

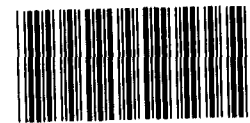
GAO

Report to the Chairman, Committee on
Small Business, House of
Representatives

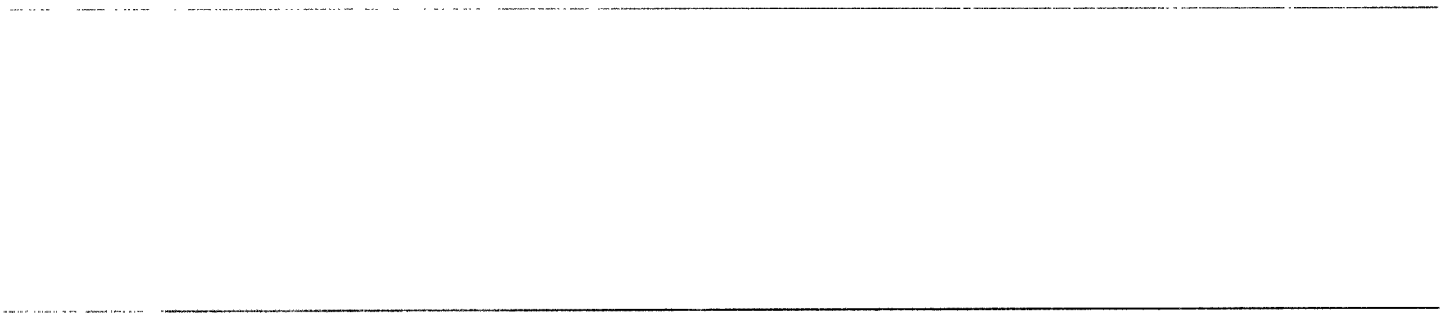
September 1990

BANK POWERS

Issues Relating to Banks Selling Insurance



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United States
General Accounting Office
Washington, D.C. 20548

General Government Division

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September 25, 1990

The Honorable John J. LaFalce
Chairman, Committee on Small
Business
House of Representatives

Dear Mr. Chairman:

This report, prepared at your request, evaluates the potential effects of banks selling insurance on consumers, other insurance sellers, and bank safety and soundness. The report also addresses the extent of coercion in bank sales of insurance and the need for regulatory controls to protect consumers.

As arranged with the Committee, unless you publicly announce the contents of the report earlier, we plan no further distribution until 30 days from the date of the report. At that time we will send copies of this report to other appropriate congressional committees, federal banking agencies, and others on request.

Major contributors to this report are listed in appendix II. Please contact me on 275-8678 if you or your staff have any questions concerning this report.

Sincerely yours,

A handwritten signature in cursive script, reading "Craig A. Simmons".

Craig A. Simmons
Director, Financial Institutions
and Markets Issues

Executive Summary

Purpose

If more banks gain powers to sell insurance, both property/casualty and life/health, opponents charge that banks will coerce consumers to buy insurance as a condition to receive credit. Further, insurance sellers suggest that banks selling insurance would compete unfairly with other sellers and endanger bank safety and soundness. In contrast, banks and some consumer groups assert that banks selling insurance would benefit consumers through cheaper premiums and convenient service.

The Chairman of the House Committee on Small Business requested GAO to evaluate the potential effects of banks selling insurance on consumers, other insurance sellers, and bank safety and soundness. The Chairman also asked GAO to address the extent of coercion in bank sales of insurance and the need for regulatory controls to protect consumers.

Background

While the Bank Holding Company Act generally separated banking from insurance activities, most banks can sell credit insurance—insurance to repay a borrower's debt if the borrower dies or becomes disabled. Moreover, some banks have additional powers to sell insurance. According to a 1987 survey published by the Federal Deposit Insurance Corporation (FDIC), about half of the states permitted state-chartered banks to sell most forms of insurance. Also, in towns with populations less than 5,000, bank holding companies, national banks, and some state banks can sell all types of insurance. A bank holding company with assets less than \$50 million can sell some types of insurance.

In this report, GAO discusses bank sales of insurance products underwritten by an unaffiliated insurance company, which bears all risk of loss due to policyholder claims. GAO does not deal with the risks that might exist should banks be allowed to underwrite insurance or affiliate with insurance companies.

To identify the potential effects of banks selling insurance, GAO met with a judgmental sample of banking and insurance organizations, their regulators, consumer advocates, and academic experts. To assess the extent of coercion by banks, GAO reviewed Federal Reserve-sponsored studies of credit insurance sold by banks and spoke with regulators in nine states where banks have limited powers to sell insurance. (See pp. 8-15.)

Results in Brief

Banks selling insurance could potentially benefit consumers through reduced insurance costs and increased convenience. However, if more banks sell insurance, opportunities may increase for banks to coerce consumers to buy insurance as a condition to receive credit.

Available evidence does not indicate that coercion is a widespread problem in existing bank sales of insurance. Tying credit to the sale of other products is already illegal. Additional measures, such as disclosing that insurance purchases are voluntary or separating insurance sales from credit approval, could protect consumers from any increased potential for abuse.

Expanded bank sales of insurance would increase competition for other insurance sellers. While a bank could abuse its position as a source of credit to compete unfairly against other sellers, existing regulatory controls, if properly enforced, should serve to limit credit abuses.

Bank sales of insurance underwritten by an unaffiliated insurance company present no risk to bank safety and soundness. The insurer underwriting the policies bears the financial risk of losses under policies sold by the bank.

GAO's Analysis

Consumers May Benefit but May Also Need Protection

Banks could possibly reduce consumers' insurance costs if they could lower the costs of selling policies through joint marketing of bank and insurance products. The increased convenience would also save consumers' time and effort in purchasing insurance products. However, it is not possible to anticipate the extent to which banks can lower the costs of selling insurance or whether these savings would result in cheaper insurance premiums.

Like other lenders selling insurance, a bank could tie the purchase of insurance to the granting of credit. Coercive tie-ins, where the customer is forced to purchase an additional product to receive credit, are illegal under existing banking law. Also, a bank's ability to coerce borrowers into purchasing insurance is limited not only by other sources of insurance but also by other sources of credit.

Although credit insurance is most susceptible to tie-ins, Federal Reserve studies found favorable consumer perceptions, which did not indicate widespread abuse by banks. Ninety percent of credit insurance buyers in 1985 thought credit insurance was a good product and would purchase similar coverage again. The consensus of state banking and insurance regulators GAO interviewed was that, while instances of abuse

may occur, coercive tie-ins are not widespread in bank sales of insurance. Fourteen of 17 regulators GAO interviewed did not believe banks routinely coerce borrowers to buy credit insurance.

While coercive tie-ins are already illegal, additional measures could protect consumers from the perception that buying insurance could improve chances of getting loans. Such measures include disclosing that insurance purchases are voluntary and requiring that insurance marketing be separated from the credit approval process. However, such a separation might reduce or eliminate the cost savings that would otherwise flow from joint marketing of banking and insurance products. (See pp. 16-25.)

Increased Competition for Other Sellers

Expanded bank sales of insurance would create a more level playing field among banks and other depository institutions and lenders that now sell insurance. While insurers underwriting policies may benefit from the flexibility of another channel for reaching customers, other insurance retail sellers would face increased competition from banks selling insurance.

Banks have potential competitive advantages over other insurance sellers. For example, banks may be able to sell insurance more cheaply through joint marketing of bank and insurance products. Also, a bank-affiliated insurance seller has access to bank customers and customer information and can share overhead costs with the bank. These advantages are not unique to banks, and any large insurance seller has an advantage over small agents.

