Office Of The Comptroller Of The Currency's Supervision Of Banks Selling Insurance

OIG-00-098 June 27, 2000

Office Of The Inspector General

United States Department Of Treasury

OFFICE OF
INSPECTOR GENERAL

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 27, 2000

MEMORANDUM FOR JOHN D. HAWKE JR., COMPTROLLER
OFFICE OF THE COMPTROLLER OF THE CURRENCY

FROM: Dennis S. Schindel
Assistant Inspector General for Audit

SUBJECT: Audit Report on the Office of the Comptroller of the Currency's Supervision of Banks Selling Insurance

This memorandum transmits the subject final report. In summary, the Office of the Inspector General (OIG) believes the Office of the Comptroller of the Currency (OCC) needs to better prepare for the impending reform of the financial services industry. Although national banks have long had the authority to engage in insurance activities, new legislation passed in November 1999 is expected to significantly increase the volume of those activities. As they grow their insurance businesses, national banks will encounter a strikingly different business environment and offer new and unfamiliar products and services that could present risks to bank safety and soundness as well as customers' rights.

The OIG believes the OCC needs to better define its supervisory role to address the expected increase in national bank insurance activities. State regulation focuses mainly on insurer solvency and market conduct. As such, states may not adequately address the operating risks bank management will encounter as they expand and grow their insurance business. Also, not all states may have the resources or willingness to supervise the expanding bank insurance activity. Accordingly, the OIG believes OCC needs to determine the degree of reliance it can place on state supervision in the future and begin to address the issues in its organizational structure, supervisory strategy and examination process.

Please note that we modified slightly our recommendation 1-1 in response to your staff's concerns with the recommendation as presented in our draft report. Also, note that OCC did not concur with several findings and recommendations contained in the report. Following our standard procedures, the findings and recommendations will be recorded into the Treasury Department's Inventory Tracking and Closure system (ITC) noting your disagreement. Treasury Directive (TD) 40-01 requires your office to submit a written reply to the Deputy Secretary within 30 days after the report is issued that explains the reasons for your lack of agreement. TD 40-01 also requires your office to simultaneously submit a copy of your reply to the OIG. OMB Circular A-50 and TD 40-03 requires resolution of your disagreement within six months of report issuance.

We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss this report, you may contact me at (202) 927-5400 or a member of your staff may contact Benny W. Lee, Director, at (415) 977-8810 in San Francisco, California.

Attachment

cc: Laura L. McAuliffe, Director, Management Improvement
Comptroller of the Currency

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EXECUTIVE DIGEST

Results In Brief

The business of banking is evolving to include selling insurance which traditionally has not been a banking activity. Although national banks have long had authority to engage in insurance activity, only a few have taken full advantage of this authority. Instead, most offer insurance products that are closely related to their lending activities. However, national bank insurance activities are expected to grow rapidly with the impending reform of the financial services industry. The recently enacted Gramm-Leach-Bliley Act of 1999[1] will remove many barriers between banking, insurance and securities and allow banks to expand and grow their insurance businesses. In doing so, bank management will encounter a new and different business environment that may affect bank safety and soundness as well as consumer protection.

Given its supervisory stance and philosophy, it is uncertain whether OCC is ready to respond to any major stress on the National Banking System as a result of a rapid expansion into insurance activities. OCC will need to better prepare for these impending changes and address the expected increase in national bank insurance activities. Although the new legislation establishes the states as the functional regulator over insurance, reliance on states may not be the prudent course of action when determining the impact of insurance activities on bank safety and soundness or compliance with consumer protection regulations. As insurance activities become increasingly important to bank viability, OCC will need to determine the reliance it can place on state supervision, better define its supervisory role over insurance activities and begin to address those issues in its organizational structure, supervisory strategies and examination processes.

Objective, Scope and Methodology

The audit objective was to determine if OCC supervision of national bank insurance activities adequately addressed bank safety and soundness and protected consumers. OIG performed its fieldwork between November 1998 and July 1999.

[1] Pub. L. No. 106-102.

The OIG discussed with OCC personnel in Headquarters and in the Western District the risks that banks face in expanding their insurance activities and reviewed OCC supervisory efforts to address those risks. The OIG also obtained the positions and perspectives on future bank insurance activities from officials at the Federal Reserve System, a state insurance regulator and several bank and insurance trade associations. (See Page 7)

Detailed Results

Bank Insurance Activity Growing

Insurance products and services provide banks an attractive low cost source of fee income to replace declining income from its lending activities. About 75 percent of all national banks currently offer insurance products to their customers. However, most products are closely related to their traditional role of credit intermediary and offered through operating subsidiaries. Only a few are engaged in higher risk activities such as underwriting and reinsurance. Insurance activity by all banks was predicted to generate over $10 billion in premiums in 1998 and increase at a compound annual rate of over 30 percent to Year 2002. (See Page 1)

The Gramm-Leach-Bliley Act of 1999 will dismantle decades-old regulatory barriers separating banking, securities and insurance. Although it does not grant banks new powers or significantly increase the scope of national bank insurance products or services, it is expected to significantly increase the volume of bank insurance activities in the years to come. The new legislation is also expected to accelerate convergence between bankers and insurers. Both OCC and the insurance industry agree bank insurance business is evolving and expect significant change in bank business strategies, as well as insurance products and services. (See Page 3)

Continued Reliance On States May Not Be Prudent

In the past, OCC relied heavily on the states to supervise the insurance activities of national banks. While OCC remains the administrator of the National Banking System, the new legislation established the states as the functional regulator of all insurance activities. However, continued reliance on state supervision of expanding bank insurance activity may not always be the prudent course of action for OCC in the future. As insurance activities expand, bank management will encounter new

and different business environments and operating risks that could affect bank safety and soundness and consumer protection. These insurance-related risks include measuring, controlling and pricing accident risks and liabilities, litigating claims and investing premiums.

States focus mainly on insurer solvency and market conduct and may not adequately address the expanded insurance activities or new risks as bank management ventures into new and expanded insurance products and services. Furthermore, individual state's supervisory focus, philosophy and resources vary widely with respect to insurance. Thus, some states may not be able to supervise the expanding national bank insurance activities without additional resources.

Some states may not be willing or able to fund the additional resources needed to supervise the expanding national bank insurance activities. Insurance revenues are a major funding source for states. On average, only 7 cents of every insurance dollar collected by states is used to regulate the insurance industry. The remainder goes into the respective states' general revenue fund and is used to fund other obligations. (See Page 9)

OCC Needs to Refocus Its Supervisory Role

The OCC needs to recognize the risk that expanded insurance activities can present to the National Banking System. Accordingly, OCC will need to address those risks through its organizational structure, supervisory strategies and processes.

While OCC initiated several efforts to revise its supervision over bank insurance activities, it continues to view the primary risks associated with national bank insurance activities as consumer protection rather than safety and soundness. As such, its examination of bank insurance activities has often been limited to general inquiries of management. (See Page 23)

OCC will need to better define its supervisory role and prepare for the increasing importance of expanded insurance activities to bank viability. Faced with increased competition and industry consolidation, banks can no longer rely on loans to drive earnings. Instead, banks will likely look for fee income from such non-traditional products as insurance to enhance shareholder

value. In doing so, banks will encounter strikingly different cultures, business environments and new and unfamiliar products and services that could impact bank safety and soundness. (See Page 25)

OCC Believes Expanded Activities Pose Little Risk

Prior to the passage of the new legislation, OCC officials stated that continued reliance on state regulation was appropriate. OCC officials were committed to enhancing supervisory efforts and meeting the challenges relating to bank insurance activities but respected the states' role as functional regulator.

OCC officials also believed that insurance activities posed little risk to bank safety and soundness because those activities were only a small part of a bank's comprehensive banking activities and were conducted through state licensed and supervised subsidiaries. As such, they believed OCC risk-based supervision fulfilled its mission as administrator of the National Banking System while honoring the tenets of functional regulation. Under its supervision-by-risk approach, OCC examiners can assess the impact of the bank's insurance activities and work with state supervisors, if necessary.

The OIG does not disagree that reliance on state regulation may have served a purpose in the past. However, the degree to which OCC can continue to rely on state supervision depends largely on a state's supervisory philosophy and resources. Such reliance may be appropriate for some but not necessarily all states. While the states are the functional regulator of all insurance activities, the new legislation provides OCC authority to examine insurance activities should those activities threaten bank safety and soundness. This concept of selective reliance on state supervision is not new and is currently used by Federal Deposit Insurance Corporation (FDIC) to examine state-chartered banks.

The OIG believes non-traditional banking activities, such as insurance, will become increasingly more important as banks respond to an increasingly competitive world economy. Thus, the operating environment and risk could change significantly as bank management expands into different products and services.

The OIG believes these risks can be reduced but not eliminated if banks conduct insurance activities through an operating subsidiary. History has shown that excessive reliance on individuals or affiliates with delegated authority to rapidly expand into new and unfamiliar insurance products and services can jeopardize a parent entity's reputation, operation and capital regardless of legal structure.

The OIG does not take issue with OCC that its supervision-by-risk concept will address national bank insurance activities, given its supervisory stance and philosophy. However, it is uncertain whether OCC is ready to effectively respond to any major stress on the National Banking System as a result of banks' rapid expansion into insurance sales activities. The only guidance on bank insurance sales activities available to OCC examiners could not be used as an examination tool nor could it be used to report violations or enforce compliance. As a result, OCC examiners were viewing insurance sales activities as a compliance issue and limiting their examination activities to general inquiries of management. (See Pages 17 and 29)

With the passage of the new legislation, national banks may now expand and grow their insurance business. To address the risks related to the expanded insurance business, OCC will need to begin to identify its workload and develop expertise, strategies and procedures to address the evolving business environment and risks relating to expanded insurance activities by national banks.

