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To: Hon. Roger C. Day
President
National Association of Insurance Commissioners

Hon. Bruce W. Foudree
Chairman
N.A.I.C. Task Force on Integrated Financial Services

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Re: Insurance Regulation in the Event of Insurer Affiliation with Banks

This paper has been commissioned by banks and bank holding companies (Citi, Chase and Security Pacific), but its purpose is neither to advocate nor to oppose participation by banks in the insurance business or insurer participation in the banking business. Our firm takes no position on those issues here or elsewhere.

Instead, we were asked to assume the legal ability of insurance and banking to enter each other's businesses, and then to assess the implications for insurance regulation, including the adequacy of the state regulatory tools already at hand, and to suggest any changes in the regulatory system which appeared to us to be needed.

As to the timeliness of the question, it is enough to recognize that bankers and insurers are looking closely at each other's activities and that some of the barriers between them are coming down. Indeed, just by reading the newspapers one can see that many institutions, with varying points of departure, aspire to be full service financial institutions and that many have already gone a long way in that direction.

The purpose of this paper is not to argue that such combinations are a good idea or a bad one, either as a matter of public policy or of profit prospects for the participants. We simply note that a lot of change in that direction is going on, enough that enlightened regulators of all the fields involved should now be considering the regulatory response.

Similarly, while much of the most dramatic and imaginative recent activity has come from financial institutions which are not banks, commercial banks are actually and potentially a major part of the full financial services movement. Whence their request to us to assume their legal ability to participate and to study whether the present system of state insurance regulation could deal with any problems posed by bank entry.

For those reasons, we have taken our orienting values neither from the insurance underwriting and distributing world nor from the banking world nor from the many other worlds (such as data management or home retailing) which may emerge as important new players in the future of financial services. We take them from the insurance regulatory world.

1. General Conclusions

Besides the rather easy finding that this is a good, and certainly not premature, time for the commissioners to be considering these questions, we have come to three general conclusions, which will be the basis of the rest of this report.

The first is that the affiliation of insurance and banking, done right, can be done consistently with public and regulatory values. If general public policy so determines, insurers and banks (which are subject to regulatory systems with similar goals, methods and procedures) can be brought under common corporate control, without overtaxing insurance regulation. State regulation of insurance should be able to deal with insurer-bank affiliation just as well as it has dealt with other affiliations in the past.

The second general conclusion is that regulating insurer-bank affiliation from the insurance side (and probably others) will be much easier and effective if the institutions retain their present identities. At the selling level, that means a continuation of the familiar technique of multiple licensing. At the level of risk bearing, capital accumulation and holding of large amounts of money under obligation to others (the insurance company and the bank), it means separate incorporation and chartering.

Our third general conclusion is not only that state regulation of insurance can deal with this development, should it occur, but that the insurance departments already possess the specific tools for dealing with insurer-bank affiliations, tools which they developed in response to earlier and parallel events.

The commissioners have an array of general powers to deal with problems of exploitation and misconduct, from agent licensure to company examination. Those general powers are supplemented by two special laws already in force in nearly all states which are based on the Model Insurance Holding Company Act and the Model Unfair Trade Practices Act of the National Association of Insurance Commissioners.

The general reason for the existence of those two model statutes is not that the commissioners were preparing for any futuristic vision of what insurers, banks and other businesses might do. It is that they were responding to actual, current events in the affiliation of insurers with firms based elsewhere in the general economy.

The rest of this paper is laid out as follows. The next section deals with our first general conclusion – that insurance regulation can deal with affiliations should they be allowed to occur. It includes a discussion of other changes faced by insurance regulation in the past.

Then comes a section on our conclusion that banks and insurers should not be allowed to do each other's businesses directly, even though they be allowed to affiliate, share premises, share customers or whatever.

The following section deals with the first of the commissioners' special resources, the holding company laws. The next section takes up the second special resource, the unfair trade practices acts.

The final section contains a few suggested changes in the two model laws to make them even more effective regulatory resources in the even of insurer-bank affiliation.

2. Insurance Regulation and Bank Affiliation

The specifics of the regulatory tools will be discussed in later sections. Here we just want to make the point that insurance regulation has dealt with major changes in the past, some, in our judgment, more controversial and potentially disruptive than affiliation with banks.

