

TAKING ADVANTAGE OF THE INSURANCE PROVISIONS IN THE GRAMM-LEACH-BLILEY ACT

INTRODUCTION

The Gramm-Leach-Bliley Act (the “Act”) includes several provisions of importance to banks and bank holding companies presently engaged in insurance activities or planning to engage in insurance activities. In broad terms, the Act —

Expands the Insurance Powers of banks and bank holding companies, but prohibits national banks from underwriting insurance;

Directs the federal banking agencies to adopt insurance Sales Practices Regulations comparable to existing regulatory guidelines; and

Affirms State Regulation of the insurance activities of banks and bank holding companies, but gives federal regulators and federal courts the ability to preempt state insurance laws that interfere with the legitimate insurance activities of banks and bank holding companies.

The following is a summary of the major provisions of the Act related to the insurance powers of bank holding companies, national banks, state banks, and federal savings associations; the insurance sales practices of banks; and the regulation of the insurance activities of banks and bank holding companies.

INSURANCE POWERS OF BANK HOLDING COMPANIES

A Qualified Holding Company May Underwrite, Broker and Sell Insurance

The Act permits a bank holding company to underwrite, broker and sell insurance and annuities. More specifically, the Act states that a bank holding company, which meets certain conditions, may engage in activities that are “financial in nature.” The Act then defines a number of activities to be “financial in nature,” including the underwriting, brokerage and sale of insurance and annuities. A bank holding company that engages in activities that are “financial in nature” is a “financial holding company.” As discussed further below, the Act prohibits national banks from underwriting insurance either directly or through a subsidiary, and this prohibition also affects state banks. Thus, if a bank is interested in underwriting insurance, it must do so through a holding company structure.

Permissible insurance activities may be conducted either directly by a financial holding company or through a subsidiary of a financial holding company. A financial holding company would be deemed to own or control an insurance firm if it owned or controlled 25 percent or more of the voting shares of the firm. The Federal Reserve Board could determine that ownership interests below this threshold constitute control.

Before engaging in permissible insurance activities, a holding company must satisfy certain conditions. It must —

File a “declaration” with the Federal Reserve Board “electing” to be a financial holding company;

File a “certification” with the Federal Reserve Board, in which it affirms that all of its subsidiary banks and thrifts are well-capitalized and well-managed. (For purposes of this requirement, a bank is well-capitalized if it has a risk-based Tier 1 ratio of 6 percent and a risk-based total capital ratio of 10 percent. A bank is well-managed if it has a composite rating of 1 or 2 and at least a 2 on the management component of that rating.); and

Ensure that all of the company’s subsidiary banks and thrifts have a Satisfactory CRA rating. (The Act directs the Federal Reserve Board to prohibit any financial holding company from establishing or acquiring a financial company if any of the holding company’s banks or thrifts have received a less than Satisfactory CRA rating in its most recent CRA exam.)

Once a holding company satisfies these conditions (and becomes a financial holding company), it may establish or acquire an insurance agency, broker and/or underwriter without any prior notice to the Federal Reserve Board. On the other hand, the holding company must notify the Board within 30 days after it enters the insurance business. Additionally, a holding company must comply with any state laws governing the establishment or acquisition of an insurance firm. For example, most, if not all, states have change in control statutes applicable to the acquisition of an insurance underwriter. A holding company must comply with such a law, unless the law discriminates against a bank or an affiliate of a bank. Furthermore, the Act provides that a state’s review of an acquisition must occur within the 60-day period before the acquisition is effective.

After entering the insurance business, a financial holding company must continue to meet the capital and management conditions, noted above. If a company fails to do so, it must enter into a written agreement with the Federal Reserve Board to correct the condition. Furthermore, if non-compliance continues, the company may face limitations on its financial activities or even be required to divest such activities. On the other hand, the CRA requirement is not a continuing condition. That is, the failure to maintain a satisfactory CRA rating at all subsidiary banks and thrifts does not subject a financial holding company to any sanctions. However, failure to meet

the CRA requirement would prevent a financial holding company from establishing or acquiring any additional companies engaged in financial activities.

Insurance Companies Owned by Holding Companies May Take Advantage of State Investment Laws

Many states permit insurance underwriters to invest in any lawful business in the state. A financial holding company may take advantage of such a state law, if it meets two conditions. First, the investment must be made by the insurance underwriter owned by the holding company, not the holding company itself. Second, the holding company may not routinely manage or operate a company in which an investment is made, except as may be necessary to obtain a reasonable return on the investment.