Recommendations

In this report, the OIG recommends certain actions it believes will help OCC prepare for the impending reform of the financial services industry. Specifically, OCC should determine the reliance it can place on the states' regulation over national banks' insurance activities. The OCC should also maintain a universe of national banks engaged in insurance activities, identify the attendant risks, develop and expand agency expertise, formulate a supervisory strategy and promulgate policies and procedures.

OCC concurred with 1 of the 5 OIG recommendations in this report. It agreed with the need for maintaining a universe of

banks engaged in insurance activities and was taking action to address the issue surrounding the recommendation.

OCC believed the 4 remaining OIG recommendations were inconsistent with the functional regulation approach embraced by the new legislation and were inappropriate in light of the limited insurance activities permitted for national banks under the new legislation. It believed Congress specifically directed Federal bank and thrift regulators to defer to the state insurance regulators and that the new legislation contained no provision for Federal supervision of insurance activities or oversight of state insurance regulators. As such, it stated those recommendations would not be implemented.

The OIG is not recommending OCC regulate bank insurance activities or oversee the work of state regulators. Instead, the OIG is recommending OCC proactively determine when it can or can not rely on the state regulators' work. The authority is clearly provided in the new legislation. To accept state regulators' work without determining its reliability would be tantamount to abdicating OCC' responsibilities as the primary supervisor over the National Banking System.

Accordingly, the OIG believes OCC should evaluate state regulators' work in terms of independence, qualifications, scope of inquiry as well as sufficiency, relevancy and competency of the state regulators' evidence and assertions. OCC needs to develop the institutional knowledge over the insurance industry before its personnel can effectively determine if it can or can not rely on the work of state regulators. If it can not rely on that work, it will need a supervisory plan and procedures to effectively examine the functionally regulated insurance entity.

The OIG modified slightly its recommendation 1-1 that OCC determine the reliance it can place on states regulators in response to OCC official comments to the draft report. However, OCC did not concur on the modified recommendation. As such, in accordance with Treasury Directive 40-01, OCC is to submit a written reply to the Deputy Secretary within 30 days of report issuance explaining the reasons for its lack of agreement. (See Pages 19 and 31).

INTRODUCTION

Background

The business of banking is evolving beyond just taking deposits and making loans to include traditionally non-banking products such as insurance. National banks have long had authority to engage in insurance activity, but few have taken full advantage of this authority. While many national banks now offer insurance products to their customers, most only offer insurance products closely related to their lending activities. These products have provided banks a growing and increasingly important source of income and required little capital.

However, the Gramm-Leach-Bliley Act of 1999 will dismantle decades-old regulatory barriers separating banking, insurance and securities services. As a result, the volume of bank insurance activity, including that of OCC regulated national banks, is expected to significantly increase. In expanding their insurance business, national banks may encounter such operating risks as measuring, controlling and pricing accident risks and liabilities as well as litigating claims on new products and services offered to customers.

In the past, national banks often conducted their insurance activities in an agency capacity thereby minimizing the exposure to liability and losses. As such, OCC viewed bank insurance activities as posing greater risk to consumers than to bank safety and soundness. Accordingly, OCC relied heavily on states to regulate and supervise insurance companies and their associated agencies and agents, as well as to protect bank customers. For those banks venturing into new or expanded insurance activities permitted under the new legislation, however, the associated risks could impact bank safety and soundness and affect the degree to which OCC can rely on state supervision of national bank insurance activities.

Bank Insurance Activity Expected To Grow Rapidly

National bank involvement in insurance is not new. In fact, their authority to engage in insurance activities dates back to 1916. This authority provides banks broad permission to act as agent for insurance sales including that of a general insurance agency soliciting and selling numerous types of insurance products and services. However, banks have generally limited their insurance

products and services to those related to their traditional role of a credit intermediary and offered them through bank operating subsidiaries. National banks also have had authority to engage in underwriting or reinsurance activities. However, an OCC survey disclosed only a few national banks were engaged in those higher risk activities and generally through an operating subsidiary.

The size of the banks' insurance activity has been the subject of speculation fueled, in part, by its recent growth, widely varying bank strategies and the lack of monitoring by Federal regulators. Neither OCC nor the Federal Reserve System routinely collected data on bank insurance activities until recently.

In late 1998, OCC obtained insurance activity information that showed about 75 percent of national banks (1,950 out of 2,600 surveyed) were reportedly involved in insurance, but only a few were involved in underwriting or reinsurance. Most were offering only credit related insurance products. OCC did not include annuities in its definition of "insurance."

The national banks reported insurance sales premiums of over $2 billion in 1997, mostly from credit life insurance, mortgage insurance and other credit-related products. Only 20 national banks were underwriting insurance and reported $2.7 million in underwriting premiums. Only 22 were involved in reinsurance and reported $43.3 million in premiums from reinsurance assumed from other insurance companies. The banks reported maximum contractual exposure from private mortgage insurance reinsured of only $27 million.

The volume of bank insurance activities is expected to significantly increase in the years to come. Insurance products and services offer banks an attractive low cost source of fee income requiring little or no bank capital. Management can keep costs and risks to a minimum by offering insurance products in an agency capacity and as an adjunct to traditional banking products, such as loans and mortgages.

A trade association estimated sales for all bank insurance products (excluding annuities) generated about $9 billion of premium revenue in 1997, nearly twice that of the prior year. Also, a consulting firm predicted bank non-annuity insurance sales premiums would exceed $10 billion in 1998 and bank insurance activities would grow at a compound annual rate of over 30 percent until year 2002.

Summary information on national bank insurance activities as of February 1999 is presented in Appendix 2.

New Legislation Will Accelerate Financial Services Reform And Growth

On November 12, 1999, the President signed into law, the Gramm-Leach-Bliley Act of 1999 which reforms the nation's financial services industry. Under this new legislation, national banks may continue to sell insurance products and services without any geographic restrictions. Banks would be prohibited from acting in a principal capacity for underwriting insurance unless OCC had approved those activities prior to enactment of the legislation.

According to OCC, the new legislation also eliminated the geographical restriction contained in 12 U.S.C. Section 92. This provision essentially allowed national banks in communities of 5,000 people or less to act as an insurance agent for fire, life or other insurance company. This change should not materially affect banks because OCC ruled in 1986 that banks could use small town branches to sell insurance throughout the country.

Although the new legislation does not significantly increase the scope of national bank insurance authorities, products or services, OCC expects the volume of national bank insurance activities to significantly increase in the years to come. The new legislation is also expected to accelerate financial industry convergence and business arrangements between banks and insurers, such as the merger between Citicorp and Travelers Group in late 1998.

While many banks now sell credit-related insurance products in an agency and agent capacity, both OCC and the insurance industry agree, the bank insurance business is evolving and they expect significant change in bank business strategies as well as insurance products and services.

Even though the new legislation does not affect OCC's authority to regulate national banks as contained in the National Bank Act of 1864 (12 U.S.C.), it does establish the states as the primary regulator over bank insurance activities. The new legislation provides that the primary Federal regulator of a bank engaged in insurance activity will be determined by its legal structure. If a national bank conducts insurance activities through an affiliate of

a holding company, the Federal Reserve Board (FRB) will be the primary Federal regulator for the affiliate. If a bank conducts insurance activities through an operating subsidiary, OCC will be the primary Federal regulator of the subsidiary.

The new legislation also provides that states shall remain the functional regulator over all bank insurance activities regardless of its legal structure or primary Federal regulator. It creates 13 "safe harbors" in which states may regulate bank insurance activities even if their laws discriminate or significantly interfere with a bank's ability to sell insurance. These safe harbors do not relate to safety and soundness issues but rather to market conduct such as discrimination, prohibited practices, proper disclosure, misrepresentation and separation of functions. Aside from the 13 safe harbors, the legislation prohibits states from preventing or restricting a bank or an affiliate from engaging, directly or indirectly, in any activity authorized under the legislation, including insurance activities.

Any state law or action existing before September 3, 1998, that prevents or significantly interferes with a bank's ability to conduct activities authorized under Federal law is preempted by the legal standards set forth in the Supreme Court's 1996 decision in *Barnett Bank of Marion County, N.A. v. Nelson.*[2] In that litigation, OCC challenged state laws that restricted bank insurance activities. The Supreme Court ruled the state laws were preempted under the Supremacy Clause in the U.S. Constitution. This clause stipulates Federal law generally takes precedence over any conflicting state law.

While the new legislation limits OCC's supervision of national bank insurance activities, it does not materially affect its authority to supervise the safety and soundness of the National Banking System. Federal regulators are to rely on state supervision of bank insurance activities, to the extent possible. However, the new legislation also provides Federal regulators the authority to examine bank insurance activities if those activities threaten bank safety and soundness.

To effectively supervise the impact of national bank insurance activities on the condition of its banks, OCC, as an agency, will have to evolve as the banking industry grows their insurance business lines. To do so, OCC will need to address such

[2] 517 U.S. 25 (1996)

operating risks as measuring, controlling and pricing accident risks and liabilities, underwriting and reinsurance, investing premium income and litigating claims.

OCC Relies On State Supervision Of Bank Insurance Activities

Although OCC is the administrator of the National Bank System, it has relied heavily on the states, as the primary regulator, to examine and supervise national bank insurance activities and protect customer rights. As a result, OCC examiners have mostly limited their activity to general discussions with management about their insurance activities.

In 1945, legislation commonly referred to as the McCarran-Ferguson Act,[3] was passed providing that states were primarily responsible for regulating and supervising the insurance business within their boundaries, including compliance with insurance and consumer protection laws. Today, every state and the District of Columbia has an insurance department responsible for regulating the insurance industry and licensing insurance companies, associated agencies and agents doing business within their borders. Each state sets its own licensing and filing requirements for insurance rates and policies. States can also revoke licenses for illegal or unethical conduct.

