurance. *BankAmerica Corporation*, 66 Fed. Res. Bull. 660 (1980); *Seafirst Corporation*, 68 Fed. Res. Bull. 318 (1982). Recently, however, the Board has permitted bank holding companies to underwrite such insurance. *Citicorp/Family Guardian*, 72 Fed. Res. Bull. 339 (1986); *Security Pacific Corporation*, 72 Fed. Res. Bull. 671 (1986). In permitting this activity by order the Board made detailed findings that the underwriting of home mortgage redemption insurance is permitted by exemption A of the Garn-St Germain Act, is closely related to banking, and does not present the possibility of such significant adverse effects that it should not be added to the list of activities permissible for bank holding companies. The Board relied on comments that the differences between home mortgage insurance and credit life insurance have diminished because traditional group credit life insurance sold by bank holding companies on second mortgages has become similar in face amount and actual (rather than contractual) term to home mortgage insurance. In addition, the Board determined that home mortgage redemption insurance is closely related to banking because it supports the lending function. The Board believes, for the reasons set forth more fully in its Citicorp order, that the underwriting of home mortgage redemption insurance is permissible for bank holding companies.

In adopting this position, the Board considered the comments of those that opposed bank holding company underwriting of home mortgage insurance, particularly the argument that Congress intended to codify in exemption A the scope of credit life and disability insurance activities permitted by the Board prior to 1982, when the Board declined to permit the underwriting of home mortgage insurance. The Board has determined that the language of exemption A of the Garn-St Germain Act, however, does not by its terms seek to codify prior Board practice, particularly a limited Board practice articulated in two individual orders.

Since home mortgage insurance underwriting involves a new type of insurance activity that may raise public benefits issues, the Board will require an application or notice from any bank

holding company seeking to engage in the activity and will not presume that all companies heretofore engaged in the underwriting of credit life insurance may automatically extend those activities to include the underwriting of home mortgage insurance.

The Board notes that in approving this activity by order the Board has relied on commitments by applicants to inform in writing borrowers who are prospective purchasers of such insurance that home mortgage redemption insurance is not required and that, if desired, it may be purchased from other sources. The Board has also relied on a commitment for written notice to borrowers that the insurance contract may be rescinded at any time after the loan commitment is made and prior to closing. In processing applications to engage in the underwriting of home mortgage redemption insurance pursuant to this amended regulation, the Board, and the Reserve Banks acting pursuant to delegated authority, will continue to require such notices be provided to borrowers. In addition, it will continue to rely on the fact that premiums for such insurance are payable periodically during the term of the extension of credit, so as to increase the borrowers' ability to rescind the insurance and to limit premium financing as an incentive to sell and underwrite such insurance.

Insurance in Connection With Serviced Loans

A third significant interpretation of the term "extension of credit" found in exemption A of the Garn-St Germain Act involves the sale and underwriting of insurance in connection with the servicing of loans. As the Board noted in its proposed rulemaking, the Garn-St Germain Act limits the sale of insurance by bank holding companies in general to insurance related to an extension of credit. The Board may no longer permit the sale of insurance related to the provision of the general financial services offered by a bank, including, for example, insurance on the contents of safe deposit boxes or savings completion insurance on certificates of deposit, Christmas club accounts, individual retirement accounts, or tuition completion plans. Insurance with respect to loan servicing by a bank holding company was the primary type of such insurance previously permitted by the Board as related to financial services.

The Board believes that the term "extension of credit" is used in exemption A to describe transactions in which the funds of the bank holding company or its subsidiaries have been placed at risk, including direct loans or leases or loans that have been

purchased. Loans that are merely being serviced by the bank holding company generally would not be covered by this definition. The Board has been persuaded, however, by the comments received to permit bank holding companies to sell credit-related life, accident and health, and involuntary unemployment insurance where a bank holding company has previously placed funds at risk by originating or purchasing loans and thereafter has sold the loans and retained the servicing rights. Of course, the bank holding company must continue to limit its insurance coverage to the outstanding balance due on the extension of credit by the borrower.

The Board notes that to require a bank holding company to cancel insurance that it has sold or underwritten on a loan origination or purchase immediately upon sale of the loan would cause substantial inconvenience for the borrower, the bank holding company, and the purchasers of the loan. It may also result in gaps in insurance coverage and greater cost to the borrower. Such cancellation requirement would also restrict the ability of bank holding companies to compete in the sale and underwriting of any credit-related insurance because the purchaser of the policy would have no control of whether and when it could be cancelled. The Board believes that in conferring the right to sell such insurance Congress must have intended that bank holding companies be able to compete effectively. Therefore, a bank holding company that offers credit insurance for a fixed term should not be forced to alter that contract by reason of the subsequent sale of the loan, particularly the sale in the secondary market where the servicing entity has traditionally been obligated to see that proper insurance coverage is maintained.

The sale and underwriting of insurance on loans being serviced is necessary only where the term of the insurance was originally shorter than that of the loan. The bank holding company selling and underwriting insurance on the loan that it originated and is servicing is, in effect, only extending the term of its original insurance policy to be coterminous with the duration of the loan. It is providing insurance that it could have provided previously. The Board does not believe that Congress intended to prevent a bank holding company lender from renewing insurance coverage on loans it sells but continues to service.

Although a bank holding company may not sell or underwrite insurance in the case where it is merely servicing a

loan and it has never placed its funds at risk either by originating or purchasing the loan, the bank holding company is permitted to collect and transmit insurance premiums, act as intermediary in renewing existing policies or adjusting coverages, and engage in other activities which are incidental to the servicing of loans. The bank holding company may collect a fee for such services, providing that the fee is based upon the provision of the service and is not a premium for insurance sold or underwritten. In that case, the bank holding company is engaging in loan servicing rather than insurance activities.

The Public Benefits Requirement of Credit Life Underwriting

The Board has decided to eliminate its requirement that those bank holding companies applying to engage in the underwriting of traditional group credit life, disability, and involuntary unemployment insurance show a public benefit in the form of a reduction in the premium cost of such insurance below the maximum or prima-facie rate established by the state and/or charged by credit insurance underwriters in the state. The Board imposed the requirement of demonstrating explicit public benefits in 1972 when it added credit life underwriting to the list of nonbanking activities permissible for bank holding companies. The Board imposed this requirement because of its concern that the underwriting of such insurance by bank holding companies presented the potential for certain adverse effects. Moreover, the Board in viewing the rate structure of credit life insurance was not convinced that the underwriting of such insurance on a *de novo* basis by bank holding companies would result in the same positive competitive effects normally associated with *de novo* entry.

During the past 14 years the underwriting of credit life insurance has remained the only permissible nonbanking activity for which the Board has imposed a requirement or condition that effectively determines the fee structure for the activity. This is a matter of concern to the Board because, under authorization of a federal statute, credit insurance rate ceilings are set by the individual states. Moreover, the rate reduction requirement can give the appearance that only lower rates than those permitted by the states are in the public interest or create a public benefit. This may be inappropriate at a time when the states have become increasingly active in reviewing and setting credit life insurance rate ceilings. These policy considerations weigh in

favor of eliminating the required rate reduction.