Regulatory measures eliminating joint marketing would reduce banks' competitive advantages over other sellers. For example, a bank could be prohibited from sharing customer information or office space with its insurance operations. While separate marketing for a bank and its insurance activities could protect other insurance sellers from increased competition, such measures would forestall consumers gaining potential cost savings and increased convenience.

Finally, banks could give preferential treatment to affiliated insurance agencies or deny credit to competing insurance sellers. Banking laws and regulations, including sections 23A and 23B of the Federal Reserve Act, limit lending by a bank to its affiliates and require interaffiliate transactions to be on a nonpreferential basis. However, similar restrictions do not apply to bank subsidiaries or departments within a bank. (See pp. 26-32.)

No Risk to Bank Safety and Soundness

Expanded bank sales of insurance underwritten by unaffiliated insurance companies would not endanger bank safety and soundness. Unlike underwriting, selling insurance does not involve financial risk of loss for policyholder claims. To the extent that sales commissions contribute to banking profits, diversification into selling insurance could strengthen safety and soundness and protect against bank failures. It is not possible to predict whether bank sales of insurance would be profitable. While selling insurance in itself presents no risk to a bank's capital, any expansion into a new business presents management challenges and could divert management attention away from core business responsibilities, such as careful management of credit risk.

Additional measures may be necessary to ensure that consumers do not become confused about whether insurance products sold by a bank are backed by federal deposit insurance. One measure would be to expressly disclose to the consumer that insurance products are underwritten by an insurance company and are not covered by banking deposit insurance. (See pp. 33-34.)

Matters for Congressional Consideration

While consumers could potentially benefit from bank sales of insurance, it is not possible to know in advance the potential for future abuses in tying the granting of credit to the purchase of insurance. If more banks gain powers to sell insurance, Congress may wish to consider the need for additional regulatory measures, including increased disclosure and separation of insurance marketing from the credit process, to protect consumers from possible coercive tie-in problems.

Agency Comments

As requested by the Committee, GAO did not obtain written comments on this report. GAO discussed the report with officials at the Federal Reserve, FDIC, and Office of the Comptroller of the Currency and has incorporated their comments where appropriate. Agency officials generally agreed with the conclusions contained in the report.

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Abbreviations

FDIC	Federal Deposit Insurance Corporation
GAO	General Accounting Office
NAIC	National Association of Insurance Commissioners
OCC	Office of the Comptroller of the Currency

Introduction

In recent years, state legislatures, banking regulatory agencies, and the courts have allowed banking institutions (commercial banks and their holding companies) to expand into selling insurance—property/casualty and life/health. As Congress considers whether nationally regulated banks should be granted powers to sell insurance products, opponents and proponents of expanded powers disagree as to the effect of banks selling insurance on consumers, other insurance sellers, and bank safety and soundness.

Insurance agents and industry trade associations allege that banks selling insurance present the following dangers:

- banks would charge unreasonably high premiums or coerce consumers to buy insurance as a condition to receive loans,
- banks would give preferential treatment to their insurance subsidiaries and affiliates and deny credit to competing insurance sellers, and
- inexperienced banks selling insurance could incur losses and endanger the safety and soundness of the banking system.

In contrast, banks and consumer groups assert that bank expansion into insurance sales would yield the following advantages:

- banks' lower costs would result in lower insurance premiums,
- increased competition between insurance sellers would also lower insurance premiums and improve service quality, and
- diversification into insurance sales would reduce risk and possibly increase bank profits, thereby protecting banking safety and soundness.

Banks Selling Insurance

While the Bank Holding Company Act generally separated commercial banking from insurance activities, some banks have limited powers to sell insurance. The extent of insurance powers varies depending upon the type of banking institution and its regulatory agency.

National Banks

Among federal banking regulators, the Office of the Comptroller of the Currency (OCC) has approved the broadest range of insurance selling activities. OCC charters and regulates national banks under the terms of the National Bank Act. The act expressly authorizes national banks located in towns with populations not exceeding 5,000 to sell all types of

insurance.¹ OCC has interpreted this authority to allow a national bank with a branch in a qualifying small town to sell insurance nationwide.

In addition, OCC relies on the general language in the National Bank Act to permit national banks to engage in other limited sales of insurance. The act authorizes national banks to exercise all incidental powers necessary to carry on the business of banking. In approving insurance sales activity incidental to banking, OCC has allowed national banks to sell credit insurance,² title insurance,³ and certain annuities.⁴ In addition, OCC has allowed national banks to lease space to an insurance agency, enclose insurance advertisements in bank mailings, sell customer lists to insurance agents, and refer customers to insurance agents and share in resulting sales commissions.

State Banks

The extent of insurance powers of state-chartered banks varies by state. According to a survey of state banking laws published by the Federal Deposit Insurance Corporation (FDIC) in 1987,⁵ all states except Texas allowed state banks to sell credit insurance. Moreover, as of 1987, about half of the states permitted state-chartered banks to sell most forms of insurance. Of those states granting insurance powers, nine states allowed bank sales of insurance only in towns with populations less than 5,000, and one state allowed such sales in towns with populations less than 200,000. State-chartered banks also may lease space to insurance agents in 31 states and share customer lists with insurance sellers in 15 states.⁶

Since the survey published by FDIC in 1987, several states have taken action to expand bank authority to sell insurance. Proposition 103 in California repealed a law that made bank holding companies and their affiliates ineligible for a license to sell insurance. Delaware, in May 1990, enacted legislation allowing state banks to sell insurance nationwide.

¹ 12 U.S.C. section 92.

² Credit insurance is designed to repay a borrower's debt if the borrower dies or becomes disabled.

³ Title insurance protects the policyholder against undiscovered defects in a property's title.

⁴ An annuity is an investment from which the owner receives periodic payments for a number of years or for a lifetime.

⁵ Victor C. Saulsbury, "State Banking Powers: Where Are We Now?" Regulatory Review, Federal Deposit Insurance Corporation (Apr. 1987).

⁶ Bank Diversification: Into Insurance?, Congressional Research Service (Feb. 9, 1990).

The Congressional Research Service reported that in 1989 legislators in 22 states introduced bills to expand insurance sales by state-chartered banks, and insurance agents had introduced countering legislation in 24 states to limit banks selling insurance.

Bank Holding Companies

The Bank Holding Company Act expressly limits the insurance activities of holding companies that own at least one bank. The Act generally prohibits a bank holding company or its subsidiaries from selling insurance.⁷ Exceptions to the general prohibition permit bank holding companies to engage in limited insurance activities similar to those that OCC has approved for national banks. Exceptions to permit selling insurance include:

- a bank holding company may sell credit insurance;
- a finance company subsidiary may sell property/casualty insurance to protect loan collateral;
- a bank holding company may sell all types of insurance in a small town with a population not exceeding 5,000;
- a small bank holding company with assets less than \$50 million may sell insurance, except for life insurance and annuities; and
- a bank holding company selling insurance on May 1, 1982, may continue those activities under a grandfather clause.⁸

Recent decisions by the Federal Reserve Board, which is responsible for administering and interpreting the Bank Holding Company Act, have expanded insurance activities of holding companies. In 1987, the Federal Reserve Board ruled that a bank holding company may sell insurance by acquiring a grandfathered holding company. In 1989, the Federal Reserve Board ruled that the general prohibition on insurance activities applies only to nonbank subsidiaries of a bank holding company; therefore, a state bank and its subsidiaries could engage in any insurance selling that the chartering state permits. In other decisions, the Federal Reserve Board has permitted other insurance-related activities, such as advertising insurance products and selling customer lists to insurance sellers.

⁷12 U.S.C. 1843 (c)(8).

⁸Title VI of the Garn-St. Germain Depository Institutions Act of 1982 (P.L. 97-320).