To coordinate regulation of multi-state insurers, state insurance regulators created the National Association of Insurance Commissioners (NAIC) in 1871. It is a voluntary organization of the chief insurance regulatory officials in the 50 states, the District of Columbia and 4 territories. The NAIC provides its members a national forum for working cooperatively on regulatory matters, as well as varied support services. The NAIC also has an accreditation program to ensure states maintain minimum standards of conduct.

Generally, the primary function of state insurance regulators is to ensure insurance companies are capable of meeting their financial obligations (solvency). States are responsible for licensing individuals (producers or agents) who provide insurance services and for regulating insurance rates and policy forms. State insurance departments also provide consumer assistance and protect both insurance consumers and companies from fraud.

[3] 15 U.S.C 1011 et seq.

Most insurance departments have historically performed solvency monitoring and financial examinations. Each state primarily focuses on insurance companies that are "domiciled," or legally residing, in their state. States generally examine insurance companies once every 3 to 5 years or when potential insolvency exists. States also monitor insurer financial filings to identify companies needing special attention.

The monitoring of non-domiciled companies (a foreign insurer if domiciled in another state or an alien insurer if domiciled outside of the United States) is generally delegated to the regulator in the state of domicile. Consequently, each state regulator is heavily reliant on other state regulators.

State insurance departments in the 50 states and District of Columbia (DC) reportedly employed over 10,000 employees and 1,700 contract employees as of December 31, 1997. According to the NAIC, some also used employees from other state agencies. Their budgets for 1997 totaled $739 million.

OCC Efforts To Prepare For Financial Services Reform

Recognizing that financial services reform legislation coupled with the Supreme Court's 1996 decision in the Barnett litigation could significantly increase bank interest in insurance activity, OCC initiated efforts to prepare for the impending changes.

In the past, OCC did not believe information on national bank insurance activity was necessary because of the low volume of insurance activities and the absence of any reported significant problems. Instead, it relied on state systems.

In October 1996, the OCC issued an advisory letter providing banks guidance on insurance and annuity sales activities. In early 1997, it surveyed 53 national banks that showed many banks were already offering insurance products and services and planned to expand and increase their insurance business. OCC assessed the risks associated with this new and expanding business and proposed changes to its supervisory processes.

In early 1997, OCC met with state insurance regulators to establish communications and share information on insurance supervision. In late 1998, OCC and NAIC completed a model agreement for sharing customer complaint information. The

agreement was approved by the NAIC in June 1999 and OCC hoped to execute agreements with all states by the end of 1999.

In April 1998, the OCC established a centralized customer complaint system in its ombudsman's office. This system allows OCC to collect, process and track complaint information. The complaints are categorized into activities and products, with each insurance complaint classified into 1 of 6 product types. The complaint data is available to OCC examiners upon request through an internal communications system.

The OCC also drafted policies and examination procedures specific to supervising bank insurance activities that are to be included in the Bank Supervision Process Handbook and Insurance Activities Handbook. The handbooks had not been issued as of July 29, 1999.

OCC officials acknowledged efforts to address bank insurance activities were impeded by delays in the passage of financial reform legislation and the priority given to identifying and addressing Year 2000 problems. As a result, it continued to rely heavily on state supervision of national bank insurance activities.

Objective, Scope And Methodology

The audit objective was to determine if OCC supervision over national bank insurance activities adequately addressed bank safety and soundness and protected consumers. OIG performed its fieldwork between November, 1998 and July, 1999.

OIG also reviewed the proposed and final versions of the financial services reform legislation. OIG discussed with OCC personnel in headquarters and in the Western District the risks banks can face in expanding their insurance activities and reviewed OCC supervisory efforts to address those risks. OIG also obtained the position and perspective on future bank insurance activities from officials at the Federal Reserve System, a state insurance regulator and several bank and insurance trade associations.

The audit was conducted in accordance with the *Government Auditing Standards* issued by the Comptroller General of the United States and included such tests as were determined necessary.

A detailed description of the audit objective, scope and methodology is presented in Appendix 1.

OCC needs to better prepare for the impending changes in the financial services industry. Some states may not have the resources or willingness to supervise the national banks' expanding and growing insurance business. As such, over reliance on the states to regulate national bank insurance activities may not be the most prudent course of action.

OCC will likely need to better define its supervisory role over national bank insurance activities and prepare the agency for the expected growth in national bank insurance activities. This growth may present risks to the National Banking System such as measuring, controlling and pricing accident risks and liabilities as well as increased litigation. OCC needs to recognize these risks can affect bank safety and soundness as well as consumer protection and that some state supervision may not adequately address those risks. As such, it needs to begin to address those risks through its organizational structure, supervisory strategies and examination processes.

Finding 1 OCC Over-Relying On State Supervision

The degree to which OCC can continue to rely on state supervision will most likely change when national banks significantly increase their insurance activities. While this reliance may have served its purpose in the past, there are signals that such reliance may not always be in OCC's best interests. Wide variations exist between state supervisory resources and philosophy. States focus on insurer solvency and consumer protection and have a protracted examination cycle. Also, recent legal actions may portend a subtle change in the relationship between OCC and state regulators. Thus, it is unclear whether state supervision will provide OCC with ready assurance that increased national bank insurance activities will not affect bank operations, capital and earnings or the rights of customers.

Not All States May Be Able To Provide OCC Assurance

OCC reliance on state supervision over national bank insurance activities assumes the quality and quantity of supervision is fairly consistent and reliable from state to state. However, wide variations exist among the states' focus, philosophy and resources. These variations call to question whether some states are able or willing to provide OCC the assurance needed to

ensure national banks' expanded insurance activities are conducted in a safe and sound manner and in a manner that protects the rights of national bank customers.

State supervision over the insurance industry generally focuses on the solvency and conduct of the insurer and underwriter, rather than on agencies and agents. Some states do not perform direct reviews or examinations of agents. Instead, they rely on insurance companies to address their agent problems. Therefore, since most national banks now sell insurance in agency or agent capacities, state regulators may not place high priority on examining a national bank's insurance activities.

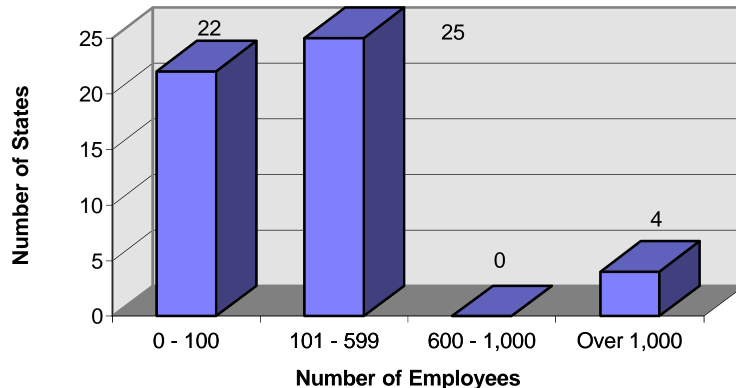
Not all states may have the resources to adequately supervise the expanding bank insurance activities. NAIC reported significant variations in resources and supervisory efforts between state insurance departments. [4]

At December 31, 1997, state insurance departments (including DC) employed about 11,800 employees, including 1,700 contract employees. Individual state staffing varied from 27 to 1,314 employees and averaged 232 employees. However, 40 of 51 (78 percent) departments had less than 232 employees. State annual budgets ranged from $1.2 million to $127.9 million.

As indicated in Chart 1, 43 percent (22) of the state departments had 100 or fewer employees while another 49 percent (25) had 101 to 552 employees. There were significant differences between the staffing of those 47 states and the staffing of New York, California, Florida and Texas. Those 4 states each had between 1,005 and 1,314 employees.

[4] *1997 Insurance Department Resources Report,* NAIC 1999.

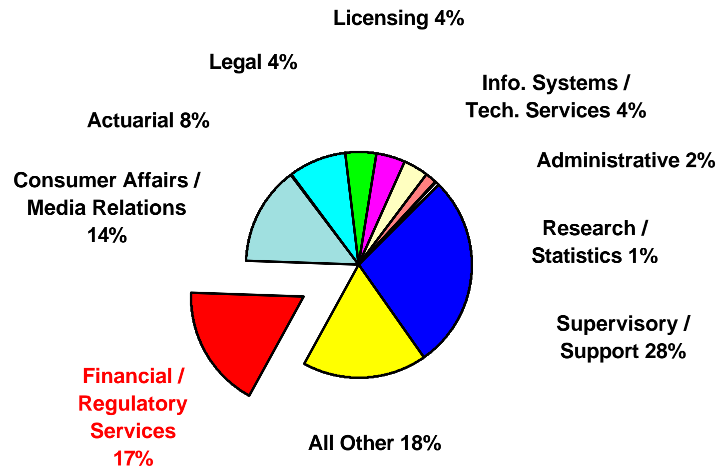
Chart 1
State Insurance Department Staffing
As Of December 31, 1997



Source: NAIC

As indicated in Chart 2, only a relatively small portion of the state staffing was involved in financial or regulatory services. NAIC classified the state and DC insurance department employees into 10 categories. The financial and regulatory service category, which included financial examiners, market conduct examiners, financial analysts/auditors and liquidation employees, represented only 17 percent (1,761) of the 10,100 state employees, excluding contract employees.

Chart 2
State Insurance Department Employees
As Of December 31, 1997



Source: NAIC

The states also reported significant variances in their insurance supervisory responsibilities for 1997. The number of licensed insurers in each state ranged from 856 to 2,550, for a total of 78,583 nationwide. About 86 percent of the licensed insurers were domiciled outside the states in which they were writing insurance policies. In all, 49 states (New Mexico and DC did not report) reported the number of individuals licensed (producers or agents) to offer insurance services varied from 7,100 to almost 206,000, totaling over 2.5 million nationwide. About a third of them were licensed to sell insurance in more than one state. Reported total insurance premiums per state and DC ranged from $1 billion to $73 billion, and averaged $15 billion.