In addition, the requirement appears to have been motivated in 1972 by concerns that are now less significant. With respect to the Board's concern in 1972 about the price structure for credit life insurance, the Board notes that since 1972 a substantial number of states have lowered their rates and have provided for more systematic review and adjustment of such rates based on premiums-to-payout ratios or similar considerations. The Board also had a concern in 1972 that bank holding companies acting as credit life insurance underwriters might unduly pressure consumers to purchase such insurance. Since pressure on the consumer to purchase insurance is more likely to be exerted by an agent at the point of sale rather than by an underwriter, the Board believes that this concern is more properly addressed in connection with the rules regarding agency activities than in the underwriting rules. In this regard, there are appropriate safeguards in place to deal with adverse effects arising out of the sale of insurance, including the anti-tying provision of the BHC Act, 12 U.S.C. 1972(b), and the disclosure requirements of the Board's Regulation Z, 12 CFR 226.4(a)(b)(6) and 226.4(d).¹ The rate reduction requirement, in any case, does not directly address the concerns that motivated the Board in 1972, either by making the price structure for credit life insurance more competitive or by alleviating any basis that might exist for pressure on borrowers to purchase such insurance.

Finally, the general rate reduction requirement falls on all bank holding companies, and only bank holding companies, regardless of how low the rate ceiling might be in the state where the holding company operates. Although there has been no showing that transactions by bank holding company lenders are more likely to result in adverse effects than transactions involving other lenders, bank holding companies are the only lenders that must comply with the rate reduction requirement.

The Board believes that these considerations are adequate to support elimination of the rate reduction requirement. Accordingly, as of the

¹ A 1985 consumer survey conducted by the Board at the request of the Board's Consumer Advisory Council suggests that most borrowers who purchase credit insurance would be willing to do so again in the future and that the vast majority of borrowers believed that their decision with respect to such insurance had no effect on the creditor's decision to grant a loan. University of Michigan, Survey Research Center, *Survey of Consumer Attitudes* (December 1985).

effective date of this regulation, those bank holding companies that currently engage in the underwriting of credit life insurance may charge premiums as permitted by the states without notice of adjustment to the Board.

The Board has been requested to impose a more stringent public benefits requirement by requiring bank holding companies that sell credit life insurance through unaffiliated underwriters to notify and reenroll all borrower/policyholders when changing underwriters. The Board believes that the policyholder's contract rights under state law provide adequate protection and that such a requirement is an unnecessary burden on bank holding companies not required under the "proper incident" standard of section 4(c)(8) of the Act.

2. Activities Permissible Under Exemption B of the Garn Act

In paragraph (b)(8)(ii), the Board has determined that the following insurance activities are permissible for bank holding companies:

(ii) *Finance company subsidiary.* Acting as agent or broker for insurance directly related to an extension of credit by a finance company⁸ that is a subsidiary of a bank holding company, if:

(A) The insurance is limited to assuring repayment of the outstanding balance on such extension of credit in the event of loss or damage to any property used as collateral for the extension of credit; and

(B) The extension of credit is not more than \$10,000, or \$25,000 if it is to finance the purchase of, a residential manufactured home⁹ and the credit is secured by the home and

(C) The applicant commits to notify borrowers in writing that: (1) they are not required to purchase such insurance from the applicant; (2) such insurance does not insure any interest of the borrower in the collateral; and (3) the applicant will accept more comprehensive property insurance in place of such single interest insurance.

⁸ "Finance company" includes all nondeposit-taking financial institutions that engage in a significant degree of consumer lending (excluding lending secured by first mortgages) and all financial institutions specifically defined by individual State as finance companies and that engage in a significant degree of consumer lending.

⁹ These limitations increase at the end of each calendar year, beginning with 1982, by the percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers published by the Bureau of Labor Statistics.

Definition of Finance Company

The Board's amended regulation differs from the proposed regulation in that it specifically defines a "finance company" to be an entity that does not take deposits and that engages to a significant degree in consumer lending,

other than lending secured by first mortgages, as well as any financial institution a state defines as a finance company, providea such an entity engages to a significant degree in consumer lending. Under this provision, therefore, finance companies would include those entities that may be authorized to accept limited types of time or savings deposits under state law but which a state has defined to be a finance company. Since exemption B appears to focus on consumer loans, the regulation requires a qualifying company be engaged in that type of lending to a significant degree as measured by either number of loans, percentage of loans, percentage of loan amounts outstanding or some similar measure. The Board will evaluate the amount of the consumer lending on a case-by-case basis.

The Board has been persuaded by those who commented that Congress in using the term "finance company" was referring to a specific type of entity rather than to all financial institutions that are not banks. The Board believes that finance companies generally are understood to be financial institutions that engage primarily in consumer lending and that ordinarily do not accept deposits. As such, these entities are distinguished from industrial banks, mortgage companies, credit unions, savings banks and other types of financial institutions. If Congress had intended to cover these other institutions, it could have used a broader term, such as "lending subsidiary" or "financial institution." Furthermore, the limitations contained in exemption B as to the size and types of loans with respect to which insurance may be sold is evidence of the intent of Congress to limit the scope of the exemption to traditional finance companies where such loans constitute the primary type of lending.

Type of Insurance a Finance Company May Sell Under Exemption B

An issue under this provision that was raised only by the five insurance agents associations and the Association of Bank Holding Companies involves the type of property insurance a finance company may sell. The Board's proposed regulation suggested that finance companies be permitted under exemption B to sell property and casualty insurance on property that serves as collateral for a loan. This insurance, most commonly sold in automobile or homeowner insurance packages, was authorized by the Board as permissible for bank holding companies and their lending subsidiaries prior to the passage of the Garn-St Germain Act in 1982. A closer

reading of exemption B reveals a much more limited scope of permissible insurance activity. Accordingly, this provision of the amended regulation permits finance company subsidiaries of bank holding companies to engage in the sale of single interest property insurance that insures against damage or loss only to the lender's interest in the property that serves as collateral for a loan.

The language of exemption B limits the permissible insurance coverage to "the outstanding balance due on an extension of credit." It does not contemplate general property insurance that covers the entire value of the property, including the balance due the lender and the equity interest of the borrower/owner. The language parallels the "outstanding balance" requirement of exemption A which, as noted above, requires that the insurance not exceed the unpaid amount of the loan. Generally such insurance is declining balance and the only interest in the collateral property that may be insured is that of the lender.

