BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

September 13, 1999

The Honorable John D. Dingell
Ranking Minority Member
Committee on Commerce
House of Representatives
Washington, D.C. 20515-6115

Dear Congressman:

Thank you for your letter concerning certain insurance issues associated with H.R. 10, the financial modernization bill that passed the House in July. The enclosure provides detailed responses to the questions posed in your letter.

As an initial matter, I would like to reaffirm the Board's support of Congressional efforts to modernize the nation's financial laws. It is important that Congress act now to set the rules that will govern the evolution of our financial system in the 21st century. It is equally important, however, that Congress establish a structural framework for modernization that best protects insured depository institutions, the federal deposit insurance funds and the American taxpayers, prevents the spread of the federal safety net, ensures a fair and level competitive playing field for all financial service providers, increases consumer choice, and relies on strong principles of functional regulation.

The Board is strongly of the view that the holding company framework—and not the operating subsidiary approach—best achieves these fundamental objectives. The questions raised in your letter highlight some of the risks that may arise from permitting operating subsidiaries of banks to engage in potentially volatile principal activities, such as insurance underwriting and reinsurance activities.

I hope these comments and the enclosed responses are useful.

Sincerely,

Enclosure

1. ***Do you have concerns about legislation that would permit a bank, directly or in a subsidiary of the bank, to engage in reinsurance activities? How would your concerns be affected if the legislation in question also exempted such a bank or subsidiary of the bank from having to comply with the requirements of an insurance regulator? Please explain.***

The Board has grave concerns with legislation that would permit insured banks to provide insurance, including reinsurance, either directly or through a subsidiary, or that would not be consistent with the principle of functional regulation. Allowing banks, directly or through operating subsidiaries, to engage in insurance underwriting and reinsurance activities would permit banks to fund these activities with low-cost funds raised through the benefit of the federal safety net. This would provide banks or their subsidiaries with a significant funding advantage over their competitors in the insurance field and inevitably lead to weakened competition in the market for insurance products. In addition, as described further below, allowing banks or their operating subsidiaries to engage in potentially volatile activities such as insurance underwriting or reinsurance activities would pose serious risks to the safety and soundness of banks and the deposit insurance funds.

Section 304 of H.R. 10 would prohibit a national bank from providing insurance in any state, either directly or through an operating subsidiary. (The Federal Deposit Insurance Act already generally prohibits insured state banks from engaging in insurance underwriting activities either directly or through a subsidiary.) Because reinsurance is regulated by the states as insurance and insures, guarantees, or indemnifies the ceding insurance carrier against liability under the underlying policies, we believe that the current language of H.R. 10 is intended to prohibit a national bank or an operating subsidiary of a national bank from engaging in reinsurance activities in any state.

We understand that other interested parties, including certain state insurance regulators, have expressed concern that the current language of H.R. 10 may not clearly prohibit national banks and their subsidiaries from engaging in reinsurance activities. Some also have expressed concern that the reference in H.R. 10 to providing insurance as principal "in a State" might be construed to allow a national bank or its subsidiaries to engage through offshore branches, offices or subsidiaries in reinsuring policies sold in the United States. We believe that H.R. 10 intends to cover these type of offshore reinsurance activities within its prohibition on providing insurance as principal. We also believe that the risks of allowing a bank or its subsidiaries to conduct reinsurance activities are too great to allow any doubt about the scope of this prohibition, or about whether any reinsurance activities that might be permitted are subject to appropriate functional regulation. The Board would be happy to work with Congressional staff and others to clarify the bill's clear intent to prohibit national banks and their operating subsidiaries from engaging in reinsurance activities.

2. Are there any insurance activities, other than sales, that you believe a bank should be able to conduct directly or in a subsidiary of the bank? If there are, should these non-sales activities be subject to insurance regulations that normally apply to such activities?

H.R. 10 would allow national banks and operating subsidiaries of national banks to continue to provide as principal those insurance products that national banks were lawfully permitted to provide as of January 1, 1999, except title insurance and annuities. These permissible products primarily consist of credit-related insurance products. Significant regulatory problems have not arisen to date with the provision of these limited types of insurance by banks.

In addition, H.R. 10 would permit national banks to provide as principal new forms of traditional banking products that may in the future be characterized as insurance under state law unless the product is treated as insurance under the Internal Revenue Code. These provisions appear appropriately limited and carefully balanced.

3. Reinsurance is a particularly risky activity. A major reason cited for the huge estimated losses in the recent Unicover case (at least $1.3 billion) is that an off-shore agent obligated the Unicover reinsurance pool for far more risk than participants in the pool had intended to assume. If banks, rather than life insurance companies, constituted the participants in the Unicover reinsurance pool, is there anything that would prevent this $1.3 billion loss from having to be absorbed by the banks' depositors and/or federal guaranty funds? If not, what are the implications for the safety and soundness of the banking system, if banks were to incur losses like those of the participants in the Unicover reinsurance pool?

If insured banks, either directly or through operating subsidiaries, were permitted to engage in insurance underwriting activities (including reinsurance activities), then any losses from these activities would have a direct negative impact on the consolidated financial condition of the bank and ultimately could result in substantial losses to the federal deposit insurance funds and the American taxpayer.

It is essential that banking organizations be permitted to engage in the newly authorized principal activities, such as insurance underwriting and reinsurance activities, only outside the bank and through a separate corporate entity for which the bank is not financially or managerially responsible and that is subject to appropriate functional regulation. Such a structure best ensures that the new activities will be financed at market rates, that the federal safety net will not be extended beyond its intended scope, and that federally insured banks and the deposit insurance funds will not bear the risks associated with such activities. This structure also more effectively limits the potential conflicts between the banking laws and the existing consumer protection laws and regulatory schemes that currently govern the new activities, including insurance. It is for these reasons that we have argued strongly that the operating subsidiary structure is not the appropriate framework for financial modernization.

As noted above, H.R. 10 would not permit national banks, directly or through an operating subsidiary, to engage in insurance activities as principal. We believe this prohibition also was intended to prohibit national banks and their subsidiaries from engaging in reinsurance activities, including the type of reinsurance activities involved in the Unicover case and, as noted above, would be happy to work with Congressional staff to assure that this prohibition is clearly stated in any financial modernization legislation.

4. An analyst recently said of the Unicover failure that it may cause a return to the notion that reinsurance is a partnership unless "brand new naive capacity comes along." Are you concerned that if legislation allows banks to engage in reinsurance without regulation, banks may become the "brand new naive capacity" that could lead to further reinsurance losses and that could undermine the safety and soundness of banks and the solvency of bank holding companies?

The Board believes the holding company structure better insulates insured banks from the potential riskiness of new activities and best ensures a fair and level playing field for all financial service providers. The protections afforded by the holding company structure are particularly important with respect to insurance underwriting activities, which can be very risky. Reinsurance activities contain all of the risks of insurance underwriting and, in our view, should not be authorized for banks or their operating subsidiaries.

For the reasons discussed above, the Board does not believe that the universal bank or operating subsidiary approach adequately protects our nation's insured banks, the deposit insurance funds, or the financial system from the risks associated with the newly authorized activities and affiliations. This approach to modernization failed both the industry and the taxpayer in the thrift industry and, by allowing the spread of the federal safety net and its related subsidy, would have seriously debilitating consequences for the vitality of competition in the financial services industry. Furthermore, this approach—by allowing a functionally regulated firm to be a direct subsidiary of a federally insured bank—increases the likelihood of conflicts between bank regulation and the functional regulation of the subsidiary's activities.