Given the wide range of insurance activities confronting state insurance departments, the quality and quantity of supervision cannot always be consistent. Adjusting for liquidation employees, less than 17 percent of state insurance department employees were engaged in solvency monitoring and financial examination. This, despite state insurance regulators' primary function being to ensure the solvency of insurance companies.

Furthermore, NAIC reported states generally examine insurance companies only every 3 to 5 years. In contrast, OCC examines the safety and soundness of a national bank every 12 to 18 months, depending on its size and condition.

The state financial examinations for insurer solvency focus on accounting methods, procedures and financial reports. The state market conduct examinations focus on agent licensing issues, complaints, products, agent sales practices, proper rating, claims handling and other aspects of insurer operations.

Individual states reportedly initiated from zero to 232 financial and market conduct examinations in 1997, for a total of 2,759 examinations. However, the top 4 states in terms of staffing ranked 1st, 3rd, 7th and 8th in the number of exams initiated. The state with the 9th largest staff (316), supervised almost 1,800 insurance companies, 75,000 licensed producers and over $30 billion in insurance premiums. Yet, it did not initiate or complete any financial or market conduct examinations in 1997.

The Year 2000 issue illustrates that some states have different philosophies as to their supervisory responsibilities and may not aggressively supervise the national banks' expanded insurance activities. The General Accounting Office (GAO) identified the Year 2000 computer problem as an area where state regulators should be actively involved because it can affect both the safety and soundness of financial institutions as well as customer protection. However, GAO testified before the U.S. Senate Special Committee on the Year 2000 Technology Problem that some state insurance departments had a weak regulatory presence regarding the Year 2000 issue. [5] Most state regulators had not provided insurance companies any formal guidance or their regulatory expectations regarding Year 2000 readiness. Some states took the position that it was not their role to supervise companies, but rather to monitor them. Others noted they did not have the expertise or resources to provide specific guidance. Although the NAIC issued its insurance regulatory expectations for preparing for Year 2000 in September 1998, GAO found some states had not provided the information to its insurers. Other states were not even aware of the NAIC guidance.

[5] *Insurance Industry Regulators Are Less Active in Encouraging and Validating Year 2000 Preparedness*, GAO Testimony GAO/T-GGD-99-56, March 11, 1999.

One insurance association official referred to the state insurance departments as "cash cows" because they generate considerable revenue for the states. The NAIC reported every state insurance department generated revenues far in excess of its budget during 1997. The surplus revenues went into the states' general revenue fund and were available for other state programs.

There may be some merit to the association official's comment. States have historically committed only a small portion of their insurance revenues to insurance regulation. States reportedly collected almost $10 billion in total insurance revenues during 1997. Yet, they committed only $739 million of those revenues to insurance department budgets, leaving over $9 billion for the states' general revenue funds. Overall, less than 7.5 cents of every insurance dollar collected in 1997 was committed to regulating the insurance industry. Between 1992 and 1996, states reportedly committed an average of less than 7 cents of every insurance dollar collected to regulate the insurance industry.

Detailed information on insurance department resources is presented in Appendix 3.

Complaint Driven Systems Are Not Always A Good Measure Of Compliance With Consumer Protection Laws

Most states have comprehensive legislation to protect the insurance consumer from unfair trade practices. Such legislation often prohibits insurers from making inappropriate recommendations or sales, discriminating, misrepresenting and providing inequitable treatment to policyholders and customers.

While each has a mechanism for responding to and resolving insurance consumer complaints, states generally expect insurance companies to police themselves and their agents. Consumers can file complaints with the insurer, the agent, the state insurance department, the bank where a policy was purchased or OCC, if it involves a national bank. Many states require that the customer be advised at the time of purchase where complaints can be filed and that complaints be forwarded to the state insurance regulator.

However, complaint driven systems may not always be a reliable measurement of compliance with consumer protection laws. Because insurance is such an "uneven playing field," the uninitiated consumers may not know a problem exists until they

file a claim against their policy. In some cases, a claim might never arise or, if it does, it could be long after the policy or contract was issued. Sometimes, the claim may have to be filed by beneficiaries who are not aware of the process or pitfalls.

State consumer complaint systems are also not always user friendly or easily accessible by regulators to identify consumer protection issues. For example, the OIG requested one of the largest state insurance regulators to provide consumer complaint information and encountered several problems.

First, the state could not easily identify all of the banks licensed to sell insurance in their state or the types of insurance products those banks offered. They were able to individually search for each bank in their license and complaint databases. However, they could not readily identify the licensed individuals affiliated with a bank. State officials stated this was because banks were not identified as registrants in the system. One official estimated the state had issued about 1,000 licenses to banks or individuals affiliated with banks.

Second, the state's system could not provide the number or nature of the complaints relating to bank insurance sales. State officials commented they needed the name of the licensee, case number, officer name or date the case was opened or closed to provide the information requested.

Finally, the state could not readily provide information on insurance complaints filed against specific banks. For example, the OIG requested information on all complaints where the insurance policies had either been sold or written by a certain very large bank. The state official found that insurance licenses were issued to 4 different bank entities whose names had all or part of the targeted bank's name. The system contained only 3 complaints against 2 of the entities and showed only that the complaints were deemed unjustified and closed. State officials commented they would have to review the case files to provide further information.

Complaint driven systems are not always a good measure if they are not used. From the inception of its new complaint system in April 1998 through March 1999, OCC received only 190 complaints about insurance out of over 94,000 complaints. The primary complaints were service related (151 or 79 percent) and disclosures (26 or 14 percent). OCC generally forwarded each

complaint to the bank involved and provided the bank's response to the consumer.

In contrast, the NAIC reported the 50 states and DC received over 391,500 insurance complaints in 1997. The number of complaints ranged from a low of 193 in one state to a high of 45,824 in another. However, these complaints came from all sources not just from banks. The NAIC could not determine which complaints involved national banks.

Signs Of Changing Relationship Between OCC And States

OCC's authority to regulate nationally chartered banks is found in the National Bank Act (12 U.S.C.). This Act establishes OCC as administrator of the National Banking System with exclusive authority to institute regulatory policy and enforce compliance with banking laws, both Federal and state. The Gramm-Leach-Bliley Act of 1999 prohibits state laws that prevent or significantly impair a national bank's ability to exercise its Federally authorized powers.

Prior to the passage of the new legislation, OCC officials acknowledged that applying state laws to national bank insurance and annuity sales presented difficult and complex supervisory issues. Nonetheless, OCC expected to work cooperatively with the states and recognized the states' functional responsibility to administer and supervise compliance with their respective insurance laws.

Recent legal actions over national bank insurance activities may signal a change in the relationship between OCC and the states. The States of Mississippi, Connecticut, Massachusetts, New York, Texas, Louisiana and Ohio filed lawsuits to enforce laws that prevented national banks from selling insurance within their boundaries. The banking industry and OCC both challenged the states' actions on the grounds these laws hindered or significantly interfered with national banks' authority to sell insurance. In every instance, the courts agreed and ruled states did not have the authority to prevent banks from selling insurance in their state and their laws were preempted under the Supremacy Clause of the U.S. Constitution.

Should national bank insurance activities significantly increase, as expected, some states may not have the resources, capacity or

willingness to expand their supervisory focus and efforts to address the impact on bank safety and soundness or consumer protection. This may be especially so, should states have to divert insurance revenues from their general revenue funds.

OCC Believed Continued Reliance On States Is Appropriate

The OIG conducted its exit conference with OCC in July 1999, prior to the passage of the new legislation. At the meeting, OCC stated it believed reliance on state regulation of national bank insurance activities was appropriate. It stated that OCC retains an important supervisory interest in all activities of national banks impacting bank safety and soundness, including insurance, but the states are primarily responsible for monitoring national bank insurance activities.

The OCC officials at the exit conference stated that, as the primary Federal regulator, OCC respects the responsibility of states in their role as functional regulator to supervise the insurance activities of national banks. The insurance activities conducted by national banks and their subsidiaries are only a small part of their comprehensive banking and financial business. Furthermore, most conduct their insurance activities through state licensed subsidiaries subject to the same supervision as other non-bank insurance agencies. They were uncertain why a national bank's insurance agency should receive more aggressive or different supervision than a non-bank insurance agency.

OCC officials stated the recent actions against states involved state laws that ran afoul of the Supreme Court's ruling that states may not prevent or significantly interfere with banks' Federally authorized right to sell insurance. These blanket prohibitions against national bank sales of insurance did not constitute "regulation" but rather were acts to prohibit the powers of national banks.

They recognized national banks are subject to state insurance regulations and states are the primary regulators of national bank insurance activities. They recognized the role of states is to administer and oversee compliance with their insurance laws consistent with the Supreme Court decision in the *Barnett Bank of Marion Co., NA v. Nelson* litigation. They also referred to a proposed rulemaking published in the Federal Register specially stating OCC does not object to state insurance regulators

inspecting national bank records relating to insurance activities regulated under state law.

The OIG believes that continued reliance on state regulators over bank insurance activities, as those activities affect safety and soundness and consumer protection, may be appropriate in some but not necessarily all instances.

The banking industry is responding to market forces to remain viable in an increasingly competitive world economy. Activities, such as insurance, once considered adjunct to the core banking activities, will become increasingly important to the viability of the banking industry. Accordingly, the OIG believes bank insurance activities will change significantly and that the new legislation will only hasten the change. As national banks grow their insurance businesses through new or expanded products and services, they will encounter new operating environments and risks with which they are not familiar or experienced. This growth into new operating environments may affect the viability of their institutions.

The OIG believes the expanded bank insurance activities could also affect the relationship between state and Federal regulators. As the industry evolves to become more competitive in the world marketplace, conflicts may arise as to varying state requirements that could affect core banking operations, increase the cost of doing business and impede commerce, especially in the international marketplace. The OIG believes the recent legal challenges by states over the authority of national banks to sell insurance in their states could be precursors of a changing relationship between OCC and state regulators. The potential impact of the new legislation on that relationship is unknown.