The fact is that insurance, despite its conservative culture and rhetorical style, is always changing. It is closely woven into the social, economic and legal fabrics of this country, and as they change, insurance changes. Insurance regulation, benefiting from the inelegant but flexible system of state jurisdiction, has responded well to the changes and has sometimes caused them. All this has been going on for a very long time.

For example, back in the 19th century, Massachusetts Insurance Commissioner Elizur Wright took the lead in requiring cash values in life insurance. Denounced as a crackpot by the industry at the time, he is now more accurately regarded as the architect of permanent personal life insurance and hence of the modern life insurance industry.

Starting with fire insurance in the late 19th century and intensifying aftrer the introduction of workers' compensation after 1910, mutual insurers, starting as true cooperatives, competed with the more established stock companies. Often the mutuals were formed because the established companies would not grant coverage, but once competition began it was bitter and loaded with moral questions about the opponent's right to exist. The commissioners took as their role the setting up of rules for fair competition and did so successfully.

A striking example came in the mid-1940s. By 1944, insurance had for nearly a century been held not to be commerce and hence not to be subject to federal laws such as anti-trust. That year the Supreme Court reversed the position.

Suddenly many of the governing arrangements of the insurance business, such as the setting of rates and commissions in concert, were in violation of the federal anti-trust laws. Working with the Congress and the industry, the commissioners managed to preserve the only rate making and regulating system which most insurers understood, to preserve state regulation and to do so in compliance with federal law.

Since then, regulation has had to deal with a contentious shift in dominance of personal property-casualty insurance from independent agents to various kinds of direct writer, preserving order while leaving the customer free to choose.

It has also dealt with, indeed often initiated, the most basic change of all in property-casualty insurance – the change from regulated cartel pricing on the public utility model to open competition pricing on the anti-trust model. That change is not over, but now the majority of insurance premiums are not regulated and the trend is continuing, soundly in our opinion. The point is that insurance regulation has somehow managed, without needless harm to existing participants, a change of the kind and extent which has virtually destroyed the pre-existing airline and securities industries.

Most of the past insurance changes were the subject of intense legal maneuvering, with both sides trying to use the legislative, regulatory and judicial processes to advance or protect their economic interests – a practice hardly confined to insurance. Through it all, on balance the commissioners did a good job of separating out the legitimate regulatory issues and embracing them alone.

With that history, there is no reason to fear that the commissioners, given adequate tools, cannot deal with the regulatory aspects of insurer affiliation with banks.

3. Insurers and Banks Should Not Do Each Other's Businesses

What insurance regulation can deal with is the affiliation of banks and insurers. What it could not deal with (probably along with the bank regulators and the business participants) would be for the institutions, willy-nilly, to do directly the business of each other.

At the selling level, multiple licensure would be the best regulatory response as well as a familiar one. Already many agents have property-casualty insurance, life insurance and real estate licenses. Some are employees of insurance companies. Many stockbrokers have insurance licenses.

From a regulatory point of view, the situation of an insurance agent's having a counter in a bank, or of an insurance agent's having the ability to accept deposits or do other banking transactions, or of a bank employee's having an insurance or broker license, all could be managed. He or she might have several hats, but it would be most unwise from the regulatory point of view to create the all-purpose hat.

At the level of risk bearing, capital accumulation and the concentration (morally if not legally) of other people's money, however, the traditional requirement of separate corporations should be applied to insurers and banks. However close the affiliation permitted, insurance companies should not exercise direct banking powers, nor should banks exercise direct insurance powers.

This is not mere formalism. Notions of risk, pricing and leverage are very different in the two businesses. Valuation of assets in banking and of liabilities in insurance are vexing to the best professionals in each field. Putting them together would hardly make them easier. Hence neither should exercise the direct powers of the other. Because of valuation problems, we think the holding company structure (sibling insurer and bank under one parent) would be best for regulation, but, because public policy over the years has encouraged the mutual form of insurer and, to a lesser extent, of bank, with their obvious problems of upstream or sibling affiliation, we recommend that banks and insurers not be prohibited from owning each other.