Insurance Delivery Systems

Insurance products—property/casualty and life/health—are marketed and sold through three insurance delivery systems: independent agencies or brokerage firms, exclusive agents, and direct writers.

Independent Agents and Brokers

An independent insurance agency generally represents and sells products of several competing insurance companies. On the other hand, a broker represents the insurance buyer in negotiations with insurance companies to tailor coverage for commercial, large, or unusual risks. Independent agents and brokers are contractors and are not employees of an insurance company. Both agents and brokers assist the insurance buyer in comparing costs and coverage of different policies. In addition to selling insurance products, an independent agent also may handle claims reporting for clients.

An independent agent's income is derived solely from commissions paid by insurers for policies sold, whereas a broker may receive both fees from customers and commissions from insurers. When an insurance policy is sold through an independent agent, lists of customers and policy expiration dates become the property of the agency, and all renewals and associated commissions belong to the agency. As a result, insurance companies represented by the agency may not bypass the agency to sell policies directly to the agency's clients.

Exclusive Agents

An exclusive agent generally represents and sells the products of one insurance company or group of affiliated companies. An exclusive agent, also referred to as a captive agent, may be an independent contractor working for the insurer or an employee of the insurance company. An exclusive agent receives compensation through a mixture of salary and commissions on policies sold. In addition to selling policies, such agents also may handle claims for clients.

Direct Writers

Direct writers are insurance companies who use direct mailing, media advertising, and telephone solicitation to sell their products directly to customers. An insurer may obtain lists of prospective buyers from diverse organizations, including employee unions and banks. Direct mailing eliminates agents and sales staff and thus can result in lower selling expenses. However, the mail order approach generally offers little personal service to customers in selecting coverage.

Banks as Insurance Sellers

A bank selling insurance may act as an independent agency representing several insurers, or a bank could act as an exclusive agent for one insurance company or group of affiliated companies. Finally, a bank can assist insurers or other insurance sellers with direct marketing activities. As indicated above, a bank may sell its customer lists to an insurance agency or a direct writing insurer. Also, a bank can include an insurer's sales material in mailings to bank customers.

Trends in Insurance Delivery

An insurance company may use more than one insurance delivery system to sell its policies. An insurer may use different delivery systems for different types of insurance or in different geographic areas. For example, an insurer may sell commercial insurance through agents while using direct mail order to market personal property insurance. Also, an insurer may use multiple delivery systems to market the same products. For example, an insurer may sell automobile insurance both through agents and by mail order.

Delivery methods also differ between life and property/casualty industries. Table 1.1 illustrates the market shares in 1986 for each delivery system for both life and property/casualty insurance. Life insurance is sold largely through exclusive agents who have 56 percent of the life market, whereas independent agents account for 63 percent of property/casualty business.

Table 1.1: Market Shares for Delivery Systems by Type of Insurance in 1986

Delivery system	Market share
Life Insurance	
Independent Agents and Brokers	43%
Exclusive Agents	56%
Direct Writers	1%
Property/Casualty Insurance	
Independent Agents	63%
Exclusive Agents and Direct Writers	37% ^a

^aThis figure is based on A.M. Best Company data, which do not distinguish between exclusive agents and direct writers of property/casualty insurance.

Source: Expanded Bank Powers by Sophie M. Korczyk.

According to A.M. Best Company, a statistical and publishing organization, as of 1988, direct writers and exclusive agents sold approximately 40 percent of all property/casualty insurance. However, within the property/casualty industry, direct writers and exclusive agents control more than half of the market for personal insurance. In 1988, direct

writers and exclusive agents sold 64 percent of private automobile insurance and 52 percent of homeowners insurance.

State Regulatory Control of Insurance Sales

Under the McCarran-Ferguson Act of 1945, states exercise primary regulatory jurisdiction over the insurance business.⁹ Each state has a department of insurance responsible for, among other things, oversight of insurance sellers, insurance marketing and trade practices, and insurance policies and premium rates. All states require insurance sellers to be licensed to transact business within the state. Prospective agents and brokers may be required to pass a written examination or fulfill certain training requirements. Thus, a banking institution selling insurance and selected bank employees are required to be licensed like any other insurance agent.

State insurance regulators are responsible for enforcing state-enacted unfair trade practices laws and regulations to protect consumers from fraud, abuse, and deception in insurance marketing and sales.¹⁰ Insurance regulators monitor insurance sellers through consumer complaints, review of marketing materials, and market conduct examinations. A market conduct examination is an evaluation of an insurer and its representatives' dealings with policyholders and claimants, such as advertising and claims handling. If an insurance seller engages in fraudulent, abusive, or deceptive practices, state regulators may take action to suspend or revoke the seller's license.

State regulators also review premium rates to ensure that premiums paid by policyholders are adequate, not excessive, and not unfairly discriminatory. Some states require prior approval for premium rates, while other states require only that rate plans be filed with the insurance department before the ratings become effective. Premiums charged for an insurance policy are set by the insurer underwriting the product and not by the seller of the policy. Sales expenses, including commissions paid by the insurer to the seller, represent one component of the premium price.

⁹15 U.S.C. sections 1011-1015.

¹⁰Long-Term Care Insurance: State Regulatory Requirements Provide Inconsistent Consumer Protection (GAO/HRD-89-67, Apr. 24, 1989).

Objectives, Scope, and Methodology

The Chairman of the House Committee on Small Business requested that we evaluate the potential effects of banks selling insurance on consumers, other insurance sellers, and the safety and soundness of the banking system. In this report, we discuss bank sales of insurance products underwritten by a nonaffiliated insurance company, which bears all risk of loss due to claims of policyholders. The Chairman also asked that we specifically address the practice of cross-selling and potential for coercive tie-in sales of insurance and other consumer abuses and provide insight into what regulatory controls are needed to protect consumers.

To identify the advantages and disadvantages of banks selling insurance, we interviewed over 50 insurance and banking industry organizations, their regulators, consumer advocates, and academic experts. Our judgmental sample of interviews included banking and insurance industry representatives and regulators likely to be involved with banks already selling insurance. Appendix I lists the organizations and individuals that we interviewed. We also reviewed legal opinions, congressional hearing records, and publications prepared by banking institutions and insurance sellers.

In an effort to assess the extent of abusive tie-ins and potential for abuse if bank sales of insurance are expanded, we examined banks' experience with credit insurance, since most banks already can sell this type of insurance. Specifically, we reviewed two studies most often cited by both opponents and proponents of banks selling insurance. Based on consumer surveys sponsored by the Federal Reserve, both studies provide information on the frequency of borrower purchases of credit insurance, borrower perceptions about lender recommendations to purchase credit insurance, and overall borrower attitudes toward credit insurance.¹¹

To analyze tie-ins in bank sales of other types of insurance, we interviewed insurance sellers, banks selling insurance, and banking and insurance regulators in two states where banks already sell insurance—Minnesota and North Carolina. In Minnesota, banks have sold insurance for many years, while North Carolina banks recently started to sell insurance. We spoke with banking and insurance regulators in seven

¹¹Robert A. Eisenbeis and Paul R. Schweitzer, "Tie-ins Between the Granting of Credit and Sale of Insurance by Bank Holding Companies and Other Lenders," Staff Study 101, Board of Governors of the Federal Reserve System (Feb. 1979) and Anthony W. Cynrak and Glenn B. Canner, "Consumer Experience with Credit Insurance," Federal Reserve Bank of San Francisco Economic Review (Summer 1986), pp. 5-20.

additional states—California, Iowa, Massachusetts, Nebraska, South Dakota, Wisconsin, and Wyoming—where banks have limited powers to sell insurance. We interviewed representatives of 13 bank holding companies that have grandfathered powers to sell insurance.¹²

We also interviewed officials of the three principal federal bank regulatory agencies—Federal Reserve, FDIC, and OCC. We spoke with officials of the National Association of Insurance Commissioners (NAIC). NAIC consists of the heads of the insurance departments of the 50 states, the District of Columbia, and 4 U.S. territories. NAIC's basic purpose is to encourage uniformity and cooperation among the states as they individually regulate the insurance industry.