The failure of exemption B to mention casualty insurance provides additional support for this view. Traditional property insurance, such as automobile or homeowners, is virtually always sold in a package with casualty or liability insurance. The absence of any authorization to sell such casualty insurance in exemption B or in the Senate Report (p. 38) is an indication that Congress views the insurance to be sold as limited to declining balance property insurance that protects the lender's interest in the property. The legislative history of exemption B also lends support to the view that exemption B was intended to permit insurance activity only where the insurance was limited to protecting the single interest of the lender.²

The Board has also considered whether general public benefits factors are consistent with the sale of single interest insurance by bank holding companies. While lending institutions may require such insurance on loan collateral as a condition of granting a loan to marginal borrowers or to those who are not otherwise insured, concern has been expressed that lenders may unnecessarily require such insurance of

² *Financial Institutions Restructuring and Services Act of 1981: Hearings on S. 1686, S. 1703, S. 1720, S. 1721 Before the Senate Comm. on Banking, Housing, and Urban Affairs, 97th Cong., 1st Sess. 155 (1981)* (statement of Robert B. Evans, Senior Vice President, National Consumer Finance Association). *Competition and Conditions in the Financial System, Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs, 97th Cong., 1st Sess., 481 (1981)* (statement of The Consumer Credit Insurance Association). See also the statement of Robert Reynolds, President, Independent Insurance Agents of America, *id.*, 330.

otherwise qualified or insured borrowers. Moreover, unsophisticated borrowers may purchase this limited insurance believing it to be comprehensive coverage of their interest in the loan collateral, or they may purchase this coverage despite the fact that it is largely duplicative of previously purchased property insurance.³

Congress was aware of these concerns, however, and was persuaded to permit the sale of such insurance by the finance company subsidiaries of bank holding companies. There was testimony before Congress that the sale of such insurance, not generally sold by independent agents, assists marginal borrowers to obtain credit. Property insurance is provided at standard group rates to those living in areas where insurance coverage is difficult to obtain or where the cost on an individual policy would be prohibitive. Such insurance serves as an alternative coverage for risks not covered by "mainstream" insurance companies, such as inventory and floor plan insurance to small businesses in high risk areas. The testimony indicated the ability to offer such insurance is necessary for bank holding company subsidiaries to compete effectively with independent finance companies on the basis of convenience.⁴ Exclusion of the sale of single interest insurance would also render exemption B a nullity, since no other insurance is permissible under that exemption.

The amended regulation permits the sale of such insurance, provided that the bank holding company finance company subsidiary does not require such insurance of borrowers who have adequate property insurance on the loan collateral. In addition, the finance company subsidiary would be required to disclose in writing that such insurance, if required, need not be purchased from the lender⁵ and that

³ See, for example, *Financial Institutions Restructuring and Services Act of 1981, Hearings on S. 1686, S. 1703, S. 1720 and S. 1721 Before the Senate Comm. on Banking, Housing, and Urban Affairs, 97th Cong., 1st Sess., 154 (1981)* (statement of the National Consumer Finance Association).

⁴ See, for example, the testimony of Frederick L. Boehm, Senior Vice President, American Bankers Insurance Company of Florida and James M. Browne, Executive Committee, National Consumer Finance Association, *Bank Holding Company Legislation and Related Issues, Hearings on H.R. 2255, H.R. 2747, H.R. 2856; H.R. 4004 Before the Subcomm. on Financial Institutions Supervision of the House Comm. on Banking, Finance and Urban Affairs, 96th Cong., 1st Sess., 304-309 (1979)*.

⁵ The requirement is already imposed by Regulation Z, § 226.4(d)(2) if the premium is excluded from the finance charge.

such insurance does not cover the borrower's interest in the property. With these conditions, the public benefits considerations on a general basis would be consistent with approval.

Property Insurance Underwriting Under Exemption B

The final issue raised by some commenters on this provision of the regulation is whether underwriting of single interest property insurance is contemplated in exemption B. Exemption B makes no distinction between acting as agent or acting as principal as is the case in exemptions C, D and F and more obliquely in G. The Board notes, however, that the Senate Report states explicitly (at p. 38) that "the exemption is not intended to permit a finance company subsidiary to underwrite such property insurance." The Board does not believe that the language of exemption B demonstrates clear intent by Congress to permit a change from the Board's past practice of declining to permit bank holding companies to underwrite property insurance.

3. Activities Permissible Under Exemption C of the Garn Act

In paragraph (b)(8)(iii) the Board has determined that the following insurance activities are permissible for bank holding companies:

(iii) *Insurance in small towns.* Engaging in any insurance agency activity in a place where the bank holding company or a subsidiary of the bank holding company has a lending office and that: (A) has a population not exceeding 5,000 (as shown in the preceding decennial census); or (B) has inadequate insurance agency facilities, as determined by the Board, after notice and opportunity for hearing.

"Principal Place of Banking Business" Requirement

The primary issue addressed by the parties commenting on this provision of the regulation is whether the Board should require a bank holding company that seeks to engage in the sale of insurance in a place with a population not exceeding 5,000 to have its principal place of banking business in such a place. The terms of exemption C do not impose such a condition. Indeed, by its terms, exemption C gives the Board the discretion to determine that any insurance agency activity conducted in a place with 5,000 or less in population is permissible for a bank holding company, even if the holding company does not maintain any office in that place. The Board, however, declines to adopt under the closely related to banking standard such a broad

authorization since it would be contrary to the general purpose Congress had in mind when enacting exemption C.

The Senate Report (p. 38) does indicate, however, a general intention to conform exemption C both to the Board's existing insurance regulation and to the National Bank Act (12 U.S.C. 92), which permits a national bank to conduct insurance activities in a town of less than 5,000. The Board's current regulation (as interpreted and applied) imposed three requirements on the sale of insurance in a small town. First, the insurance could be sold only in the small town in order to avoid the channeling of business from subsidiaries located elsewhere. Second, the bank holding company must have a subsidiary serving the public operating in the town in order to provide a nexus to the town and to avoid remote operation of an insurance agency. In applying this requirement, the Board has generally approved small town insurance agency activities if the holding company has a subsidiary bank or nonbanking subsidiary engaged in lending operations located in the small town. Finally, the bank holding company must have its banking headquarters or "principal place of banking business" in a small town to limit the size of the bank holding company qualifying to engage in such insurance. 12 CFR 225.25(b)(8) and BHC Letter 201, July 14, 1980.

The Board included this third or "principal place of banking business" requirement to the Board's insurance regulation⁶ in response to the decision in *Alabama Association of Insurance Agents v. Board of Governors*,⁷ which directed the Board, before implementing its existing regulation with respect to insurance sales in towns of 5,000 to make findings "whether the present wording of the regulation would permit remote insurance agency activity . . ." 558 F.2d at 729. The court was concerned that the proposals under review contemplated the sale of insurance in small towns in Alabama and Georgia from central locations in Birmingham and Atlanta.⁸

The National Bank Act, however, imposes slightly different requirements on insurance activities in small towns. While the national bank must have an office in the small town, there is no

requirement in the National Bank Act that the national bank be headquartered in a town of 5,000. Thus, both the Board's existing regulations and the National Bank Act require that an institution providing general insurance agency activities in a small town have at a minimum some office in that town, although the office need not be the institution's head office.