Insurance Subsidiaries of Holding Companies Regulated by States

The Act provides that an insurance firm owned by a financial holding company will be principally regulated by state insurance regulators. On the other hand, the Act gives the Federal Reserve Board some residual power to step in and take actions affecting an insurance subsidiary of a holding company. For example, the Board may examine an insurance subsidiary if it believes that the subsidiary is engaged in activities that pose a material risk to an affiliated bank or thrift, and may impose additional capital requirements on an insurance agency for activities other than insurance activities. Furthermore, the Board can take an enforcement action against an insurance subsidiary if it believes that such an action is necessary to prevent or redress an unsafe or unsound practice that poses a material risk to an affiliated bank and an alternative action directed at the affiliated bank will not eliminate the risk.

Four Month Effective Date

These affiliation provisions are effective 120 days after enactment of the Act, on March 11, 2000.

INSURANCE POWERS OF NATIONAL BANKS

National Banks May Sell Insurance

The Act permits qualified national banks to broker and sell insurance and annuities through a “financial subsidiary.” A financial subsidiary of a national bank is defined as a company “controlled” by one or more banks or thrifts that engages in activities that are financial in nature or incidental to such activities. Control, for these purposes, is defined just as it is for holding companies. Thus, a national bank would be deemed to control an insurance agency if it (individually or with a group of other banks, state or national) owned or controlled more than 25 percent of the shares of the agency.

A financial subsidiary engaged in insurance sales could be located wherever state law permits the establishment and operation of an insurance agency. In other words, the Act imposes no geographic limitations on insurance sales by financial subsidiaries of national banks. Such subsidiaries, however, would be subject to state licensing and other requirements.

Separately, the Act left intact the authority for a national bank to sell insurance from an office located in a “place” with a population of less than 5,000. Over time, the OCC has interpreted this authority to permit insurance sales to customers located outside of that “place,” and even the placement of satellite offices outside of the “place.” Looking ahead, it seems reasonable to assume that most national banks will rely on the provisions of the new law to sell insurance and avoid the location and reporting requirements associated with the “place” of 5,000 authority. On the other hand, it likely that the OCC will not treat a “place” of 5,000 agency as a financial subsidiary. In that case, a “place” of 5,000 agency would not be subject to the various conditions applicable to financial subsidiaries, noted below.

The Act requires the OCC to give “approval” for the establishment or acquisition of an insurance agency by a national bank. Presumably, OCC regulations will define what constitutes approval. Additionally, like holding companies, the acquisition or establishment of an insurance agency by a national bank is subject to applicable state laws.

Conditions Applicable to National Banks and Their Financial Subsidiaries

In order to sell insurance through a financial subsidiary, a national bank must be well-capitalized, well-managed, and have a satisfactory CRA rating. These are the same conditions applicable to a holding company that seeks to sell insurance. Furthermore, a national bank that fails to meet the capital and management conditions, plus a risk management requirement that is noted below, will face sanctions imposed by the OCC.

The Act places several additional conditions on national banks and their financial subsidiaries. These are as follows:

the bank’s investment in, and the retained earnings of, a financial subsidiary must be deducted from the capital of the bank;

the assets and liabilities of financial subsidiaries may not be consolidated with the parent bank;

the bank must establish procedures for managing financial and operational risks associated with the bank and the financial subsidiary;

the bank must ensure that the financial subsidiary has a separate corporate identity;

the bank and its financial subsidiary must comply with standard anti-tying requirements (these requirements prohibit a national bank from extending credit to a customer on the condition that the customer obtain some other product or service

from a financial subsidiary, but do not prevent one financial subsidiary from bundling its products and services with those of another financial subsidiary);

the assets of a financial subsidiary, when combined with the assets of all other financial subsidiaries owned by the bank, cannot exceed 45 percent of the parent bank's assets or \$50 billion, whichever is less;

no more than 20 percent of a national bank's capital may be lent to or invested in financial subsidiaries (This actually permits national banks a little more flexibility than bank holding companies. Banks in a holding company structure are subject to the same 20 percent aggregate investment and lending limit to affiliates, plus a 10 percent limit on loans and investments to individual affiliates. Thus, a national bank has a slightly greater ability to extend credit to or invest in an individual financial subsidiary than does a bank to a holding company affiliate.); and

the top 50 national banks must have an issue of long-term debt that is rated in one of the top three rating categories, and those in the second 50 must meet the same rating requirement or a comparable one established by the Treasury and Federal Reserve Board. (This requirement applies only when a financial subsidiary of a national bank is acting as a principal. In other words, it does not apply if a financial subsidiary of a national bank is engaged only in insurance sales or brokerage activities.)

National Banks May Not Underwrite Insurance

The Act prohibits national banks and their subsidiaries from underwriting insurance and annuities. This prohibition does not affect products (1) that the Office of the Comptroller of the Currency ("OCC") had authorized for national banks as of January 1, 1999, or (2) that national banks were lawfully providing as of that date. Thus, the prohibition does not affect the underwriting of credit insurance or the reinsurance of mortgage insurance. It does prevent a national bank from underwriting life insurance, annuities, property and casualty insurance, and other products regulated as insurance as of January 1, 1999. It also prevents a national bank or its subsidiary from underwriting title insurance. (See additional discussion of title insurance below.)