We did our work between December 1988 and January 1990 in accordance with generally accepted government auditing standards. At the request of the Committee, we did not obtain written comments on this report. We discussed the contents of our report with officials at the federal banking agencies—Federal Reserve, FDIC, and OCC—and have incorporated their comments where appropriate. The officials generally agreed with the conclusions in our report.

¹²Fourteen bank holding companies are allowed to continue selling insurance under the grandfather provisions of the Garn-St. Germain Act of 1982.

Consumers May Benefit but May Also Need Protection From Potential Abuses

In the debate over expanding bank powers to sell insurance, proponents and opponents disagree on how bank sales of insurance would affect consumers. Banks and consumer groups assert that banks will lower the costs of selling insurance, thereby reducing overall insurance costs, and will expand service to consumers. However, the insurance industry argues that banks would charge higher premiums and reduce service. Moreover, critics of bank sales of insurance contend that banks would take advantage of their position as lenders to coerce consumers to buy insurance.

Bank Entry May Have Little Effect on Insurance Premiums

Banks could possibly reduce the cost of insurance if they can lower the costs of marketing and selling policies to customers. However, sales expenses represent only one component of insurance costs, and any reduction in the cost of selling insurance may not significantly affect premiums paid by policyholders. Also, state regulatory oversight of insurance premiums may limit, in the short run, any seller's ability to affect premium rates. However, expanded bank sales of insurance may increase convenience for consumers, thereby reducing consumers' transaction costs.

Economies of Scope Present Potential for Cost Reduction

Banks can reduce production costs if they can achieve economies of scope in selling insurance products. An economy of scope refers to the ability to reduce costs through the joint production or marketing of two or more products or services. By offering a wider variety of products and services, a company may be able to sell a greater volume overall and lower the overhead costs per unit sold. Cross-selling, the concurrent marketing of several distinct services or products through one seller, is one way to achieve economies of scope. If bank sales of insurance are expanded, banks could use their existing offices and staff to offer more products and services to current customers.

Cross-selling is a common practice in both the banking and insurance industries. In addition to traditional deposit accounts and loans, banks offer other banking products and services, such as credit cards, trust services, credit insurance, and financial planning advice to their customers. Insurance companies routinely offer several types of insurance to policyholders. In fact, an insurer may provide discounts to policyholders purchasing several types of insurance or offer some types of coverage only to existing policyholders.

While expanded bank sales of insurance present the potential for banks to achieve economies of scope, it is not possible, we believe, to anticipate the extent to which banks could lower the costs of selling insurance. Available statistical studies of banking costs, in general, are based on small banks dealing with existing products and geographic restrictions and do not address bank expansion into insurance sales. Therefore, these cost studies cannot be used to project whether bank sales of insurance will lower the costs of selling insurance.

**Sales Expenses Are a
Fraction of Premiums Paid
by Policyholders**

Any reduction in sales costs is unlikely to substantially lower insurance premiums paid by consumers. Sales expenses represent only one component of an insurer's cost, while losses and expenses for underwriting and claims handling represent the bulk of insurance costs. According to A.M. Best Company, commissions represented nearly 12 percent of property/casualty premiums in 1988 and almost 10 percent of life/health premiums. As a result, a 1-percent reduction in sales commissions would translate into a premium reduction of, at most, one-tenth of 1 percent.

**State Regulation Limits
Seller's Effect on
Insurance Premiums**

State regulatory oversight of insurance premiums may limit, in the short run, any seller's ability to affect premium rates. First, premiums charged for an insurance policy are set by the insurer underwriting the product and not by the seller of the policy. Then, regulators in most states oversee premium rates through rate plans to be filed with the insurance department or by requiring prior approval for premium rates. Since premiums are set by the insurer with regulatory oversight, a bank selling insurance could not unilaterally change premiums charged to consumers.

In addition, almost all states prevent insurance sellers from reducing premiums paid by consumers through anti-rebating laws. The ban on rebates prevents an insurance seller from paying a portion of the premiums or sharing its commission with the customer. As a result, banks could not immediately reduce premiums paid by consumers to reflect any cost savings. Instead, the insurer marketing its products through a bank would have to revise its rates subject to regulatory oversight. If banks could reduce sales costs, to compete on the basis of price, insurers distributing products through banks would request lower premiums to pass cost savings along to customers.

Increased Convenience May Reduce Consumers' Transaction Costs

Banks could reduce an individual's overall costs of purchasing insurance by reducing the consumer's transaction costs. The total price of an insurance product is not only the premium paid to the insurer but also the consumer's time and effort to obtain information about insurance products and complete the transaction. With expanded insurance sales authority, a bank could provide "one-stop shopping" for both banking and insurance needs. The Consumer Federation of America and the National Insurance Consumer Organization assert that the increased convenience for consumers would be a primary advantage of banks selling insurance.

With one-stop shopping, a bank could assist consumers in choosing from a range of banking and insurance products. Both traditional bank products and life insurance products are important elements of a consumer's financial plans. Increasingly, banks and insurance companies offer similar products. Banks provide financial products, including letters of credit, municipal bond insurance or guarantees, and annuities, that offer insurance-like protection. Life insurers sell policies that offer an investment or savings function.

Bank Sales of Insurance Increase Potential for Abuse of Consumers

As we reported in January 1989, expanded powers for banks would increase the diversity of banking, thus increasing the potential for conflicts of interest and their abuse.¹ However, these conflict situations and potential abuses exist for all insurance sellers. For example, a bank or any other insurance seller has a "salesman's stake" in promoting products and services while at the same time purporting to provide objective advice. However, unlike other insurance sellers, a bank or any lender also could use its position as a source of credit to coerce borrowers to buy insurance through the bank as a condition to receive loans.

Conflicts of Interest Are Not Unique to Banks

A conflict of interest is a situation in which a person or business serving more than one interest can benefit by favoring one interest at the expense of others. Conflicts of interest occur during the normal course of many business operations, including banking and insurance. An abuse of a conflict of interest occurs if the bank or its representative takes advantage of the conflict situation in violation of customary industry practices, fiduciary responsibilities, or laws and regulations.

¹Banking: Conflicts of Interest Abuses in Commercial Banking Institutions (GAO/GGD-89-35, Jan. 27, 1989).

Like other insurance sellers, a bank and its employees routinely encounter situations in which their interests would be better served by actions not in the best interest of the customer. This may occur when the seller has a “salesman’s stake” in promoting products or services while at the same time purporting to provide disinterested investment advice. For example, any insurance seller, including a bank or its employees, could abuse consumers by encouraging purchases of high-profit insurance products while supposedly providing objective advice. To increase income, the seller may recommend those products that yield the highest commissions rather than the best coverage or cheapest premiums for consumers.

In addition, a bank could abuse a customer’s interest by using confidential customer information in a manner not agreed to by customers. For example, the bank could use lists of prospective borrowers to market insurance products during the credit process or provide information to an insurance seller contrary to customers’ privacy interests. Also, a bank could give preferred treatment to certain customers, such as offering lower interest rates for borrowers who purchase insurance.