A further reason for keeping insurers and banks corporately separate is that, despite their many common functions, insurers and banks take enough different risks that the single-purpose customer of either should not be put at risk in fields he had no intention of getting involved with.

Finally, the different institutions have a variety of insolvency guaranty funds, which are, by their nature and the source of their money, dedicated to a particular kind of business.

4. Insurance Holding Company Laws

The main way bank affiliation would fit into the history and objectives of insurance regulation would be as a part of the insurance holding company phenomenon.

For most of the history of insurance regulation, the commissioners did not have specific authority to approve or disapprove either (a) changes in control of insurance companies, or (b) inter-corporate transactions between insurers and companies affiliated with them.

Even so, the regulatory system worked, probably because the main purpose of the multi-company fleets or holding company systems was to make it easier to engage in the insurance business.

In this phase, the holding company was a sort of escape valve from excessive restriction, either governmental or cartel. The commissioners, of course, knew what was happening and let it happen.

In the mid-1960's, however, the reasons for setting up holding companies changed. Executives of major insurers began to form holding companies with the declared purposes of, first, moving capital out of the insurance business and, second, broadening the range of financial services their enterprises could offer. It was an early round in the debate over one-stop shopping and full financial services.

The change in purpose away from facilitating an insurance business and toward diversification and disinvestment caused concern among the regulators. In 1967, both the National Association of Insurance Commissioners and the New York Insurance Department created special committees to study insurance holding companies and their regulatory implications (see *1968 Proceedings of the N.A.I.C., Vol. I*, p. 117, *Vol. II*, p. 503; *109th Annual Report of the N.Y. Supt. of Ins.*, p. 149).

In 1969 the N.A.I.C. adopted a model holding company law (see *1969 Proceedings of the N.A.I.C., Vol. II*, pp. 735, 737, 756). Nearly all states have holding company laws, most based on the N.A.I.C. model.

The essence of the holding company laws was to allow the structure to exist, but to give the states new powers to regulate conduct and change within the structure. The laws have two main features.

First, they subject inter-corporate transactions within a holding company system to standards of fairness and disclosure and require prior approval of extraordinary transactions such as large dividends.

The commissioners concluded, after extensive examination of alternatives, that those additional powers, wisely and forcefully exercised, were both necessary and sufficient to protect policyholders and the public. The record suggests they were right.

Second, the laws require prior regulatory approval of changes in control of an insurance company, with the applicable standard to include the trustworthiness and competence of the acquiror, the likely impact on the financial condition of the insurance company, effects on competition and the protection of the interests of policyholders.

As enacted, some of the statutes required consideration of the interests of stockholders and, tacitly, of incumbent management in the review of transfers of control. That invited legal challenge under the Commerce Clause and the Williams Act. The legal situation is presently unclear (see *Edgar v. MITE Corporation*, 102 S. Ct. 2629 (1982)).

But the relevant point for us is that only the second, or takeover, aspect of the insurance holding company laws is under constitutional challenge. The features that matter for the ability of the states to regulate insurance holding company systems, whether or not they include banks, have not been challenged and are unlikely to be.

The insurance holding company studies and the N.A.I.C. model law and New York statute all occurred before federal law and (in some states) state law curtailed affiliations between insurers and banks (see *U.S. Bank Holding Company Act Amendments of 1970*). Indeed at the time a large, proposed affiliation had been announced (First National City Corporation-Chubb).

The commissioners at the time were thus aware of the possibility of insurer-bank combinations, but they had lived with the affiliation of insurers with general businesses for a long time with no special legislation at all (*e.g.*, Sears-Allstate) and during their deliberations some of the largest affiliations of all took place (*e.g.*, ITT-Hartford, American Express-Fireman's Fund, National General-Great American, City Investing-Home).

Our conclusion is that the insurance holding company laws have worked, were drafted with bank affiliation in mind, and should be adequate to deal, from the regulatory point of view, with the inter-corporate aspects of insurer-bank affiliation. We will suggest a few specific changes, but the basic holding company law idea continues, in our judgment, to be sound.

5. Unfair Trade Practices

Inter-corporate questions are, of course, not the whole story. Another important part is fair dealing with customers and fair competition with competitors.