The degree to which OCC can continue to rely on state regulation over national bank insurance activities depends largely on an individual state's resources and willingness to address and supervise the risks expected from this paradigm shift in the industry. For example, states focus on insurer solvency and market conduct and generally examine national bank insurance activities only once every 3 to 5 years. Will this examination scope and frequency adequately address the operating risks national banks will face as they grow their insurance business? Will it continue to provide OCC the assurance it needs? If not, OCC will have to carefully consider what reliance it can place on

state supervision with respect to the impact insurance activities have on the condition of a bank.

The concept of selective reliance on state regulation is not new. It is also incorporated into the new legislation. The Federal Deposit Insurance Corporation Improvement Act (FDICIA)[6] of 1991 permits a Federal banking agency to alternate its examinations with state supervisory authorities, provided the Federal banking agency determines that the state examination carries out the purpose of a full scope, on-site examination. At the FDIC, managers are required to review each state examination report to ensure the state identified all risks to the deposit insurance fund, took appropriate corrective actions and assigned an appropriate rating to the bank. If a state meets the criteria, FDIC will accept the report for examination purposes. If not, FDIC will not use it to meet its examination requirements. This approach provides FDIC the basis for an informed decision on the quality and reliability of the state supervision over state chartered banks.

The OIG believes the concept of selective reliance coupled with the authority to examine bank insurance activities could provide OCC a basis for determining the degree of reliance it can place on state supervision of the expanding national bank insurance activities. A major concern is whether a state examination every 3 to 5 years will adequately address the risks associated with national banks' expanding insurance activities.

Recommendation

Recommendation 1-1:

The Comptroller of the Currency should determine the degree of reliance OCC will place on state supervision of consumer protection and safety and soundness issues related to national bank insurance activities.

Management Response and OIG Comment

OCC did not concur with the OIG finding or recommendation. With respect to the OIG concerns relating to the consistency of state insurance supervisory efforts, OCC believes Congress was

[6] Pub. L. 102-242.

aware of the states' insurance regulatory framework when it mandated that the states would regulate national banks' insurance activities in the same manner as other insurance providers. OCC believes the new legislation contains no provisions for Federal supervision of insurance activities or for Federal oversight of state insurance regulators. It also believes Congress specifically directed the Federal bank and thrift regulators to defer to the state insurance regulators. As such, the OCC stated it would not implement the recommendation.

The OIG is not recommending OCC regulate insurance activities or oversee the work of state regulators. It is recommending OCC be proactive, rather than reactive, in determining when it can rely on the work of state regulators on activities that could affect the safety and soundness of a national bank.

The new legislation directs the OCC to rely on the state insurance regulators "to the fullest extent possible". It does not direct OCC to rely entirely on state insurance regulators. This would be tantamount to abdicating its responsibilities as primary supervisor of the National Banking System.

The OIG believes a prudent course of action would be to determine the reliability of state regulator information and reports before using them for examination and supervision purposes, similar to what the FDIC does with the state banking regulators. The new legislation provides Federal banking regulators authority to examine bank insurance activities when they can not rely on the work of the functional regulators. Sections 111 through 115 clearly provide OCC authority to examine national bank insurance activities under the following conditions. First, OCC must believe those activities pose a material risk to the safety and soundness of the bank. Second, it must believe an examination is needed to evaluate the risks threatening bank safety and soundness. And last, it must believe, after reviewing functional regulator reports, the bank is not complying with the laws that OCC has specific jurisdiction to enforce.

The OCC agrees with the above interpretation, but believes exercising that authority would be unusual rather than routine. The OIG agrees exercising that authority may be the exception rather than the rule. However, OIG also believes OCC needs to know and understand the quality, timeliness and scope of the state regulators' work when deciding to accept the states' work for examination purposes or examine the functionally related

entity. Given the wide variances in state resources and responsibilities, accepting states' reports on face without testing for sufficiency and relevancy would not be prudent.

The OCC also stated that the insurance agency activities authorized under the new legislation do not involve significant safety and soundness risks for national banks for a number of reasons. First, the new legislation does not authorize new types of insurance activities. Second, it requires national banks to conduct their insurance activities in a financial subsidiary and restrictions protect the bank from risk.

The OIG agrees the new legislation does not authorize new insurance activities for national banks and requires banks to conduct their activities through a subsidiary. However, the consensus is that the volume of bank insurance activities will increase significantly under the new legislation. While it does not authorize new insurance products and services, these products and services may be new to management of banks first entering insurance or expanding existing activities and legal structure may not always be an adequate safeguard over that liability and risk.

More importantly, however, the OIG believes the ramifications and risks associated with the new legislation are only just beginning to be realized. For example, the new and expanding insurance sales activity could present off-balance sheet risks. Will banks be required to capitalize those risks similar to other off-balance sheet risks, such as derivatives? If so, how will this affect the bank's competitiveness or capital structure?

In April 2000, the Under Secretary for Enforcement of the Department of the Treasury stated in a public speech that his office suspected money-laundering vulnerabilities in the operations of financial services providers, such as the insurance industry. The Under Secretary spoke of a review to see if it was appropriate to expand suspicious activity reporting requirements under the Bank Secrecy Act (BSA) to those providers.

The obvious question is how much reliance can the Treasury Department and OCC place on state regulator solvency and market conduct examinations, conducted every 3 to 5 years, to determine if a national bank insurance subsidiary is complying with the BSA and not involved in suspected money laundering activity? And, if it can not rely on those examinations, what then? Being implicated in money laundering activities could

seriously impair a bank's reputation, divert management focus and energies and subject bank assets to seizure and forfeiture.

In January and April 2000, OCC provided examining personnel direction on evaluating national bank insurance activities. In those memorandums, OCC commented the new legislation did not change the OCC core mission of ensuring the safety and soundness of the National Banking System and it did not change the need to understand and assess all risks affecting the banks. OCC directed examiners to evaluate the consolidated risk of the national bank, including risks originating in or resulting from functionally regulated subsidiaries and affiliates.

The direction in those memorandums clearly states that examiners have the authority to examine an affiliate or subsidiary of a national bank and can request information directly from the affiliate if the state regulators' reports are insufficient for examination purposes. It's possible that examiners, if knowledgeable in the insurance industry, could determine if a given report was relevant, but it is unlikely they would be able to evaluate a state regulators' independence, qualifications, scope of inquiry or evidence. A copy of the OCC April 2000 memorandum is included in this report as Appendix 4.

While the direction provided by OCC in those memorandums seems compatible with the intent of the OIG recommendation, OCC stated in its comments to the OIG report that it was required under the new legislation to defer to state regulators and would not implement the OIG recommendation.

Given its non-concurrence, OCC will need to refer the matter to the Deputy Secretary of the Department of the Treasury for resolution under TD 40-01.

Finding 2 OCC Needs To Reassess Its Focus Of Bank Insurance Supervision

The OCC needs to better define its supervisory role and prepare for the expected expansion of insurance activities by national banks. To do so, it needs to recognize that bank management may not be familiar with many of these new and expanded products and services or the attendant risks that can affect national bank safety and soundness. As such, OCC needs to begin to address these risks though its organizational structure, supervisory strategy and examination process.

OCC Has Done Little To Prepare Agency For Impending Changes

OCC efforts to address the impending changes have not dealt with the potential impact of expanding national bank insurance activities on its supervisory strategy and examination approach. Although it initiated several efforts in recent years, these efforts have produced little substantive change. Instead, OCC supervision of national bank insurance activities remains heavily reliant on state supervision that focuses on insurer solvency and consumer compliance rather than safety and soundness issues.

The October 1996 OCC advisory letter providing bank management and examiners guidance on insurance and annuity sales activities was only a "best practices" guide. It was not a regulatory requirement that OCC could use for reporting violations and enforcing compliance. In its advisory letter, OCC indicated it would develop examination guidance and identify key indicators of bank insurance problems. OCC officials at the exit conference expected to publish and release the examination policies, guidelines and handbook soon, but none had been issued as of July 29, 1999.

Although the 1997 survey disclosed bank insurance activities were expanding and growing, OCC did not identify the universe of banks engaged in insurance activity until receiving a Congressional request in November 1998. The 1997 OCC survey disclosed most banks were selling credit life as well as life and disability insurance. Most large and mid-sized banks reported they planned to expand within 5 years into higher risk activities such as property and casualty, title and private mortgage insurance, reinsurance, insurance company affiliations,

underwriting, insurance premium financing and payment processing. Nevertheless, OCC concluded bank insurance activities were not a safety and soundness concern.

The 1997 survey also resulted in several recommendations to improve supervision of bank insurance activities. These recommendations included (1) drafting a bank insurance examination handbook, (2) obtaining insurance expertise, (3) collecting information on bank insurance activities and (4) tracking complaints on banks selling insurance. As of July 29, 1999, OCC had only implemented tracking of complaints.

According to an OCC official, the information collected on bank insurance activities will be entered into the new OCC Examiner View System. It will provide an initial universe of bank insurance activities, and OCC plans to establish a policy for maintaining updated information. OCC expects its new Examiner View System to be fully implemented in Year 2000.

OCC implemented a centralized customer complaints system called REMEDY in its ombudsman's office in April 1998. Complaints are categorized according to activity and product. Complaints in the insurance category are classified into six product types. OCC examiners can request this information from its Customer Assistance Group through internal e-mail. This group can also provide examiners standard and customized reports, including the number and type of complaints per bank, the status and resolution as well as trend analysis by complaint type. However, one OCC official told the OIG that examiners were probably not using this insurance complaint information because of their limited examination of bank insurance activities.

In late 1998, OCC drafted and presented to each state and the District of Columbia an agreement for sharing insurance complaint information on national banks. The NAIC approved the draft agreement in June 1999. As of September 15, 1999, 16 states and the District of Columbia signed agreements, another 3 were expected to sign in the near future and OCC was negotiating with several other states.