Tie-Ins Between Insurance and Credit Present Opportunity for Abuse

To pass along cost savings achieved through economies of scope, a bank may “tie” two or more products and services into a package. Such tie-ins can benefit consumers as long as they have the option not to purchase the additional goods. An involuntary or coercing tie-in occurs when, in order to purchase the desired product or service, a customer must purchase a second product or service. Involuntary tie-ins may be illegal under federal antitrust laws, and banking laws explicitly prohibit tying credit to any other banking product or service. However, even where the bank does not intend a tie-in, a borrower may purchase an additional product such as insurance from the bank in hopes of improving the chance of receiving a loan. Such implied or perceived tie-ins may result if banks cross-market insurance to borrowers or, in particular, if the bank loan officer sells insurance.

Some types of insurance would be particularly susceptible to credit tie-ins. Foremost, credit insurance may be tied to credit transactions, since only consumers who owe on loans or credit accounts purchase credit insurance. According to a Congressional Research Service report, a consumer is most likely to purchase credit insurance when a loan is

originated, and as a result, the lender is well placed to offer the insurance.² In fact, one study sponsored by the Federal Reserve found 90 percent of credit insurance in 1985 was sold by lenders.

Property insurance also may be tied to credit when a loan is secured by collateral. For example, any lender that also sells insurance could offer auto insurance policies to borrowers with car loans or homeowner insurance to mortgage holders. However, the opportunity for a bank to coerce borrowers into purchasing insurance is limited not only by the existence of other sources of insurance but also by other sources of credit. In 1987, about 40 percent of auto loans and less than 40 percent of home mortgages originated with commercial banks. Many other lenders, in fact, also sell insurance, including automobile finance companies and mortgage companies.

Limited Evidence Does Not Indicate Widespread Abuse of Credit Tie-Ins

While insurance opponents of bank sales of insurance maintain that coercive tie-ins are widespread, little evidence is available to substantiate claims that banks coerce customers to buy insurance. Although credit insurance is most susceptible to tie-ins, studies of credit insurance sales have found consumers' favorable perceptions did not indicate problems with widespread abuse. As for banks selling other forms of insurance, state regulators in our interview sample said that, while instances of abuse may occur, coercive tie-ins are not widespread. Given banks' limited experience with credit insurance and the few banks that sell other insurance, we cannot generalize about the extent of abuses if bank sales of insurance are expanded.

Little Evidence That Coercion Is a Widespread Problem in Credit Insurance

Opponents of banks selling insurance claim lenders dominate credit insurance sales through overt or implied tie-ins between insurance and credit approval. To support their point, independent agents and their trade associations cite the fact that two-thirds of borrowers purchase credit insurance from their lender. In 1985, 67 percent of bank borrowers also bought credit insurance through their banks. Moreover, these opponents point out, about 20 percent of borrowers with credit

²Insurance Sales: The Effects of Possible Bank Diversification on the Insurance Industry, Congressional Research Service (Nov. 30, 1989).

insurance in 1985 said their lender strongly recommended or required the purchase of credit insurance.³

However, the fact that borrowers purchased credit insurance from their lender does not necessarily mean that borrowers were coerced to buy insurance from the bank. A Federal Reserve-sponsored study found that, excluding borrowers required to purchase coverage, less than 4 percent of credit insurance buyers in 1985 thought the loan approval process was affected by whether they bought credit insurance. Bankers suggested that borrowers purchase credit insurance from lenders, because this insurance is convenient and relatively inexpensive when compared to the loan. Indeed, 90 percent of those borrowers who purchased credit insurance in 1985 responded that credit insurance was a good product. Further, more than 90 percent of those who purchased credit insurance indicated that they would purchase similar coverage in the future. Even among those borrowers who did not purchase coverage, more than half thought credit insurance was a good idea.

Little Indication of Abuse in States With Expanded Bank Sales of Insurance

Independent agents and some state insurance regulators have suggested that if banks were granted broad power to sell insurance, banks would coerce their customers into buying insurance. However, 14 of the 17 state banking and insurance regulators that we interviewed do not believe that banks routinely coerce borrowers to buy credit insurance. Our discussions disclosed only limited anecdotal evidence of such coercive practices in states where banks already sell insurance.

Our discussions with regulators, consumer advocates, insurance agents and bankers in Minnesota and North Carolina did not indicate widespread coercion by banks selling insurance. In Minnesota, where state banks have sold insurance for over 90 years, the state's Department of Commerce, which regulates both banking and insurance, has received few complaints about coercive tie-ins by banks. Officials said that the one case involving numerous consumer complaints about coercive credit tie-ins did not involve a banking institution. In North Carolina, where banks recently began selling insurance, the Attorney General's office and state bank regulators were unaware of any widespread coercion problems in North Carolina banks.

³In many states, banks may legally require the purchase of credit insurance as a condition to receive credit. They may not, however, require that the insurance be purchased from a particular source. Under title I of the Truth in Lending Act (15 U.S.C. 1605B), the cost of credit insurance must be added into the loan's annual percentage rate.

However, we found instances of a situation which could possibly represent coercive tie-ins in insurance products. According to several persons in our interview sample, some banks have refused to accept binders—legally binding promises to provide insurance coverage—from other agents and instead offered to sell their own policies to borrowers during loan closing. A bank's ability to reject a binder in lieu of an actual policy during closing varies according to state laws and regulations. For example, a bank in North Carolina can refuse to accept binders, while in New York, this practice is prohibited.

The difficulty of coercing tie-ins between insurance and banking products is illustrated by the low market share held by bank holding companies that sell general insurance. Of the 10 bank holding companies selling insurance in our sample that responded, most estimated that few of their banking customers also bought insurance through the bank or its affiliate. Estimates ranged from less than 1 percent to less than 15 percent. These percentages of bank customers buying general insurance are low compared to the 67 percent of bank borrowers buying credit insurance.

The limited experience of national banks and state-chartered banks that sell insurance may not be representative of the extent of abuses that would occur if bank sales of insurance are expanded. Currently, bank holding companies, national banks, and state-chartered banks in 10 states can sell insurance in small towns with populations less than 5,000. Since a bank serving a small town may exercise a near monopoly in providing credit in the community, the small town exemption allows banks with the most opportunities for tie-in abuse to sell insurance. None of the regulators in our sample expressed concern about possible abuses by small town banks. In large markets where consumers can choose from multiple sources of credit and, therefore, are less susceptible to coercive tie-ins, most banks are now restricted from selling insurance.

Controls Over Abusive Practices of Banks Selling Insurance

As we reported in our 1989 report on conflicts of interest in banks, three factors work to control conflict situations and limit their abuse: competition, banking internal controls, and regulatory oversight. While this combination can serve to limit abuses, these factors cannot prevent all abuses. However, after some point, additional controls and oversight may hamper banking operations and diminish potential benefits for consumers.

Competition

Competition between financial service providers serves to deter conflict of interest abuses. To maintain business relationships and profitability, banks try to avoid adverse publicity and poor customer relations that could result from abuses. Competition serves as a barrier as long as customers are aware when they are adversely affected and can easily take their business elsewhere. As pointed out earlier in this chapter, banks are not the dominant source for consumer credit. Faced with unfair insurance sales practices by banks, consumers could find another credit source. Competition between insurance sellers will be discussed in chapter 3.

When competition is lacking or when it is difficult or expensive for customers to obtain necessary information, they may not be able to take their business elsewhere. According to the National Federation of Independent Businesses, banks are the primary source of credit for small businesses, and a small business may depend upon one bank for all of its credit needs. Generally, a small commercial borrower cannot quickly change lenders because of the lag time in applying for loans and undergoing an evaluation of its creditworthiness. In the short run, a small commercial borrower could feel pressured to purchase insurance products from the bank if the borrower has no other immediate source of credit. However, in the long run, borrowers can develop relationships with other commercial banks if they find their current banks' practices unreasonable.