Accordingly, the amended regulation explicitly retains the requirement that in order to provide insurance agency activities in a town with a population not exceeding 5,000 the bank holding company must have an office that serves the public in the small town. The amended regulation specifically requires that the office be a lending office in order to provide the bank holding company with a link to the town, to avoid remote operation from a central location of a network of small town insurance agencies, and generally to maintain insurance as a fee generating activity to help sustain a small town lending office as an independent, viable profit center. This is consistent with the purpose of the National Bank Act that insurance agency activities serve as a supplemental source of income for a bank or branch of a bank located in a small town.

The Board also notes that it has traditionally required that a bank holding company engaging in insurance agency activities in a town not exceeding 5,000 limit its solicitation or sales of insurance to the small town and to other areas of less than 5,000 adjacent to the town, in part to preclude the referral or channeling of business from affiliates. See BHC 201, *Federal Reserve Regulatory Service* 4-844 (July 14, 1980). This requirement would not preclude the bank holding company insurance agency from selling insurance to those residing outside the community who initiate the transaction at the agency's place of business in the town of less than 5,000, nor would it prohibit advertising in the community newspaper or a telephone book that may serve an area larger than the community of 5,000.

The Board believes that under these limitations, bank holding companies may continue to conduct insurance activities in small towns in a manner consistent with prior Board requirements and with the purposes of the Garn-St Germain Act and the National Bank Act.

The Board does not believe it is necessary to continue to limit bank holding company insurance agency activities in small towns only to those bank holding companies that are headquartered in a small town. While

⁶ 44 Fed. Reg. 6505 (Nov. 9, 1979).

⁷ 533 F.2d 224 (5th Cir. 1976), modified on rehearing, 558 F.2d 729 (1977), cert. denied, 435 U.S. 904 (1978).

⁸ The court was also concerned that larger bank holding companies might not need the benefit of the revenue from insurance sales in a small town and the Board ought to consider some limitation on the size of the bank holding company eligible to sell such insurance.

the Board's existing regulation has such a requirement, nothing in the legislative history expressly states that *all* of the specific limitations in the Board's regulation must be incorporated into exemption C on a wholesale basis. This is made clear by the fact that the legislative history provides that exemption C was also intended to conform to the provisions of the National Bank Act. As explained above, the National Bank Act, as interpreted by the Comptroller of the Currency, has no similar requirement that a national bank providing insurance agency services through an office in a small town itself be headquartered in a small town.

The Board believes the "principal place of banking business" requirement does not further the purposes of the small town exemption in current law, that is to provide insurance alternatives in a small town and to provide an additional income source for lending operations serving the small town. Moreover, the Board does not believe it appropriate or consistent with the Act to require a bank holding company located in a small town to divest its insurance agency business simply because it is acquired by a bank holding company in a slightly larger town. The ability to provide an effective insurance alternative may depend on having a presence in and knowledge of a small town, but it does not depend on being headquartered there.

Exemption C is not, by its terms, limited to those holding companies of a limited size or those with a lead bank located in a small town. This is in contrast to exemption F in which Congress explicitly provided for general insurance agency powers (except for the sale of life insurance) for small bank holding companies (those under \$50 million in total assets). Focusing on the size of the town rather than the size or nature of the bank holding company engaging in the insurance activity is more in accord with the accepted principle that public policy favors the promotion of competition and not the protection of particular competitors.

Since the restrictions imposed in the amended regulation adequately preserve the limited scope of insurance agency activities permitted under exemption C, the Board has declined to impose the "principal place of banking business test," particularly in the absence of any basis for such a requirement in statutory language.

Definition of Place

The amended regulation parallels exemption C in permitting general insurance activities in a "place" with a population not exceeding 5,000. The

Board has not defined the term "place," preferring to permit bank holding companies to demonstrate on a case-by-case basis that a particular location qualifies. The reference to the decennial census in exemption C implies that the "place" must be a cognizable political subdivision such as a village, town, municipality, or township for which population figures are available. A bank holding company could engage in the sale of insurance from a single office in a small town and in surrounding larger political subdivisions, provided the total population of all such "places" served by the lending office does not exceed 5,000. A bank holding company must cease its otherwise impermissible insurance agency operations if the "place" is found in a subsequent decennial census to have grown to a population exceeding 5,000.

4. Activities Permissible Under Exemption D of the Garn Act

In paragraph (b)(8)(iv) the Board has determined that the following insurance activities are permissible for bank holding companies:

(iv) *Insurance agency activities conducted on May 1, 1982.* Engaging in any specific insurance agency activity¹⁰ if the bank holding company, or subsidiary conducting the specific activity, conducted such activity on May 1, 1982, or received Board approval to conduct such activity on or before May 1, 1982.¹¹ A bank holding company or subsidiary engaging in a specific insurance agency activity under this clause may:

(A) Engage in such specific insurance agency activity only at locations:

(I) In the State in which the bank holding company has its principal place of business (as defined in 12 U.S.C. 1842(d));

(II) In any State or States immediately adjacent to such State; and

(III) In any State in which the specific insurance agency activity was conducted (or was approved to be conducted) by such bank holding company or subsidiary thereof or by any other subsidiary of such bank holding company on May 1, 1982; and

(B) Provide other insurance coverages that may become available after May 1, 1982, so long as those coverages insure against the types of risks as (or are otherwise functionally equivalent to) coverages sold or approved to be sold on May 1, 1982 by such bank holding company or subsidiary.

¹⁰ Nothing contained in this provision shall preclude a bank holding company subsidiary that is authorized to engage in a specific insurance agency activity under this clause from continuing to engage in the particular activity after merger with an affiliate, if the merger is for legitimate business purposes and prior notice has been provided to the Board.

¹¹ For purposes of this paragraph, activities engaged in on May 1, 1982, include activities carried on subsequently as the result of an application to engage in such activities pending before the Board on May 1, 1982, and approved subsequently by the Board or as the result of the acquisition by such

company pursuant to a binding written contract entered into on or before May 1, 1982, of another company engaged in such activities at the time of the acquisition.

This provision of the regulation parallels exemption D of the Garn-St Germain Act and grandfathers those insurance agency activities in which individual bank holding companies were engaged on May 1, 1982. Under this provision, therefore, a bank holding company or subsidiary thereof may continue to engage in particular types of insurance agency activities that were permissible prior to the passage of the Garn-St Germain Act but which are now prohibited by that Act. A qualifying bank holding company may engage, for example, in the sale of property and casualty insurance on property serving as collateral for loans made by a lending subsidiary of the holding company.