Title Insurance Activities of National Banks Limited

The Act has several provisions specifically related to the title insurance activities of national banks. As a general rule, the Act prohibits national banks from underwriting or selling title insurance. There are, however, several exceptions to this general rule. First, a national bank may sell insurance in a state if the banks chartered in that state are authorized to sell such insurance. A state authorization may be by law, rule, or interpretation, but may not be based on a "wild-card" statute, which allows state banks to engage in activities permissible for a national bank. Second, any national bank engaged in title insurance underwriting or sales may continue to do so if it was actively and lawfully conducting such activities prior to the date of enactment of the Act. A national bank with a grandfathered title insurance underwriting operation will lose its

grandfather if it affiliates with a company that underwrites title insurance or establishes a subsidiary that underwrites title insurance. Finally, a subsidiary of a national bank may sell title insurance.

Four Month Effective Date

The authority for a national bank to sell insurance is effective 120 days after enactment of the Act, on March 11, 2000.

INSURANCE POWERS OF STATE BANKS

State Law Governs Insurance Sales Activities

The Act does not address, directly, the insurance sales powers of state banks. As a general matter, those powers are determined not by federal law, but by the laws (or regulations or interpretations) of the state in which a bank is chartered. Some states, however, have adopted “wild-card” statutes, which permit their banks to engage in activities permissible for national banks. State banks located in states with such wild-card statutes may be able to take advantage of the new insurance agency powers authorized to subsidiaries of national banks by the Act after those provisions are effective.

FDICIA Still Applies to Insurance Underwriting

Unlike insurance sales activities, the insurance underwriting powers of state banks are affected, directly, by federal law. Since enactment of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991, federal law has prohibited state banks and their subsidiaries from underwriting insurance, unless national banks may do so. The combination of the Gramm-Leach-Bliley Act prohibition on insurance underwriting by national banks and the pre-existing FDICIA provisions bar state banks and their subsidiaries from underwriting insurance.

States Subject to Few Conditions

The Act distinguishes between state banks that are members of the Federal Reserve and those that are not. Subsidiaries of state member banks engaged in financial activities are subject to the same conditions applicable to financial subsidiaries of national banks. Thus, a state member bank engaged in the sale of insurance through a subsidiary must certify that it is well-capitalized, well-managed, and has a satisfactory CRA rating. Additionally, an insurance agency subsidiary of a state member bank is subject to the size limits imposed on financial subsidiaries of national banks, and transactions between a state member bank and an insurance agent subsidiary are subject to the Section 23A limits. A state non-member bank and its subsidiary engaged in insurance sales are not subject to these conditions.

INSURANCE POWERS OF FEDERAL SAVINGS BANKS



Sales Through Service Corporations; Underwriting Through Unitary Holding Companies

Prior to the enactment of the Act, the Office of Thrift Supervision (OTS) allowed federal savings banks to sell insurance through downstream service corporations. That authority was not altered by the Act. Thus, federal savings banks may continue to sell insurance through service corporations. On the other hand, if a federal savings bank is interested in underwriting, it must do so through a parent holding company. The OTS does not permit federal savings banks or their subsidiaries to underwrite insurance. However, the parent of a federal savings bank may engage in financial activities, including the underwriting of insurance. In fact, as of November 4, 1999, 18 insurance companies had applications pending at the OTS to establish or acquire a federal savings association.

DISCLOSURE AND OTHER CONDUCT REQUIREMENTS

Sales Practice Regulations Mandated

The Act directs the federal banking agencies to issue regulations governing the insurance sales practices of banks and thrifts. The federal banking agencies also are required to establish a procedure for responding to customers who allege that a bank or thrift has violated the regulations.

Insurance sales practices subject to regulation are as follows:

Tying -- Tying and coercive practices are prohibited;

Disclosures -- Potential customers must be told, orally and in writing, that insurance products are not insured by the FDIC and may carry investment risk;

Customer Acknowledgment -- Sales personnel must obtain the consumer's acknowledgment that the required disclosures were given;

Misrepresentation -- Neither sales personnel nor advertisements can misrepresent the nature of the product;

Setting -- Insurance sales activities must be separated, to the extent practicable, from teller windows. (Note: Insurance sales do not have to be separated from lending activities.);

Referrals -- Tellers can refer customers to insurance sales personnel and tellers may receive a one-time, nominal fee for such referrals, as long as the fee is not linked to a sale; and

Domestic Violence -- A customer's status as a victim of domestic violence cannot be used as a criterion in the underwriting, pricing, renewal, scope of coverage, or payment of claims related to life or health insurance sold by a bank or any person acting on behalf of the bank. (Note: This is an obligation that really falls on the underwriter of the insurance, not the bank. Nonetheless, regulators could require a bank to obtain some commitment from the underwriter that it did not engage in such activities.)