Banking Internal Controls

Banks use internal control systems to manage conflict situations and limit abuses. A bank may use "Chinese Walls" to limit the passage of sensitive or confidential information between units or even to physically separate operations. The Chinese Wall concept could be used to prevent information about credit applicants from being used to sell insurance or to separate the credit and insurance departments. A bank also may have a code of ethics providing guidance to employees in resolving conflicts of interest. For example, a bank may prohibit a loan officer from discussing insurance with a prospective borrower until the loan decision is final or may require a loan officer to disclose that insurance purchases are voluntary.

Regulatory Oversight

Federal and state banking laws, regulations, and supervision play an important role in protecting consumers from bank abuses. Federal anti-trust laws prohibit certain involuntary tie-ins, and federal banking laws specifically prohibit tying bank credit to other banking products and

services. In addition, the Federal Reserve Board considers the potential for perceived tie-ins in allowing a bank holding company to sell insurance. In approval orders to individual banking institutions, the Federal Reserve Board may specify controls necessary to limit potential abuses. OCC likewise considers the potential for tie-ins by national banks selling insurance and may impose additional controls.

Some states where banks have gained power to sell insurance have additional laws and regulations that serve to protect consumers. For example, during every transaction with customers of related companies, Wisconsin requires banks to disclose the relationship and to provide instructions for the consumer to report coercive sales pressure to company management or the Commissioner of Banking. To prevent the "salesman's stake," Wisconsin prohibits bank employees who sell insurance on a commission basis from making credit decisions.

Banks selling insurance are subject to state insurance regulation as well. A bank or its employees may be required to obtain an agent license and are subject to the same state insurance regulations as other insurance sellers. While legal provisions vary from state to state, unfair trade practice laws and regulations generally prohibit coercive tie-in sales for borrowers, as well as misrepresentation and false advertising.

Additional Regulatory Controls May Warrant Consideration

While existing regulatory controls prohibit coercive tie-ins by a bank selling insurance, it is reasonable to expect that the greater the degree of joint marketing, the more likely consumers are to believe credit is tied to insurance. Thus, consumers may need additional protection from perceived tie-ins.

While a prohibition on joint marketing may prevent even the perception of tie-ins between credit and insurance, such a measure also would forestall consumers benefitting from expanded bank sales of insurance. As banks enter joint ventures with insurance sellers or gain powers to sell insurance directly to customers, other measures for consideration include mandatory disclosure and marketing separation. At the least, banks could be required to disclose that the purchase of insurance is voluntary and does not affect the granting of credit. Also, banking operations, particularly the credit process, may be insulated from insurance marketing by

- restricting a bank from offering insurance to a borrower until the loan decision is final,

- prohibiting loan officers from offering insurance to a borrower or earning commission on insurance sales, and
- physically separating insurance marketing staff and office space from other banking operations.

Some of these measures, however, may reduce or eliminate the cost savings that might otherwise flow from the joint marketing of banking and insurance services.

Conclusions

Expanded bank sales of insurance could potentially benefit consumers through reduced insurance costs and increased convenience. However, we do not believe it is possible to predict the extent to which potential benefits may be realized.

Similarly, expanded bank powers to sell insurance may increase opportunities for banks to coerce consumers to buy insurance as a condition to receive credit. However, while instances of abuse may occur, coercive tie-ins have not been a widespread problem in banks selling credit insurance or in those banks already allowed to sell other forms of insurance. These limited experiences cannot be generalized to predict the extent of future abuses. While coercive tie-ins are already illegal, additional measures could help to protect consumers.

Matters for Congressional Consideration

While consumers could potentially benefit from bank sales of insurance, it is not possible to know in advance the potential for future abuses in tying the granting of credit to the purchase of insurance. If more banks gain powers to sell insurance, Congress may wish to consider the need for additional regulatory measures, including increased disclosure and separation of insurance marketing from the credit process, to protect consumers from possible coercive tie-in problems.

Increased Competition for Other Sellers but No Risk to Banking Safety and Soundness

Opponents and proponents disagree on how expanded bank sales of insurance would affect insurance sellers. Insurance agents and their trade associations suggest that banks would reduce competition in the insurance market through unfair competition. In particular, agents claim that banks would give preferential treatment to their affiliates and deny credit to competitors. Banks and many consumer groups assert that bank sales of insurance would increase competition.

Both sides in the debate over expanded bank powers also disagree on how banks selling insurance would affect the safety and soundness of the banking system. On one side, opponents claim insurance sales would increase the riskiness of banking and endanger the safety and soundness of the banking system. On the other side, banks and their supporters contend that insurance sales would enhance banking profitability, thereby protecting banking safety and soundness.

Competitive Consequences of Banks Selling Insurance

Uniform powers for banks to sell insurance would create a more “level playing field” among banking institutions, nonbank depository institutions, and other nonbank lenders in selling insurance. As discussed in chapter 1, current insurance sales authority for state-chartered banks varies from state to state. Even among national banks, only those banks operating in towns with populations less than 5,000 may sell insurance. In contrast, other depository institutions, including savings and loan associations, credit unions, and mutual savings banks, can offer insurance to customers. Moreover, other lenders, such as finance companies, can sell insurance to their borrowers. Finally, other nonbank financial services firms, including insurance companies, can offer banking products, such as savings accounts and loans. This checkerboard of powers does not allow otherwise similar institutions to compete on an equal basis.

Within the insurance market, the effect of banks selling insurance on product pricing and availability is uncertain. As discussed in chapter 2, banks could potentially reduce the costs of selling insurance, though any cost saving would not immediately result in lower insurance premiums for consumers. While bank sales of insurance would increase convenience for consumers, bank entry, as an agent, to the insurance market would not affect the amount of insurance available. The amount of insurance available depends on the underwriting capacity of insurance companies.

Expanded bank sales of insurance could enhance price competition between insurance underwriters. Increasing price competition between insurers has forced many insurance companies to seek lower sales costs as well as to improve marketing for their products. To the extent that banks could sell insurance more cheaply, insurers could pass reduced production costs along to consumers as lower insurance premiums. Insurers also would benefit from the flexibility of another channel for reaching consumers. Many insurers already buy customer lists from banks to take advantage of banking's customer base. According to a 1988 Louis Harris survey done for Coopers and Lybrand, 34 percent of life insurers and 28 percent of property/casualty insurers surveyed use banks to market or sell their products. Moreover, four out of five insurers surveyed plan to increase their distribution through banks over the next 5 years.

Current insurance sellers—the most vocal opponents of banks selling insurance—are likely to lose market share and some of their profits if bank sales of insurance expand. In particular, independent insurance agents, whose commissions often result in higher costs than other delivery systems, may lose from banks' entry. Currently, banks may lease space in their offices or sell lists of bank customers to insurance sellers. However, if banks gain powers to sell insurance, agents not affiliated with banks may lose their bank office space and access to bank customer information. Not surprisingly, independent agents opposing expanded bank powers suggest that banks have unfair competitive advantages in selling insurance.

Potential Competitive Advantages for Banks Selling Insurance

Banks have potential advantages that may enable them to compete successfully with other insurance sellers. As discussed in chapter 2, banks may be able to sell insurance more cheaply because of economies of scope achieved through joint marketing. These efficiencies, however, are likely to be reduced if additional steps are taken to preclude coercive tie-in sales. A bank may market insurance products to current bank customers through its network of branch offices as well as through mailings to credit card holders, depositors, and borrowers. Besides providing space within its offices and customer lists, a bank could also share overhead functions, such as check clearing, accounting, and other administrative functions, with its insurance operations. However, these advantages are not unique to banks, and any large, diversified firm may have competitive advantages. Moreover, an advantage does not necessarily translate into unfair competition.