OCC continues to view the primary risk associated with bank insurance activities as consumer protection rather than safety and soundness. OCC safety and soundness supervisors and examiners generally do not address bank insurance activities. Instead, OCC

examiners are instructed to limit their supervisory activities to general discussions with management about the bank's insurance activities and to consult with OCC supervisors if they discover insurance activities jeopardize a bank's safety and soundness.

OCC officials acknowledged they had made little or no changes to supervisory and examination processes and were continuing to rely on states to supervise national bank insurance activities. In March 1999, an OCC Western District official stated the district had not established routine contact or interaction with officials from the California Department of Insurance. OCC headquarters officials stated they were waiting for passage of financial reform legislation and had given priority to Year 2000 examinations.

OCC Needs To Better Prepare For Bank Insurance Activity

While current bank insurance activities are mostly limited to selling credit-related insurance products in an agency and agent capacity, both OCC and the insurance industry agree that bank insurance activity is an evolving business line and expect significant changes in bank business strategies as well as insurance products and services.

OCC surveys clearly showed national banks intend to grow their insurance business through new and expanded products and services. As they do, bankers will face strikingly different business cultures and environments with new and unfamiliar risks that could impact bank safety and soundness.

An article in an independent banking journal described the impact of and reasons for the reform of the financial services industry. [7] The author states that, with the removal of legal barriers, banks are very likely to actively pursue insurance products. Likewise, insurance companies, in an effort to increase profits, will very likely supplement or replace their distribution systems with better bank systems.

The author points out that the banking industry is under stress from increased competition, an altered perception of what constitutes acceptable lending risk and industry consolidation. As a result, bankers are encountering a sharp increase in the cost of

[7] Raymond A. Guenter, *Bank Insurance Powers – Yesterday, Today, and Tomorrow*, 17 Annual Review of Banking Law 351, Boston University, 1998

their deposits, a more expensive lending process and a decrease in profitability. Consequently, they can no longer rely so heavily on loans to drive earnings and must look to fee income from the sale of products such as insurance to enhance shareholder value.

According to the author, bankers are now more driven to take advantage of their insurance authorities and a significant segment of the insurance industry is receptive to permitting them to do so. One of the greatest advantages banks have over insurance companies is banks can create and operate their own distribution systems. Also, bankers generally enjoy a more positive reputation than their competitors. As a result of competitive pressures and the shortcomings of their own distribution systems, many insurers are receptive to using the banking industry as an alternative distribution channel. This is especially so for life, health and disability insurance products which may offer the greatest potential for growth.

However, the bank insurance powers will be of little use if the cost efficiencies of the banks' distribution systems are nullified by legal restrictions. Congressional action may be needed to draw an acceptable line between what states can and can not do in regulating national bank insurance activities.

The author states that as the legal restrictions over bank insurance activities recede, banks will need to reassess their business plans, earnings expectations and compliance structure. Being successful will require more than just deciding to "do insurance." Regardless of the way bankers get into the insurance business, failure to meet customer expectations when claims arise could cost more in customer loyalty than is earned from insurance.

Banking and insurance are very different businesses. For example, where bankers tend to avoid or minimize risks in managing their banks, insurers tend to embrace risk and profit from uncertainty, catastrophes or events that can threaten their institutions. Bankers can thrive and never make a bad loan. But few insurers could sell insurance policies if customers never filed claims on their policies or if insurers did not pay those claims.

Some bankers may not have the experience, exposure or information systems to recognize and manage the risks associated with their insurance products. A recent article in a national banking publication contrasted the differences between insurance

and banking products, workflow characteristics and management information systems. [8]

For example, most life insurance products today are investments, with term life insurance playing an important role. Although familiar with individual life insurance and investment products, large banks' familiarity diminishes quickly with group life or disability insurance products. It vanishes altogether with health insurance products that have transformed into managed care and bear little resemblance to financial services.

Property and casualty insurance products pose considerable risk to banks. These products focus on accident risk and on property characteristics and costs, not credit risk or repayment capacity. Half of the business is liability related which, in commercial insurance lines, means business survival revolves around intelligently measuring, controlling and pricing risk. The insurance industry uses reinsurance as a lender of last resort to reduce unwanted excessive risk. But, no property and casualty insurer can avoid risk as evidenced by Hurricane Andrew which cost the industry $15 billion and made the entire property and casualty industry unprofitable in 1992.

The author also pointed out the differences between insurers' and bankers' workflow characteristics. For example, insurance is an infrequent complex purchase often involving independent agents, the likes of which banks have little experience. Key to the insurance industry is underwriting because low margins drive the need to mass-market products. As a result, profits mostly come from investing premium revenue rather than underwriting policies. Policy processing is the backbone of the insurance business. Insurance policies are not payment accounts like bank accounts. Insurance transactions are fewer but far more complex requiring customer contact, proof of need (a claim) before drawing funds, data entry and individual processing in a inherently antagonistic and often litigious situation. Often times, insurance risks and costs are not known before the workflow begins, especially when involving bodily injuries.

And last, the author points out differences in the bankers' and insurers' management information systems. While they use similar hardware and systems software, most applications are

[8] Diogo Teixeira, *Banking and Insurance Very Different Businesses*, American Banker, March 17, 1999.

different. Insurance systems focus on tabulating and reporting losses, catastrophic events and actuarial tables, the results of which are much different than bank financial reporting systems.

The author concluded there were deep historical reasons for the uniqueness of the insurance industry, and only those totally dedicated to the business have survived - while those who forget this lesson may regret it.

In the late 1980s, the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce investigated four insurance company failures in the United States that were expected to cost taxpayers more than $5 billion, and the near-failure of two other companies. The Subcommittee found state regulation over insurance company solvency was seriously deficient and believed the industry was vulnerable to the same mismanagement and fraudulent activity that led to the failure of the savings and loan industry. The Subcommittee reported many common elements among the insolvent and problem insurance companies, including rapid expansion, over reliance on managing general agents, extensive and complex reinsurance arrangements, excessive under pricing, reserve problems, false reports, reckless management, gross incompetence, fraudulent activity, greed and self dealing.[9] The Subcommittee concluded state regulators and independent audit firms had failed to identify, report and correct such problems before they got out of control.

As banks expand and grow their insurance business, OCC will need to reconsider its current consumer compliance perspective towards bank insurance activities. It will need to begin to develop expertise and incorporate into its supervisory strategy certain examination procedures to address these new products and services. It will need to recognize that state supervision is limited and to become more discriminating as to which states are able and willing to supervise the national banks' new and expanded insurance business.

The OCC 1997 survey results and recommendations provide a good foundation for implementing the necessary changes. From its 1997 survey, OCC identified the risks in the bank insurance activities as those relating to reputation, compliance, strategic and

[9] Staff of House Subcommittee on Oversight and Investigations, Committee On Energy And Commerce, 101st Cong., 2d Sess., *Failed Promises: Insurance Company Insolvencies* (Committee Print 1990)

transaction risk. Reputation risk relates to business losses from adverse publicity. Similar to reputation risk, compliance risk relates to losses from violations of law or ethical standards. Strategic risk relates to losses when business decisions do not coincide with bank goals, are not supported by due diligence or are poorly implemented. Transaction risks relate to losses due to not delivering timely and efficient products and services.

The recommendations resulting from the 1997 survey were fundamentally sound. Basically, the recommendations were to measure OCC's workload and risk, formulate a supervisory strategy, develop agency expertise and promulgate policies and procedures. These recommendations appear relevant today considering the expanding national bank insurance activities, the impending reform of the financial services industry and the changing relationship between OCC and state supervisors.

OCC Believed Expanded Activities Pose Little Risk

OCC officials at the exit conference in July 1999 stated they were committed to continuing and enhancing OCC supervisory efforts to meet the new challenges relating to national bank insurance activities. They agreed the financial services industry would continue to evolve and offer new challenges to those involved and that the volume of bank insurance activities will increase significantly in the years to come. However, OCC officials believed they were taking appropriate steps to prepare for the increased bank insurance activities.

OCC officials stated its risk-based supervision approach allowed it to fulfill its mission as primary national bank supervisor while honoring the basic tenets of functional supervision. Under this approach, OCC examiners identify the risks and focus on management’s policies, procedures and controls over that risk. Where insurance activities are housed within a bank subsidiary or affiliate, OCC examiners were instructed to assess the risk and impact of insurance activities on the national bank. If the insurance activities impact bank safety and soundness, examiners were instructed to notify the primary supervisor (state or FRB) before requesting reports, making inquires or directly examining the insurance entity. The new legislation requires OCC to rely on state examinations to the extent possible and to first direct information requests to the states.

The OCC officials also inferred that bank insurance activities pose little risk to bank safety and soundness for a number of reasons. First, insurance activities conducted by national banks are only a small part of the comprehensive banking and financial business. Second, most national banks conduct their insurance activities through operating subsidiaries. Third, insurance activities were neither new nor unfamiliar because national banks have had the authority to engage in insurance activities for years.

The OIG does not take issue with OCC's comment that OCC supervision-by-risk philosophy will address the expanding insurance activities of national banks. The concern is that current examinations of national banks may not be adequate to detect or address the potential impact of significant increases in those insurance activities. The OCC Advisory Letter 96-8 guidance was not intended as an examination tool. Rather, it was to help bank management identify and manage their insurance risks. Because it is not a regulatory requirement, the letter can not be used as a basis for reporting violations or enforcing regulatory compliance. While OCC officials stated the examiners have authority to examine bank insurance activities if they present a risk to the bank, the OIG was told that examiners were generally viewing bank insurance as a compliance issue. As such, they were limiting their activities to management inquiries.

The OIG also agrees, in the past, insurance activities have not resulted in any known problems to national banks. However, the risk could change as banks grow their insurance business and it becomes increasingly important to bank competitiveness and viability.