Limitations on Expansion of Grandfather Rights

Exemption D also provides for limited expansion of grandfathered insurance agency activities in order to permit qualifying bank holding companies to remain effective insurance agent competitors. As the Senate Report states (at p. 39): "Without providing such companies with a broadened ability to expand and grow, they would not long survive in a competitive environment." Exemption D suggests certain types of geographic and product line expansion that should be considered permissible for grandfathered insurance agency subsidiaries of qualifying bank holding companies.

Several commenters urged the Board to permit expansion of grandfathered insurance agency activities without restriction. They argued that the language in exemption D that purports to place limits on the expansion of grandfathered activities is merely advisory and not mandatory. They based this view on the language of exemption D and particularly upon the use of the word "including" to introduce the limitations or restrictions on the expansion of grandfathered activities. These commenters argued that the word "including" means that the proposed types of expansion listed in exemption D are not exhaustive but merely suggest possible forms of expansion that the Board might include in its regulation.

The use of the word "including" to introduce lengthy and detailed limitations on grandfathered activities is ambiguous. The legislative history, however, makes it clear that the limits imposed on exemption D with respect to grandfathered activities are to be mandatory rather than advisory. The

legislative history of exemption D as contained in the Senate Report (pp. 39-41) is more detailed than that of any other provision and describes at length the types of expansion that the Board may approve under the terms of the exemption. The detail of the statutory provision and the legislative history indicates that the conditions are not merely advisory, and the Board believes that it may permit only those specific types of expansion of grandfathered activities listed in exemption D.

Expansion of grandfathered activities pursuant to exemption D presents three issues that the Board has resolved in paragraph (iv) of this regulation. Those issues include (1) defining which subsidiaries of a bank holding company may engage in otherwise impermissible insurance agency activities under exemption D, (2) the scope of permissible geographic expansion, and (3) the scope of product line expansion.

Specific Subsidiaries That May Engage in Grandfathered Activities. Exemption D specifically states that a bank holding company may continue to engage in the sale of specific types of insurance sold on May 1, 1982, at existing or new locations only through "the same bank holding company or the same subsidiary or subsidiaries with respect to which insurance was sold on May 1, 1982 . . ." Thus, grandfather rights do not inure to the benefit of the entire holding company system by virtue of the fact that a particular subsidiary was engaged in insurance agency activities prior to May 1, 1982. Only the subsidiary of the bank holding company that was engaged in insurance activities on May 1, 1982, or received Board approval to engage in insurance activities prior to May 1, 1982, has grandfather status. The legislative history supports this reading of exemption D. The Senate Report states:

"The authority to engage in activities under the grandfather amendment only extends to the entity, be that the holding company itself or a subsidiary or subsidiaries thereof, which qualifies for grandfathered activity status. This limitation is intended to prevent a bank holding company from transferring any grandfather rights among the companies within the holding company system . . ." Senate Report, p. 40.

Some commenters suggested that a "grandfathered subsidiary" is limited solely to the types of insurance (or equivalent types) which it sold prior to May 1, 1982. Other commenters argued that the language of the statute should be read to permit a subsidiary that was engaged in *any* insurance agency activity prior to May 1, 1982 to be grandfathered with respect to all insurance agency activities engaged in

by any company in the holding company system prior to that date.

The Board believes that the emphasis in the legislative history on the transfer of grandfather rights shows the intent of Congress to prohibit not only the transfer of such rights from "grandfathered" subsidiaries to those affiliates wholly without grandfather rights, but also to prohibit the transfer of grandfather rights with respect to particular kinds of insurance from one "grandfathered" subsidiary to another. Thus, a subsidiary that sold only credit life insurance prior to the grandfather date should not acquire grandfather rights to sell property and casualty insurance solely because an affiliate sold property and casualty insurance prior to the grandfather date. The grandfather rights of a particular subsidiary are limited to the precise activities (or their functional equivalent) engaged in prior to May 1, 1982. As discussed in more detail below, this requirement does not preclude the transfer of grandfather rights in the case of a bona fide merger. *Citicorp*, 69 Fed. Res. Bull. 554, 555 (1983).

A question has been raised whether a subsidiary bank of a bank holding company, or a nonbank subsidiary of such a subsidiary bank, that was engaged in insurance activities on May 1, 1982, pursuant to the provisions of state law may take advantage of the grandfather provisions of exemption D and, if so, whether such an entity must terminate its grandfathered insurance agency activities if it is acquired by a bank holding company without grandfather rights under section 4(c)(8).

The Board notes that resolution of this issue depends in the first instance on the fundamental question of the scope of coverage of the nonbanking prohibitions of section 4 of the Act to subsidiary banks of bank holding companies, an issue which the Board has under review in a separate rulemaking proceeding regarding § 225.22(d) of Regulation Y, (12 CFR 225.22(d)) (*See* 48 FR 23520 (May 25, 1983) and 49 FR 794 (January 5, 1984)), and also in connection with the Board's request for comment on what, if any, action it should take in the case of real estate investment and development powers of holding company banks authorized pursuant to state law. (50 FR 4519 (January 31, 1985)). The Board did not seek comment on this issue or those raised by a commenter in the course of this rulemaking.

This rulemaking is limited in scope and is intended only to clarify the extent to which insurance activity is permitted under exemptions A through G of Title VI of the Garn-St Germain Act. In other words, this regulation is intended only

to specify what insurance activities are permissible for entities subject to the nonbanking provisions of section 4 of the Act. It is not intended to specify which entities are subject to these provisions, an issue that, as noted, is the subject of separate rulemaking proceedings. Accordingly, the Board has reserved judgment on the issues raised by this comment for consideration in connection with the Board's rulemaking proceedings on § 225.22(d) of Regulation Y and the proceeding on real estate development powers of holding company banks. The issue of whether an entity with grandfather rights under exemption D must terminate those activities if it is acquired by another bank holding company is currently under consideration in the context of a pending application. *See Sovran Financial Corp./Suburban Bancorp*, 72 Federal Reserve Bulletin 276 (1986).

Finally, the Board notes that this rulemaking, which is only intended to clarify the exemptions in Title VI of the Garn-St Germain Act, does not authorize any bank holding company to commence any insurance activity, or to acquire a company with insurance activities, without compliance with the notice and application requirements of section 4(c)(8) of the Act.

Geographic Expansion by a Grandfathered Subsidiary of a Bank Holding Company. A variety of alternatives for geographic expansion were suggested by those commenting on this paragraph of the proposed regulation. Some commenters suggested that the Board should permit a grandfathered subsidiary of a bank holding company (or the holding company itself if it engaged in the insurance activities directly) to expand its grandfathered insurance activities into any new state without restriction. Such a position treats the specific limitations on geographic expansion in exemption D as nonbinding, a position the Board has considered and rejected.

All other commenters agreed that the explicit language of exemption D permits the grandfathered subsidiary of a bank holding company to engage in the sale of insurance in the bank holding company's home state and states adjacent thereto. There was substantial disagreement, however, concerning the scope of additional expansion.