Physical Access to Customers

According to Standard and Poor's Insurance Rating Service, the branch networks used by banks represent a powerful distribution advantage. Since depositors visit branches frequently, the bank has physical access and contact to market more products to existing customers. Similarly, leasing arrangements and joint ventures by insurers and agents with banks attempt to capitalize on a bank's position as a point of sale. According to the Minnesota Insurance Agents Association, half of its members work for agencies affiliated with banks.

Our sample of bankers and state regulators indicated that banks generally choose to co-locate insurance operations within bank offices. Of the 11 sample banks selling insurance, only one did not co-locate its insurance and banking activities. Five sold insurance through bank offices, and the remaining five sold insurance through bank offices as well as in other locations. Of the six states that commented on the location of bank insurance operations, regulators in all six states said banks are not restricted from selling insurance within bank branches.

Access to Customer Information

Banks, like other lenders and financial advisors, possess highly sensitive and confidential information regarding customer finances. Opponents of expanded bank sales of insurance assert that banks' access to credit information presents an unfair advantage. Through its lending operations, a bank could have information that a consumer is purchasing property that requires insurance, such as an automobile or a house. As a result, a bank could offer insurance to the borrower while other sellers are not aware of the opportunity to compete for the borrower's business. However, the majority of automobile and home loans originate with lenders other than banks. In many cases, these other lenders already have powers to sell insurance to borrowers. Therefore, access to credit information in itself is not necessarily an unfair advantage.

Another concern of competing insurance sellers is that banks could provide customer information to affiliated insurance agencies at no charge. Currently, other insurance sellers are able to purchase bank customer lists. The magnitude of any advantage a bank-affiliated agent may gain from access to customer information is unclear. While independent agents in North Carolina said that access to customer records is useful in selling insurance, bank-affiliated agents in Minnesota and representatives of several insurers said that only customer names and addresses were helpful.

Shared Overhead Costs

A bank could also share overhead and processing functions with its insurance operation. As a result of economies of scope and scale, the bank-affiliated insurance activities may have lower production costs than if the insurance agency operated as a separate entity. These advantages, however, are not unique and may exist for all large, diversified financial service providers.

For example, in recent years, insurance companies have purchased independent agencies or agency computer systems serving to consolidate administrative functions and reduce operating costs. Independent agencies are joining consortiums and developing information systems to reduce processing costs and achieve economies of scale. Small firms that are unable to attain economies possible through large-scale operations may be unable to offer prices competitive with larger institutions, including banks.

Banks Could Abuse Credit to Compete Unfairly Against Other Sellers

If the number of banks selling insurance is expanded, banks could abuse their position as a source of credit to compete unfairly against other sellers. A bank could give preferential treatment to an affiliated agency or deny credit to competing insurance sellers. We do not know the extent to which banks might use credit to influence their competitive position.

- A bank could subsidize an affiliated insurance agency by providing loans at favorable, nonmarket lending rates or without applying appropriate credit standards. Opponents of expanded bank sales of insurance argue that, moreover, a bank has access to low-cost insured deposits, which it could use to fund its insurance agency. However, any large, diversified financial company, including large banks, bank holding companies, and national insurance agencies, may be able to borrow funds more cheaply than a small independent agent or specialty insurance agency. Lenders may provide lower rates to diversified companies because they believe such institutions are less risky than the less diversified insurance agencies.

Absent legal restrictions,¹ access to low-cost funding, including insured deposits, could provide banks selling insurance with a cost advantage over other sellers. To the extent that a bank could pass along the cost differential in the form of lower premiums, the bank could take over a share of the market from independent insurance sellers. However, two

¹ Controls, including regulatory oversight, that serve to protect against credit abuses are discussed below.

factors serve to limit any advantages of low-cost funding for bank insurance operations. First, a bank might use low-cost funding to subsidize its insurance sales activity as a short-term strategy to establish the bank's presence in the insurance market. In the long run, however, a bank would probably direct its loanable funds to the most profitable activities.

Second, as previously indicated, any advantage from low-cost funding would not necessarily affect premiums paid by consumers, since an insurance seller cannot unilaterally change premiums charged to customers. Even if banks could sell insurance more cheaply, lower premiums would result only if insurers are willing to pass cost savings along to consumers and state regulators permit these price changes.

Independent agents assert that a bank selling insurance would deny credit or charge an excessive rate of interest on loans to competing insurance sellers. The Congressional Research Service has pointed out the possibility that if every bank in a town sells insurance or is affiliated with an insurance agency, an independent agency may not be able to get credit in that town.² If competing sellers are unable to get credit and necessary liquidity, independent agencies not subsidized by a bank could be eliminated from the market. As a result, insurance markets in areas with restricted access to credit might be monopolized by banks and their insurance affiliates. Currently, banks in small towns may sell insurance, while banks in larger, more competitive markets cannot.

Controls Can Limit Abuses and Ensure Competition

As discussed in chapter 2, competition, banking internal controls, and regulatory oversight serve to control credit abuses. In a competitive market, each lender must make loans at competitive interest rates in order to retain business. Thus, a bank subsidizing its affiliates, in the long run, could not offer competitive rates on loans. While one bank might deny loans to an insurance competitor or charge higher interest, banks in unison are unlikely to do so; such action could be challenged under federal antitrust laws. However, where credit abuses are likely or competition is lacking, additional regulatory controls may be necessary to ensure fair competition.

²Insurance Sales: The Effects of Possible Bank Diversification on the Insurance Industry, Congressional Research Service (Nov. 30, 1989).

Banking Internal Controls

Banking internal control systems serve to limit credit abuses and ensure that a bank remains competitive. As discussed in our report on banking conflict of interest abuses, “Chinese Walls” or firewalls are an important component of bank controls. These walls are intended to limit the passage of sensitive, critical, or confidential information within the bank and between the bank and affiliates, as well as to limit inappropriate transactions between units.

Without an adequate wall, unauthorized or unnecessary possession of information could unfairly give advantage to the bank or its affiliate at the expense of other insurance sellers. For example, information about borrowers could be used by a bank-affiliated insurance agency to market insurance products before the credit process is complete. Of the 11 banks in our sample that responded, 7 banks indicated that they restrict or limit access to customer information by the affiliated insurance agency.

Regulatory Oversight

Federal and state banking laws, regulations, and supervision serve to help control credit abuses. A bank’s ability to give preferential treatment and subsidize an affiliated insurance agency is restricted by banking laws and regulations. Section 23A of the Federal Reserve Act (12 U.S.C. Section 371C) limits loan and credit transactions with any one affiliate within a bank holding company to 10 percent of the bank’s capital and the aggregate amount of lending to all affiliates to 20 percent. Such transactions should be fully collateralized.

Section 23B of the Federal Reserve Act requires transactions between banks and their affiliates within a holding company to be at arm’s length with fair market pricing. For example, a bank is not to provide customer lists or accounting services to an affiliate for less than the bank would charge an unaffiliated company. Similarly, where a bank shares space or overhead functions with an affiliate, the bank is to charge the affiliate for its share of the costs.

We have reported that economic separation between a bank and its affiliates within a holding company can reduce incentives and opportunities for a bank to give preferential treatment to affiliates.³ Economic separation provides that a bank and its affiliates must be adequately and separately funded with no commingling of assets, that any services or loans

³Bank Powers: Insulating Banks From the Potential Risks of Expanded Activities (GAO/GGD-87-35, Apr. 14, 1987).

obtained from the bank be obtained at rates comparable to those charged nonaffiliated parties, and that the bank be prevented from unduly transferring assets to, or purchasing bad assets from, a weak affiliate.

While existing banking laws and regulations restrict credit and require arm's length transactions for bank affiliates, similar restrictions do not apply to transactions among bank departments or between a bank and its subsidiaries. At this time, banks permitted to sell insurance may do so through an affiliated insurance agency, a subsidiary agency, or an insurance department within the bank.