Much of the debate over whether banks and insurers should be allowed to affiliate, especially so as to put the point of insurance sale close to the point of credit extension, has centered on the possibility of coercion or tie-in selling.

Banking law and general commercial law contain their own prohibitions against such practices but, as this memorandum deals only with insurance regulation, it is appropriate to note that state insurance regulation has been mindful of the possible problems as well.

After the Supreme Court held insurance to be subject to the anti-trust laws, Congress responded by granting an exemption conditioned on insurance's being regulated by the states (P.L. 15, 79th Congress (1945)). The N.A.I.C. then developed model laws designed to satisfy the condition of regulation by the states to the extent existing laws did not already do so.

The best known model law had to do with rate regulation, but a companion had to do with "Unfair Practices in the Business of Insurance" (see *1947 Proceedings of the N.A.I.C.*, p. 219).

Over the years the N.A.I.C. and the states have added to that model law to deal with new or potential abuses of customers and competitors in the marketplace. As amended, it is in force in some 45 states.

In 1977 the N.A.I.C. amended the model unfair trade practices act to add prohibitions against "coercion of debtors" (see *1977 Proceedings of the N.A.I.C., Vol. I*, p. 226).

The amended act prohibits a lender from conditioning a loan on the purchase of insurance from a designated agent or company, from soliciting insurance before committing to lend, and from a number of other abuses in the general area of tie-in sales. The sanction is a fine or the suspension or revocation of the insurance company's or agent's license held by the lender or its collaborator. We shall propose amendments, but the structure and the general idea are sound and have been in place for six years.

The "credit" provision of the N.A.I.C. model unfair trade practices law is just another example of insurance regulation's ability to move with change in the regulated industry. By 1977, major lenders, such as Household Finance and Beneficial, had major insurance operations.

As with holding companies, insurance regulation recognized what was happening in the credit area without either encouraging or discouraging it, and the regulatory decision was not to prohibit structure but to regulate conduct.

6. Conclusions and Recommendations

Our basic recommendation is that, whether commissioners are for or against affiliation of insurers and banks as a matter of public policy, the N.A.I.C. be prepared for the possibility so that, should it happen, the insurance buying public would continue to be well protected by the regulatory agencies it has come to rely on.

From that follow our three general conclusions stated at the outset.

First, state regulation is capable of doing the job. Second, banks and insurers should not directly perform each other's functions, however closely the corporations may be permitted to affiliate. Third, the existing insurance holding company laws, and especially the holding company and unfair trade practices laws, are generally adequate to the task.

Finally, we offer a few specific suggestions for consideration by the commissioners, with a view to possible amendment of the model laws.

First, the laws should specifically prohibit banks from directly performing insurance functions and insurance companies from performing banking functions. Where there is a lot of "trust" money, it should be kept in corporately separate compartments and subject to the compartmentalized regulatory system we now have.

Second, the insurance holding company laws should be amended to cover insurance agents and brokers, or at least those above a specified size. During the decade since the laws were enacted, the decade of risk management, agents and brokers have taken on many of the socially sensitive insurance functions (such as workers' compensation claims) which used to be performed only by companies, and the present laws are far from clear as to their applicability beyond companies.

While we think this amendment is desirable on its own, it would be specifically useful here in making clear that the commissioners would have the same authority to supervise affiliations between banks and insurance agents and brokers as they now have with respect to insurance companies.

Third, the insurance holding company laws should be amended to reflect recent court decisions, a matter on which the commissioners are already working.

The original purpose of the model act was to protect policyholders, and it is more becoming and, in all likelihood, technically sounder for the commissioners to tighten its scope to that original purpose than to wait for the federal courts to do so. In the bank context, the value of such action would be to protect one of the commissioners' key resources in dealing with bank-insurer affiliation, the danger being that some federal court might not treat the conduct sections of the act as severable from the control sections and, in ruling on the latter, might declare an entire act unconstitutional.

Fourth, the debtor coercion provisions of the model unfair trade practices act (Section 5) should be reviewed to be sure they are strong enough, both in anticipation of possible bank affiliation and for the affiliations with powerful non-bank lenders which already exist. If the commissioners find that the laws are not strong enough, then we would certainly recommend appropriate amendment in the borrower's favor.

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