Some commenters argued a grandfathered subsidiary of a bank holding company could expand the specific insurance agency activities in which it engaged prior to May 1, 1982, into any state where any affiliate was engaged in *any* type of insurance activity prior to the grandfather date.

Under this view, a bank holding company subsidiary engaged in the sale of property and casualty insurance on the grandfather date could sell such insurance in any state where an affiliate sold credit life insurance prior to the grandfather date.

Other commenters suggested expansion be permitted only into those states where the grandfathered subsidiary or an affiliate sold the specific type of insurance on the grandfather date. Thus, for example, a subsidiary engaged in the sale of property insurance on the grandfather date would expand its activities into any state where an affiliate also sold property insurance on the grandfather date.

Finally, some commenters argued for no geographic expansion, restricting the grandfathered subsidiary to those states where it sold insurance on the grandfather date. The amended regulation adopts the middle position of permitting a grandfathered subsidiary to expand into those states where an affiliate sold the same type of insurance on the grandfather date.

The Board believes unlimited expansion into any state where any insurance was sold on the grandfather date is not supported by the language or legislative history of exemption D or by the limited nature of the grandfather provision. The language and legislative history of exemption D emphasize that it is the specific subsidiary that is grandfathered with respect to the insurance activities it conducted prior to May 1, 1982, and not the entire holding company system. Exemption D allows the sale of insurance at new locations of "the same bank holding company or the same subsidiary . . ." (emphasis added). As noted above, the Senate Report is clear in limiting grandfather status to the specific subsidiary that engaged in the activity on the grandfather date (p. 40). If the focus of exemption D is the individual subsidiary and the specific types of insurance sold by that subsidiary on the grandfather date, it is inconsistent to read exemption D as permitting the transfer of the right to engage in insurance activities in a given state to an affiliate that sells only a completely different kind of insurance.

The Senate Report describes exemption D as permitting expansion of a bank holding company's insurance business "within reasonable limits." The exemption "does restrict the locations and scope of grandfathered insurance activities" without restricting the volume of insurance sales. (Senate Report, p. 39). The Board believes it is not consistent with the limited nature of this grandfather provision to permit, for

example, a bank holding company subsidiary engaged in the sale of property insurance in one state to expand into the 49 other states where an affiliate may sell credit life insurance. In fact, the legislative history appears to presume that only companies engaged in the sale of property and casualty insurance need be grandfathered, since the sale of credit life insurance is still permitted under exemption A. There appears to be no intention to permit a grandfathered property and casualty insurance subsidiary to expand its locations on the basis of the location of credit life agency subsidiaries.

Accordingly, the Board's final regulation provides that a bank holding company may sell a particular kind of insurance from new or expanded locations only in its home state, states adjacent thereto, and states in which it, or an affiliate, sold that kind of insurance (or insurance that is functionally equivalent) prior to May 1, 1982. The language of exemption D, while limiting the grandfathered activities to those agency activities conducted by the specific grandfathered subsidiary, does allow expansion into states where such specific types of agency activities "were conducted by the bank holding company or any of its subsidiaries on May 1, 1982 . . ." If a bank holding company subsidiary is selling a particular type of insurance in a given state, the Board does not believe there is any regulatory or business purpose served by restricting another grandfathered subsidiary from engaging in the same activity in the same location.

Product Line Expansion. The Board's amended regulation also provides for product line expansion. A grandfathered subsidiary of a bank holding company may seek approval from the Board to engage in the sale of new types of insurance that protect against the same types of risks as, or are otherwise functionally equivalent to, insurance sold on the grandfather date. Although the Board's proposed regulation requested comment upon the issue of whether property and casualty insurance on leased items is the functional equivalent of property and casualty insurance on collateral for a loan, the Board believes that this issue and the other issues of "functionally equivalent" coverage would be more properly addressed on a case-by-case basis in the course of individual applications.

Transfer of Grandfather Rights Among Subsidiaries

The amended regulation specifically provides that a grandfathered subsidiary

of a bank holding company (or its successor) may retain its grandfather rights after merger with an affiliate, if such merger is based on legitimate business concerns, e.g., centralized management or increased efficiency, rather than as a means of extending insurance powers. The Senate Report contains language that indicates an intent on the part of Congress to limit the possibility of expansion of grandfather rights simply by means of transferring those rights from one grandfathered subsidiary to the entire holding company system, but the subsequent Conference Report (S. Rep. No. 641, 97th Cong., 2d Sess. 91 (1982)) provides a limited exception to that general rule when it states that "nothing in this title is intended to prevent the transferring of grandfathered insurance activities of the bank holding company to the parent company or to any of its subsidiaries if the transferral is brought about for management or efficiency purposes." The regulation provides that bank holding companies must advise the Board prior to any such merger for legitimate business purposes in order to confirm the transfer of grandfather rights.

Retention of Grandfather Rights Upon Acquisition By Another Bank Holding Company. Prior to adoption of this regulation, the Board had, in limited circumstances, allowed a bank holding company qualifying for certain grandfather rights under exemption D (specifically related to the sale of credit-related property and casualty insurance that was directly linked and limited to extensions of credit by the grandfathered bank holding company and its subsidiaries) to retain those rights and continue to engage in the grandfathered activities after its acquisition by another bank holding company that did not have grandfather rights. The acquiring bank holding company did not, however, gain any grandfather rights with respect to its own subsidiaries. See *BankAmerica Corporation*, 69 Fed. Res. Bull. 568 (1983); *Fuji Bank*, 70 Fed. Res. Bull. 50 (1984).

5. Activities Permissible Under Exemption E of the Garn Act

In paragraph (8)(b)(v) the Board has determined that the following insurance activities are permissible for bank holding companies:

(v) *Supervision of retail insurance agents.* Supervising on behalf of insurance underwriters the activities of retail insurance agents who sell: (A) fidelity insurance and property and casualty insurance on the real and personal property used in the operations

of the bank holding company or its subsidiaries; and (B) group insurance that protects the employees of the bank holding company or its subsidiaries.

This provision, which merely restates exemption E of the Garn Act, is of limited applicability. The legislative history indicates an intent on the part of Congress to avoid preempting certain practices permissible under Texas law. Senate Report, at p. 41. The Board received no substantive comments on this provision.

6. Activities Permissible Under Exemption F of the Garn Act

In paragraph (b)(8)(vi) the Board has determined that the following insurance activities are permissible for bank holding companies:

(vi) *Small bank holding companies.* Engaging in any insurance agency activity if the bank holding company has total consolidated assets of \$50 million or less. A bank holding company performing insurance agency activities under this paragraph may not engage in the sale of life insurance or annuities except as provided in paragraphs (i) and (iii) of this section; and it may not continue to engage in insurance agency activities pursuant to this provision more than 90 days after the end of the quarterly reporting period in which total assets of the holding company and its subsidiaries exceed \$50 million.