The OIG also agrees that risk is reduced when banks conduct their business through operating subsidiaries or holding company affiliates. However, the OIG does not agree the legal structure completely removes that risk. For example, the Subcommittee on Oversight and Investigation reported on the failure of a insurance company, a wholly owned subsidiary of a large insurance company. Its failure was averted when its parent company contributed over $250 million to keep the affiliate solvent. The parent company was not legally obligated to assume the affiliate's losses but choose to do so because it recognized its responsibility to protect the policyholders and public from the consequences of the affiliate's inadequate controls.

A central issue in the Subcommittee's investigation was excessive reliance on individuals with delegated management authority from those wishing to expand or enter the insurance business. These individuals include managing general agents, brokers and other companies. The Subcommittee reported these individuals, if not monitored and controlled, can place an institution at great risk in periods of rapid expansion, especially into unknown product lines.

The OIG agrees national banks have long had the authority to engage in insurance activities and that few have even taken full advantage of those powers. However, the OCC survey disclosed while most banks have limited their activities to familiar credit-related products, they intended to grow their insurance businesses into new products and services in the near future. As they do so, bank management may be dealing with a rapid expansion into product and service lines with which they are not familiar or have little or no experience.

Given its supervisory stance and philosophy, it is uncertain whether OCC is ready to effectively respond to major stress on the National Banking System as a result of this rapid expansion into insurance activities.

Recommendations

The OIG recognizes the role of the Federal Financial Institution Examination Council in promulgating uniform examination procedures among Federal regulators. The following OIG recommendations are made with the understanding that the new legislation does not materially affect OCC' role as administrator of the National Banking System and that OCC will, to the extent necessary, coordinate with other Federal regulators when addressing the OIG recommendations.

Recommendation 2-1

The Comptroller of the Currency should establish, maintain and make available to OCC personnel a universe of national banks engaged in insurance activities, including the types of products and services, to identify the agency's risks, manage its workload and identify staff development needs.

Management Response and OIG Comments

OCC concurred and is taking action the OIG believes will address the issues surrounding the finding and recommendation. It has begun to collect information about national bank insurance activities. It expects to maintain the universe data in "real time" and have it available to its examiners by year-end.

Recommendation 2-2:

The Comptroller of the Currency should further develop and expand the agency's level of expertise and knowledge in the business of insurance as it affects national banks.

Management Response and OIG Comments

OCC did not concur with the finding or recommendation. As discussed under Finding 1 Recommendation 1, OCC believes the recommendation is inconsistent with the functional regulation approach embraced by the new legislation and is inappropriate in light of the limited insurance activities permitted for national banks under the new legislation.

The OIG believes OCC personnel will need good working knowledge of the insurance industry and its business practices and risks to determine if the state regulator's reports and information can be used for examination purposes and to examine the functionally regulated entity, if necessary. While the preponderance of new national bank insurance activity may be in sales, the OCC survey showed at least 20 national banks were engaged in underwriting insurance in 1999.

In its January and April 2000 memorandums to examining personnel, OCC stated it expected examiners to evaluate the consolidated risk profile of banks including understanding and assessing all risks affecting national banks, including those originating in or resulting from, functionally regulated subsidiaries or affiliates. It stated this assessment may involve greater reliance on the work of other agencies, especially as it relates to the functionally regulated entity. It stated that if examiners find the functional regulator's reports insufficient, they are authorized to seek information directly from the functionally regulated entity or to examine it, provided the three criteria discussed in Finding 1 Recommendation 1 are met.

The OIG questions whether OCC examiners can perform as OCC expects without a good working knowledge of the insurance industry. The differences between insurance and banking are great. Yet, OCC has not implemented its own recommendations to develop a bank insurance examination handbook and obtain insurance expertise.

Lacking a working knowledge and basic understanding of the insurance industry practices, reports and risks, examiners may find it very difficult to evaluate the sufficiency of state regulator reports in terms of scope of inquiry and sufficiency, competency and relevance of the evidence and assertions. Furthermore, being unfamiliar with the industry practices, products and reports, examiners may not know what information to request from the insurance subsidiary or affiliate or how to interpret and use it. As such, the OIG believes OCC needs to acquire, push down or make available working knowledge of the insurance industry if examiners are to perform as expected.

In its April 2000 memorandum, OCC directs the examiners to contact a senior advisor in OCC Headquarters for further information and guidance. The OIG believes that relying on such limited, concentrated and distant knowledge may not be workable or prudent.

Given its non-concurrence, OCC will need to refer the matter to the Deputy Secretary of the Department of the Treasury for resolution under TD 40-01.

Recommendation 2-3

The Comptroller of the Currency should develop a supervisory strategy over national bank insurance activities that addresses not only consumer protection but also safety and soundness issues associated with the expanded insurance activities.

Management Response and OIG Comments

OCC did not concur with the finding or recommendation. As discussed under Finding 1 Recommendation 1, OCC believes the recommendation is inconsistent with the functional regulation approach embraced by the new legislation and is inappropriate in light of the limited insurance activities permitted for national banks under the new legislation.

The OIG believes the OCC needs to be more proactive, rather than reactive, in recognizing and dealing with the potential risks expanding insurance activity could pose to the safety and soundness of the National Banking System. The two OCC memorandums and the universe of bank insurance information should heighten the examiners' awareness of bank insurance activities and put examiners on notice of the agency's expectation of them. However, these efforts do not define and provide examiners with the goals, objectives and priorities in examining or supervising national back insurance activities without which, their efforts could become unfocused, misdirected or lost.

The OCC memorandums were a step in the right direction and seem compatible with the intent of the OIG recommendation. However, OCC stated in its response to this report that it considered the recommendation to be inappropriate and that it would not implement it.

Given its non-concurrence, OCC will need to refer the matter to the Deputy Secretary of the Department of the Treasury for resolution under TD 40-01.

Recommendation 2-4

The Comptroller of the Currency should develop supervisory and examination procedures to ensure adequate, consistent and uniform coverage over national banks' insurance activities.

Management Response and OIG Comments

OCC did not concur with the finding or recommendation. As discussed under Finding 1 Recommendation 1, OCC believes the recommendation is inconsistent with the functional regulation approach embraced by the new legislation and is inappropriate in light of the limited insurance activities permitted for national banks under the new legislation.

The OIG believes OCC needs to provide examiners better direction if they are expected to evaluate the sufficiency of state regulator reports, request and use relevant information from the state regulator or insurance subsidiaries and affiliates or to examine a national bank insurance subsidiary or affiliate. This is especially so if OCC expects those activities be on an exception rather than routine basis. The need for such direction is also

exacerbated by the examiner's lack of working knowledge over the industry and the agency's lack of a supervisory plan or strategy over national bank insurance activities.

In its April 2000 memorandum to examiners, OCC stated it was establishing a process for determining when and how to make or respond to requests for functional regulator information or how to conduct examination activities involving functionally regulated entities. It stated it would issue specific procedures "shortly."

While the OCC direction seems compatible with the intent of the OIG recommendation, the OCC stated in its official comments to this report, that it considered the recommendation to be inappropriate and that it would not implement it.

Given its non-concurrence, OCC will need to refer the matter to the Deputy Secretary of the Department of the Treasury for resolution under TD 40-01.

OBJECTIVE, SCOPE AND METHODOLOGY

The overall objective of the audit was to determine if OCC supervision provided adequate coverage of safety and soundness and consumer protection issues relating to national bank insurance activities. The OIG focused on current bank insurance activities but also considered increased activities expected in the future because financial reform legislation removes many barriers between banks and insurance companies. The audit did not include annuities among the insurance activities.

The audit was conducted in accordance with the *Government Auditing Standards* issued by the Comptroller General of the United States and included such tests as were determined necessary.

The OIG researched and reviewed the proposed and final versions of the financial services reform legislation to determine the impact on national banks as well as OCC's supervision of bank insurance activities. The final legislation was passed into law in November 1999, subsequent to OIG's fieldwork but before issuance of the final report.

The OIG conducted its audit fieldwork between November, 1998 and July, 1999. Fieldwork was performed at OCC headquarters in Washington, D.C., the Western District in San Francisco, California, and at the Ombudsman's office in Houston, Texas. The OIG also performed fieldwork at several additional locations in Washington, D.C., including the Board of Governors of the Federal Reserve System and the following industry groups: American Insurance Association, Association of Banks-in-Insurance, American Bankers Association, and the National Association of Insurance Commissioners (NAIC). The OIG also met with officials of one of the largest state insurance regulators.

At the start of the audit, the OIG asked OCC and the other organizations for universe data identifying banks and their insurance activities. Information was not available until the OCC collected it in response to a November 1998 Congressional request. OCC provided the information to the OIG in March 1999.

The OIG discussed current bank insurance activities with OCC, Federal Reserve and other organizations visited, along with associated safety and soundness and consumer protection issues and risks. In addition, the OIG asked each for their perception of future bank insurance activities and risks from the impending financial reform.

At OCC headquarters, the OIG interviewed personnel from Core Policy, Bank Supervision Operations, Licensing Policy and Systems, Legislative and Regulatory Activities, Securities and Corporate Practices and Large Bank Supervision to identify the supervisory roles and responsibilities over national bank insurance activities. The

OIG also discussed OCC enforcement policy and practice with personnel from the Enforcement and Compliance Division.

The OIG interviewed OCC personnel in the Ombudsman's office to identify OCC's complaint process and the complaints received relating to bank insurance activities. The OIG also interviewed a bank examiner in OCC's Western District to discuss the district's supervision procedures and insurance activity of banks within its district.

The OIG met with the Federal Reserve, several banking and insurance organizations, the NAIC and a large state insurance regulator to gain external parties’ perspective on financial services reform. These discussions were wide ranging, and included business overviews and regulatory roles and responsibilities in the banking and insurance industries. The OIG obtained detailed statistical information on state insurance departments from the NAIC including the information in Appendix 3 of this report.