Additional Regulatory Measures Could Protect Competition

While preferential treatment of affiliates and subsidiaries is already addressed in the existing regulatory system, additional measures may be necessary to ensure competition in insurance markets if bank powers are expanded. While none of our interviewees could provide an example in which a bank denied credit to a competitor, regulators may have difficulties monitoring such situations. Since regulators can identify possible banking abuses through complaint data, one way to identify credit abuses may be to specifically track complaints by insurance sellers that a bank denied credit.

Further regulatory measures could reduce banks' competitive advantages over other insurance sellers. For example, a bank and its affiliated insurance agency could be required to use different names and logos, locate in separate space, advertise separately, refrain from selling each other's products, and develop separate customer bases. Basically, regulations could be designed to prevent banks from realizing economies of scope through joint marketing. While such measures would protect other insurance sellers from increased competition, full separation of marketing for a bank and its affiliated agency would forestall consumers gaining potential benefits from banks selling insurance.

Insurance Sales Present No Risk to Banking Safety and Soundness

Contrary to opponents' claims, bank sales of insurance underwritten by an unaffiliated insurance company would not endanger banking safety and soundness. Unlike underwriting, selling insurance does not involve financial risk of loss. Insurance underwriters, not insurance sellers, are responsible for paying losses incurred under policies sold to the public. In marketing insurance products, a bank does not incur liability for policyholders' claims.⁴ As a result, bank sales of insurance would not jeopardize a bank's capital and financial condition.

Moreover, potential commissions earned from insurance sales could enhance bank profitability. In recent years, banks have attempted to remain profitable by diversifying their income sources. Banks have supplemented their traditional source of income—the difference between interest earned on loans and interest paid on deposits—by charging fees for services. Insurance commissions would offer another source of income. To the extent that insurance sales result in more stable bank profits, bank diversification into selling insurance could potentially strengthen safety and soundness and protect against bank failures.

We cannot predict whether bank sales of insurance would be profitable. Empirical studies of profits in banking and insurance selling suggest that combining insurance selling and regular banking services could increase the stability of overall profits. If insurance commission profits tend to increase when loan profits decrease, overall profits would be more stable. Nonetheless, the extent to which bank sales of insurance could increase the stability of profits and decrease the risk of failure depends on the bank's management of the two operations and the types of banking services and insurance products sold.

Not all banks will find insurance selling to be profitable. For a bank within a holding company, profits earned by an affiliated insurance agency may accrue to the bank holding company, and the bank itself would be no more profitable. Also, in recent years, several banks have abandoned insurance sales because they found it unprofitable. Reasons mentioned for these withdrawals include the following: the banks were not competing successfully against existing insurance sellers, they did not develop a broad enough customer base among the customers of the bank, and bank managers did not like customers substituting insurance products for bank products.

⁴An insurance agent may be liable to policyholders for any mistakes made in selling insurance. Errors and omissions insurance is purchased by independent agents to protect against capital losses. Any bank selling insurance could be required by regulators to acquire similar coverage.

While selling insurance in itself presents no risks to a bank's capital, any expansion into a new business presents management challenges. Safety and soundness could be at risk if substantial management attention were diverted from core banking responsibilities, such as managing credit risk, to building and managing the insurance line of business. Recent studies of bank and thrift failures found management inadequacies and lack of adequate regulatory oversight contributed to failures. If banks gain powers to sell all types of insurance, regulators need to ensure that banks can manage the expanded powers. The Consumer Federation of America suggested that banking revenues earned from general insurance sales should be limited as a percentage of total income to ensure that banking remains the principal focus of banking management.

Additional measures may be necessary to ensure that consumers do not become confused about whether insurance products sold by a bank are backed by federal deposit insurance and that the federal financial safety net does not extend to an insurance agency affiliated with a bank. One measure would be to expressly disclose to the consumer that insurance products are underwritten by an insurance company and are not covered by banking deposit insurance.

Conclusions

Expanded bank powers to sell insurance would create a more level playing field between banks and other depository institutions and credit sources. The entry of banks into the insurance market would have mixed effects on other insurance players. While insurers underwriting products may benefit from the flexibility of another channel for reaching customers, other insurance sellers would face increased competition from banks selling insurance.

Banks have potential competitive advantages over other insurance sellers resulting from economies of scope in joint production of banking and insurance services. An insurance seller affiliated with a bank would not only have access to bank customers and customer information but could share overhead costs with the bank as well. These advantages are not unique to banks, and any large-scale insurance seller has an advantage over small independent agents.

However, a bank affiliated with an insurance agency could give preferential treatment to its affiliate or deny credit to competing insurance sellers. In addition to competition and banking internal controls, regulatory oversight can protect against preferential treatment by a bank.

While existing banking laws and regulations prohibit a bank from subsidizing an affiliate, similar restrictions do not apply to bank subsidiaries or departments within a bank.

Regulatory measures prohibiting joint production by banks and affiliated insurance agencies would prevent banks from using competitive advantages over other sellers. However, measures such as separate logos, offices, and staff would forestall potential benefits for consumers by precluding economies of scope and increased convenience. If insurance sales are less attractive to banks, insurance sellers would benefit by being protected from increased competition and pressure to lower costs. Trade-offs exist between allowing consumers to benefit from banks selling insurance and protecting other sellers from competition by banks. These trade-offs must be considered in deciding the degree of joint marketing and production to allow.

Stringent measures restricting bank sales of insurance underwritten by an unaffiliated insurance company are not warranted to protect the bank or the safety and soundness of banking. The insurer underwriting the policies bears the financial risk of losses under policies sold by the bank. To the extent that bank sales of insurance are profitable, selling insurance could enhance banking safety and soundness.

Organizations and Individuals Interviewed

Grandfathered Bank Holding Companies

Bank Shares, Incorporated
Bremer Financial Corporation
Citizens & Southern Corporation
Crestar Financial Corporation
Dacotah Bank Holding Company
First Bank Systems, Incorporated
First Oklahoma Bancorp
First Security Corporation
First Virginia Banks, Incorporated
First Wachovia Corporation
Firststar Corporation
Norwest Corporation
Signet Banking Corporation
United Banks of Colorado, Incorporated

Banking Industry Organizations

American Bankers Association
Association of Bank Holding Companies
Independent Bankers Association of America
Insurance/Financial Affiliates of America
Massachusetts Bankers Association
Minnesota Bankers Association

Independent Insurance Agents' Associations

Independent Insurance Agents of America
Independent Insurance Agents of North Carolina
Minnesota Association of Professional Insurance Agents
National Association of Insurance Brokers
Professional Insurance Agents Association
Professional Insurance Agents of New England

Insurance Holding Companies and Affiliates

AIG Marketing, Incorporated, a subsidiary of American International Group, Incorporated
Aetna Life & Casualty Company
Alfa Insurance Corporation
Allstate Insurance Company
Depositors Insurance Company, a subsidiary of Allied Group, Incorporated
Economy Fire and Casualty Company, a subsidiary of Kemper Corporation
GEICO Corporation
John Hancock Mutual Life Insurance Company

Appendix I
Organizations and Individuals Interviewed

Metropolitan Life Insurance Company
Nationwide Insurance Companies
The Prudential Insurance Company of America
State Farm Insurance Companies
Travelers Insurance Company

**Insurance Industry
Organizations**

American Council of Life Insurance
American Insurance Association
Health Insurance Association of America
Insurance Federation of Minnesota
Insurance Information Institute
Life Insurance Marketing and Research Association, Inc.
Massachusetts Association of Life Underwriters
National Association of Life Underwriters

**Consumer Interest
Organizations**

Consumer Federation of America
National Insurance Consumers Organization

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