This provision permits bank holding companies with total consolidated assets not exceeding \$50 million to engage in general insurance agency activities, except that they may not engage in the sale of life insurance or annuities unless otherwise authorized to do so under subsections (i) and (iii) of this regulation. (These subsections generally permit the sale of credit life insurance or any type of insurance in a town with a population not exceeding 5,000.) The Senate Report (at p. 42) makes it clear that exemption F ceases to apply "if the value of a bank holding company's system assets exceed \$50 million." The assets of the entire holding company system rather than those of its bank subsidiaries or its insurance agency subsidiary are determinative for meeting the \$50 million limit of this provision.

The regulation requires a bank holding company to cease general insurance agency activities pursuant to this provision within 90 days after the end of the quarterly reporting period in which the bank holding company's total assets exceed \$50 million. Since a small bank holding company may not have complete and accurate financial figures until it prepares its quarterly report and since quarterly reports are generally completed several weeks after the end

of a quarterly reporting period, the Board believes this 90-day requirement provides a reasonable, minimum time to alter the structure of the bank holding company's insurance activities.

Thereafter, the bank holding company may continue to engage in the sale of insurance pursuant to other exemptions.

7. Activities Permissible Under Exemption G of the Garn Act

In paragraph (b)(8)(vii) the Board has determined that the following insurance activities are permissible for bank holding companies consistent with exemption G of the Garn-St Germain Act:

(vii) *Insurance agency activities conducted before 1971.* Engaging in any insurance agency activity performed at any location in the United States directly or indirectly by a bank holding company that was engaged in insurance agency activities prior to January 1, 1971, as a consequence of approval by the Board prior to January 1, 1971.

Agency Activities

In this provision the Board has adopted a position, already articulated in several orders on individual applications, permitting any qualifying bank holding company to engage in general insurance agency activities without restriction as to location or to type of insurance sold. See *First Wisconsin Corporation*, 71 Fed. Res. Bull. 171 (1985); *Norwest Corporation*, 70 Fed. Res. Bull. 235 and 470 (1984). A company qualifies under this provision if it was engaged in insurance agency activities as a consequence of Board approval prior to January 1, 1971. A very limited number of active bank holding companies received such Board approval in the period from passage of the BHC Act in 1956 until January 1, 1971.

The regulation does not limit the insurance agency activities of a qualifying company by requiring that the company engage only in the sale of such types of insurance as it sold prior to 1971 from such locations as it conducted insurance agency activities prior to 1971. As the Board has already stated in the above-cited orders, it does not find any indication in the language of exemption G that Congress intended to limit the insurance agency activities of qualifying companies in any fashion.

To limit the sale of insurance to the types sold prior to 1971 would render exemption G more restrictive than exemption D, which grandfathers those insurance agency activities engaged in prior to 1982. By definition, any pre-1971 insurance agency activities would also qualify under exemption D as pre-1982 activities. Such a limited reading of

exemption G, therefore, would render it superfluous for purposes of grandfathering permissible types of insurance agency activity.

Prior to 1971 the Board did not examine individual types of insurance to determine whether the sale of such insurance would be "closely related to banking." Section 4(c)(6) of the Bank Holding Company Act of 1956, the operative nonbanking provision, used the standard of "closely related to the business of banking." See Pub. L. 84-511, section 4(c)(6); 70 Stat. 137 (1956). Under this "business of banking" standard, the Board considered only whether the entire insurance agency business of a particular bank holding company was conducted in such a manner that it was closely related to the banking business of the applicant bank holding company. As a consequence, the Board did not scrutinize each type of insurance an applicant proposed to sell, and in several cases prior to 1971 the Board approved general insurance agency activities for bank holding companies. See *First Bankstock Corp.*, 45 Fed. Res. Bull. 917 (1959); *Northwest Bancorporation*, 45 Fed. Res. Bull. 963 (1959).

For the reasons set out in its previous order, the Board's regulation permits the limited number of qualifying companies to engage in general insurance agency activities pursuant to exemption G regardless of their precise insurance agency activities prior to 1971. *First Wisconsin Corporation*, 71 Fed. Res. Bull. 171 (1985); *Norwest Corporation*, 70 Fed. Res. Bull. 470 (1984).

Underwriting Activities

Several commenting bank holding companies argued that exemption G also permits qualifying companies to engage in general insurance underwriting activities without restriction. These companies argued that the language of the statute merely speaks of insurance activities rather than insurance agency activities as in exemption C, D, and F. The Board has not proposed nor has it adopted a regulation that would permit qualifying exemption G companies to engage in general underwriting activities.

The language of exemption G provides that a company qualifies for grandfather rights only by reason of receiving Board approval to engage in agency activities prior to January 1, 1971. The Board believes, therefore, that exemption G is intended to deal only with agency activities. The Board also believes that Congress intended to permit bank holding companies to engage in only the general kinds of activities the Board

permitted prior to 1971. While the Board did permit general insurance agency activities prior to 1971, it permitted only very limited credit-related underwriting activities.

The Board does not believe that Congress intended in a limited grandfather provision to confer on a few qualifying companies broad new powers never before permitted to any bank holding company. The Board had declined prior to 1971 to permit bank holding companies to engage in life insurance underwriting activities (*Transamerica Corp.*, 43 Fed. Res. Bull. 1014 (1957)). In the Board's view, a limited grandfather provision such as exemption G should not be read to permit bank holding companies, which qualify for grandfather rights because they received Board approval prior to 1971 to engage in insurance agency activities, to expand those activities to include general insurance underwriting—an activity the Board has consistently refused to permit under section 4(c)(8).

In any event, even assuming *arguendo* that general insurance underwriting would be exempt from the general insurance prohibition of the Garn-St Germain Act, this does not mean that such an activity would be "so closely related to banking as to be a proper incident thereto" under section 4(c)(8) of the Act, and, as noted, the Board has previously determined that such general insurance underwriting does not qualify under this standard. *NCNB Corporation*, 64 Fed. Res. Bull. 506 (1978).

Applications Required

Several bank holding companies have also suggested that qualifying exemption G companies need not make specific applications to engage in any insurance agency activities. These commenters claim that exemption G removes any qualifying company from the requirement of meeting either the "closely related" or "public benefits" tests of section 4(c)(8) of the BHC Act. As the Board has previously stated, the exemptions contained in section 4(c)(8) are not intended to be dispositive of the public benefits issues raised in particular applications. For the reasons set forth in these orders, the Board will continue to require applications from exemption G companies.