The regulations apply not only to the sale of insurance by the bank, but also to insurance sales activities of any person engaged on behalf of the bank. Additionally, the federal banking agencies can decide which, if any, of the regulations should apply to subsidiaries of a bank. On the other hand, the regulations do not reach an affiliate of a bank that is not a subsidiary, unless that affiliate acts on behalf of the bank.

Individual states are free to adopt their own regulations governing insurance sales practices. Thus, it is possible that banks may find their insurance sales practices subject to regulation by both the federal banking agencies and the states. State sales regulations, however, are subject to the anti-discrimination standards discussed below. Additionally, the federal banking agencies may preempt applicable state regulations, if they jointly determined that those regulations did not provide customers as much protection as the federal regulations. A state could reverse this preemption by adopting a law to that effect within three years of the preemption.

Regulation Due in One Year

The federal regulations governing insurance sales practices must be finalized within one year of the date of enactment of the Act.

THE REGULATION OF THE INSURANCE ACTIVITIES OF BANKS AND BANK HOLDING COMPANIES

State Regulated Affiliates, Federal Preemption Possible

The Act affirms state regulation of the insurance activities of banks and bank holding companies. It also requires any bank or bank holding company that underwrites or sells insurance to be state licensed. This is consistent with the current treatment of bank insurance operations. For example, the OCC already requires national banks that sell insurance to comply with state licensing laws. The Act includes several provisions that are designed to prevent states from unfairly regulating the insurance activities of banks or bank holding companies or otherwise discriminating against banks or bank holding companies engaged in insurance activities.

State Anti-Affiliation Laws Preempted



The Act provides that a state may not prevent a bank from affiliating with an insurance agency, broker or underwriter. This effectively preempts so-called state anti-affiliation laws.

State Insurance Sales Laws Subject to Alternative Preemption Tests

The Act creates two federal statutory standards under which state insurance sales laws, such as licensing requirements, can be preempted. First, state insurance sales laws adopted prior to September 3, 1998, may not “prevent or significantly interfere” with the insurance sales activities of banks or bank holding companies. Second, state insurance sales laws adopted after September 3, 1998, may be preempted under either the “prevent or significantly interfere” standard, or a non-discrimination standard that prohibits a state from treating a bank’s insurance operation differently than an insurance operation not related to a bank. These two preemption standards are available to any bank, national or state, and any bank holding company engaged in insurance activities authorized by the Act.

The Act also specifically states that it is not intended to limit the application of the decision in the case of Barnett Bank of Marion County N.A. v. Nelson, 517 U.S. 25 (1996). In that case, the U.S. Supreme Court held that states may not prevent or interfere with the ability of a national bank to sell insurance from a place with a population of less than 5,000. In reaching this conclusion, the court also cited a number of other standards under which state laws affecting the legitimate activities of national banks could be preempted. Thus, a national bank could seek to preempt a state insurance sales law under one of the applicable statutory preemption standards, noted in the preceding paragraph, or under the standards outlined by the Supreme Court in the Barnett case, if relevant.

Certain State Laws Subject to a Safeharbor

The Act shields from federal preemption 13 categories of state insurance sales laws. In other words, state laws that fall within the scope of these categories cannot be preempted by federal banking agencies under any of the standards noted above. Many of the state laws that fall within these categories, however, are similar to requirements otherwise applicable to banks, such as the anti-tying rules and regulatory disclosure requirements. Furthermore, a state must affirmatively adopt such a law or regulation for it to fall within one of these categories.

Non-Discrimination Standard Applies to Other State Insurance Laws (e.g., Underwriting)

The Act permits state insurance laws, other than sales laws, to be preempted under non-discrimination standards applicable to state sales laws adopted after September 3, 1998. In other words, state insurance laws related to underwriting and insurance matters, other than sales, could be preempted if they treat the insurance operations of banks or bank holding companies differently than other non-bank related insurance operations.

Uniform Regulation of Brokers and Dealers



The Act provides for the establishment of a self-regulatory body, the National Association of Registered Agents and Brokers (NARAB), which would establish uniform licensing, appointment, continuing education, and related qualification requirements for insurance agents and brokers. For banking organizations engaged in insurance sales activities in more than one state, this provision could streamline licensing and other qualification requirements. On the other hand, it is not certain that NARAB will ever come into existence. The Act provides for the creation of NARAB, only if a majority of the states have not adopted uniform licensing and qualification requirements within three years after passage of the Act.

Immediate Effective Date

These regulatory provisions are effective immediately upon enactment of the Act.

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