Regulatory Flexibility Analysis—Paperwork Reduction Act. The Board has certified that adoption of this amended regulation dealing with permissible insurance activities for bank holding companies is not expected to have a significant economic impact on small business entities within the meaning of the Regulatory Flexibility

Act [5 U.S.C. 601 *et seq.*]. The Board is required by section 4(c)(8) of the BHC Act, 12 U.S.C. 1843(c)(8), to determine whether nonbanking activities are closely related to banking and thus are permissible for bank holding companies. The Board is clarifying the scope of insurance activities it considers to be closely related to banking and permissible for bank holding companies, with Board approval. The amended regulation does not impose different or more burdensome requirements than the prior regulation for applications to the Board to engage in such activities, nor does it restrict permissible activities for bank holding companies except in conformance with the requirements established by Congress in the Garn-St Germain Depository Institutions Act of 1982, codified at 12 U.S.C. 1843(c)(8)(A)-(G). To the extent that it eliminates the mandatory rate reduction requirement for bank holding companies applying to engage in credit life underwriting activities, the amended regulation provides for additional flexibility. Similarly, by clarifying the scope of permissible activities, the amended regulation will permit certain additional applications to qualify for more expeditious processing in the regional Federal Reserve Banks under authority delegated by the Board, 12 CFR 225.23.

The amended insurance regulation imposes no additional information collection requirements and imposes no substantial change in the requirements for applications to engage in insurance activities.

List of Subjects in 12 CFR Part 225

Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements.

For reasons set out in this notice, the Board is consolidating §§ 225.25 (b)(8) and (b)(9) of the Board's Regulation Y (12 CFR 225.25 (b)(8) and (b)(9)), dealing with permissible insurance agency and underwriting activities for bank holding companies, into a single § 225.25(b)(8). Accordingly, the Board revises §§ 225.1(a) and 225.25(b)(8); and removes §§ 225.25(b)(9) and 225.128 as set forth below:

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

1. The authority citation for Part 225 is revised to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1843(c)(8), 1844(b), 3106, 3108, 3907 and 3909.

2. Section 225.25(b)(8) is revised to read as follows:

§ 225.25 List of permissible nonbanking activities.

(b) * * *

(8) *Insurance agency and underwriting.* (i) *Credit Insurance.* Acting as principal, agent, or broker for insurance (including home mortgage redemption insurance) that is:

(A) Directly related to an extension of credit by the bank holding company or any of its subsidiaries; and

(B) Limited to assuring the repayment of the outstanding balance due on the extension of credit⁷ in the event of the death, disability, or involuntary unemployment of the debtor.

(ii) *Finance company subsidiary.* Acting as agent or broker for insurance directly related to an extension of credit by a finance company⁸ that is a subsidiary of a bank holding company, if:

(A) The insurance is limited to assuring repayment of the outstanding balance on such extension of credit in the event of loss or damage to any property used as collateral for the extension of credit; and

(B) The extension of credit is not more than \$10,000, or \$25,000 if it is to finance the purchase of a residential manufactured home⁹ and the credit is secured by the home; and

(C) The applicant commits to notify borrowers in writing that: (1) they are not required to purchase such insurance from the applicant; (2) such insurance does not insure any interest of the borrower in the collateral; and (3) the applicant will accept more comprehensive property insurance in place of such single interest insurance.

(iii) *Insurance in small towns.* Engaging in any insurance agency activity in a place where the bank holding company or a subsidiary of the bank holding company has a lending office and that: (A) has a population not exceeding 5,000 (as shown in the preceding decennial census); or (B) has inadequate insurance agency facilities,

⁷ "Extension of credit" includes direct loans to borrowers, loans purchased from other lenders, and leases of real or personal property so long as the leases are nonoperating and full payout leases that meet the requirements of paragraph (b)(5) of this section.

⁸ "Finance company" includes all nondeposit-taking financial institutions that engage in a significant degree of consumer lending (excluding lending secured by first mortgages) and all financial institutions specifically defined by individual States as finance companies and that engage in a significant degree of consumer lending.

⁹ These limitations increase at the end of each calendar year, beginning with 1982, by the percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers published by the Bureau of Labor Statistics.

as determined by the Board, after notice and opportunity for hearing.

(iv) *Insurance agency activities conducted on May 1, 1982.* Engaging in any specific insurance agency activity¹⁰ if the bank holding company, or subsidiary conducting the specific activity, conducted such activity on May 1, 1982, or received Board approval to conduct such activity on or before May 1, 1982.¹¹ A bank holding company or subsidiary engaging in a specific insurance agency activity under this clause may:

(A) Engage in such specific insurance agency activity only at locations:

(1) In the State in which the bank holding company has its principal place of business (as defined in 12 U.S.C. 1842(d));

¹⁰ Nothing contained in this provision shall preclude a bank holding company subsidiary that is authorized to engage in a specific insurance agency activity under this clause from continuing to engage in the particular activity after merger with an affiliate, if the merger is for legitimate business purposes and prior notice has been provided to the Board.

¹¹ For purposes of this paragraph, activities engaged in on May 1, 1982, include activities carried on subsequently as the result of an application to engage in such activities pending before the Board on May 1, 1982, and approved subsequently by the Board or as the result of the acquisition by such company pursuant to a binding written contract entered into on or before May 1, 1982, of another company engaged in such activities at the time of the acquisition.

(2) In any State or States immediately adjacent to such State; and

(3) In any State in which the specific insurance agency activity was conducted (or was approved to be conducted) by such bank holding company or subsidiary thereof or by any other subsidiary of such bank holding company on May 1, 1982; and

(B) Provide other insurance coverages that may become available after May 1, 1982, so long as those coverages insure against the types of risks as (or are otherwise functionally equivalent to) coverages sold or approved to be sold on May 1, 1982 by such bank holding company or subsidiary.

(v) *Supervision of retail insurance agents.* Supervising on behalf of insurance underwriters the activities of retail insurance agents who sell: (A) Fidelity insurance and property and casualty insurance on the real and personal property used in the operations of the bank holding company or its subsidiaries; and (B) group insurance that protects the employees of the bank holding company or its subsidiaries.

(vi) *Small bank holding companies.* Engaging in any insurance agency activity if the bank holding company has total consolidated assets of \$50 million or less. A bank holding company performing insurance agency activities under this paragraph may not engage in the sale of life insurance or annuities

except as provided in paragraphs (b)(8) (i) and (iii) of this section, and it may not continue to engage in insurance agency activities pursuant to this provision more than 90 days after the end of the quarterly reporting period in which total assets of the holding company and its subsidiaries exceed \$50 million.

(vii) *Insurance agency activities conducted before 1971.* Engaging in any insurance agency activity performed at any location in the United States directly or indirectly by a bank holding company that was engaged in insurance agency activities prior to January 1, 1971, as a consequence of approval by the Board prior to January 1, 1971.

§ 225.25 [Amended]

3. Section 225.25(b)(9) is removed and reserved.

4. Section 225.25 (b)(10) and (b)(11) footnotes numbered 8, 9 and 10 are redesignated 12, 13 and 14, respectively.

§ 225.128 [Removed]

5. Section 225.128 is removed.

§ 225.135 [Removed]

6. Section 225.135 is removed.

Board of Governors of the Federal Reserve System, October 3, 1986.

William W. Wiles,
Secretary of the Board.

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