The OIG also met with officials of a state insurance department to discuss its regulatory and supervisory approach, including interaction with OCC, licensing, level of banks' insurance activity, complaints and enforcement processes. The OIG selected the state insurance regulator because its staffing and budget was among the largest in the nation.

Appendix 2

NATIONAL BANK INSURANCE ACTIVITIES
AS OF FEBRUARY 1999

1. Total number of national banks engaged in insurance: **1,950**

2. National banks insurance activities:

Type of Insurance	No. of Banks Directly Engaged: Sales	No. of Banks Directly Engaged: Underwriting	No. of Banks Directly Engaged: Reinsurance	No. of Bank Operating Subsidiaries: Sales	No. of Bank Operating Subsidiaries: Underwriting	No. of Bank Operating Subsidiaries: Reinsurance
Credit Related Life Insurance	1,906	12	2	54	7	9
Private Mortgage Insurance	220	0	0	18	0	11
Other Life Insurance	164	0	0	104	1	0
Accident and Health Insurance	715	0	0	94	0	0
Property/Liability Insurance	61	0	0	89	0	0
Other Insurance	61	0	0	45	0	0

3. Number of national banks contracting insurance services from independent contractors or agents:

Sales	152
Underwriting	4
Reinsurance	12

4. National banks 1997 insurance direct sales premium revenue: **$2.1 Billion**

5. National banks 1997 insurance underwriting premium revenue: **$2.7 Million**

6. National banks 1997 reinsurance assumed: **$43.3 Million**

7. National banks 1997 at-risk reinsurance of private mortgage insurance: **$27.0 Million**

SOURCE: Office of the Comptroller of the Currency

1997 INSURANCE DEPARTMENT RESOURCES
50 States and District of Columbia
(dollars in millions)

	State	State Staff	Contract Staff	Total Staff	Department Budget	Insurance Revenues	Premium Volume	Exams Initiated	Licensed Producers	Consumer Complaints
1	New York	865	449	1,314	$95.0	$921.7	$68,719	232	137,751	45,824
2	California	1,135	56	1,191	$127.9	$1,346.0	$72,978	134	205,960	28,269
3	Florida	1,043	87	1,130	$55.2	$465.9	$33,293	190	156,966	42,340
4	Texas	1,003	2	1,005	$43.2	$770.5	$52,473	108	144,394	24,958
5	Illinois	353	199	552	$22.8	$208.9	$41,247	161	93,551	14,081
6	Louisiana	261	261	522	$21.8	$189.2	$10,828	62	28,420	4,099
7	New Jersey	402	76	478	$37.2	$321.3	$25,137	38	78,700	14,012
8	North Carolina	388	19	407	$29.4	$288.0	$20,137	53	86,757	10,100
9	Ohio	248	68	316	$18.6	$384.3	$30,611	0	75,000	8,105
10	Pennsylvania	274	30	304	$18.2	$224.1	$46,204	216	113,039	21,305
11	Maryland	249	17	266	$14.3	$182.5	$11,950	72	62,612	18,461
12	Arizona	138	84	222	$4.4	$159.7	$12,349	160	42,839	6,034
13	Missouri	210	0	210	$11.7	$186.1	$15,066	140	77,890	4,735
14	Connecticut	164	33	197	$12.4	$222.7	$13,977	101	49,280	10,311
15	Virginia	190	3	193	$15.3	$249.9	$17,824	68	71,003	8,227
16	Kentucky	174	1	175	$11.4	$155.7	$8,742	45	13,130	6,756
17	Georgia	168	0	168	$17.5	$444.7	$18,677	64	66,511	12,290
18	Washington	164	2	166	$11.1	$229.6	$14,469	21	41,965	7,923
19	Massachusetts	163	2	165	$8.0	$26.7	$27,586	30	47,761	3,375
20	Kansas	155	2	157	$7.7	$140.1	$5,811	24	33,262	5,781
21	Michigan	127	15	142	$16.3	$194.1	$33,934	35	63,742	4,993
22	Wisconsin	122	8	130	$8.0	$104.2	$15,600	65	59,398	9,169
23	Delaware	67	61	128	$4.3	$57.8	$3,109	48	21,328	6,985
24	Mississippi	114	14	128	$4.7	$113.9	$4,471	25	45,839	7,000
25	Oklahoma	122	1	123	$6.0	$138.8	$6,229	59	39,276	6,236
26	Minnesota	121	0	121	$7.0	$170.0	$15,332	15	52,771	3,792
27	Colorado	95	21	116	$6.3	$117.2	$13,114	44	45,177	8,041
28	South Carolina	107	4	111	$5.7	$103.9	$7,406	40	49,056	4,093
29	Arkansas	102	0	102	$5.6	$114.9	$4,971	21	35,288	2,981
30	Oregon	99	1	100	$6.1	$89.8	$8,193	23	29,250	4,748
31	Tennessee	91	8	99	$5.8	$278.0	$15,835	28	56,000	4,013

Appendix 3
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1997 INSURANCE DEPARTMENT RESOURCES
50 States and District of Columbia
(dollars in millions)

	State	State Staff	Contract Staff	Total Staff	Department Budget	Insurance Revenues	Premium Volume	Exams Initiated	Licensed Producers	Consumer Complaints
32	Iowa	90	8	98	$5.8	$121.4	$7,078	59	43,292	2,525
33	Nevada	65	30	95	$3.7	$103.9	$4,169	50	22,855	2,377
34	Nebraska	93	0	93	$5.7	$54.2	$4,608	47	30,630	2,733
35	North Dakota	46	46	92	$2.7	$27.5	$1,878	11	14,250	795
36	New Mexico	77	14	91	$3.5	$85.2	$3,232	9	n/a	1,700
37	Alabama	69	17	86	$7.8	$160.7	$13,330	18	49,000	193
38	Indiana	84	2	86	$4.0	$141.2	$16,290	43	100,874	5,278
39	Utah	72	4	76	$3.6	$74.1	$5,114	15	26,684	1,056
40	Maine	72	3	75	$6.1	$47.0	$3,654	6	13,496	1,333
41	West Virginia	72	3	75	$4.1	$105.1	$3,466	5	25,820	2,695
42	Idaho	65	6	71	$4.9	$52.9	$2,546	5	17,196	1,507
43	Dist. of Columbia	62	2	64	$4.8	$47.2	$3,679	16	n/a	856
44	New Hampshire	51	13	64	$3.1	$59.9	$2,758	28	20,332	1,418
45	Rhode Island	53	10	63	$3.1	$47.3	$3,692	15	12,786	806
46	Alaska	50	3	53	$4.8	$33.5	$1,572	7	7,122	559
47	Hawaii	47	5	52	$4.4	$80.1	$4,541	19	8,868	1,950
48	Vermont	49	0	49	$3.5	$31.9	$1,962	71	10,633	840
49	Montana	43	2	45	$1.9	$37.6	$1,675	5	17,968	1,927
50	Wyoming	24	6	30	$1.2	$12.1	$1,027	2	8,826	524
51	South Dakota	24	3	27	$1.3	$39.4	$2,004	6	15,212	1,438
	Totals	10,122	1,701	11,823	$738.9	$9,962.4	$764,547	2,759	2,569,760	391,547

Source: National Association of Insurance Commissioners

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: All Examining Personnel

From: Leann G. Britton, Senior Deputy Comptroller, Bank Supervision Operations
Emory W. Rushton, Senior Deputy Comptroller, Bank Supervision Policy

Date: April 10, 2000

Subject: OCC Supervision and Gramm-Leach-Bliley Act of 1999

In his *Message to All Employees* last week, Comptroller Hawke previewed his remarks to the New York Bankers Association regarding the effects of the Gramm-Leach-Bliley Act of 1999 (GLBA) on bank supervision and related issues. For examiners, the preeminent point of those remarks is that the OCC remains the primary supervisor of national banks - and that our comprehensive responsibilities for maintaining the health of the national banking system are undiminished by GLBA. Along with that reaffirmation, the Comptroller emphasized the need for close cooperation and coordination among all involved regulators to ensure top quality supervision with minimum overlap and burden. This memorandum will discuss those principles in more detail.

A. OCC Mission Unchanged

Contrary to the impression created by many published reports, GLBA did not dramatically change the supervisory landscape for insured depository institutions. In fact, GLBA reaffirmed the present supervisory structure (see Appendix A) and, as the Comptroller noted in his remarks, reinforced the role of the primary supervisor. It also strengthened the mandate to the FRB to focus its examination activities on holding companies and non-bank affiliates, and to use the examination reports of primary supervisors when seeking information, in each case "to the fullest extent possible." Hence, the mission of the OCC remains to ensure the continued safety and soundness of the national banking system. This includes understanding and assessing all risks affecting national banks, including risks that originate in, or result from, functionally regulated subsidiaries or affiliates. Consequently, examiners should continue to review and assess this consolidated risk and the systems for monitoring and controlling risk. Moreover, while GLBA introduced some minimum clarifying requirements for inter-agency consultation and coordination in matters of mutual interest, we do not expect those requirements to adversely affect our supervisory capabilities or results.

B. Coordination with "Functional" Regulators

GLBA codified the concept of "functional regulation," namely, that banking activities are to be primarily regulated by banking regulators, holding company activities by the holding company regulator, securities activities by securities regulators, and insurance activities by insurance regulators. The functional regulation provisions, which went into effect on March 11, 2000, limit the circumstances under which the OCC and the other federal bank regulators may require reports of, examine, and take remedial actions against bank affiliates and subsidiaries deemed to be functionally-regulated entities. However, as noted in our Memorandum to you dated January 10, 2000 (MM-00-1), GLBA does not restrict examiners from seeking information on a functionally regulated entity from other sources, such as the owner/affiliated national bank, in order to evaluate the consolidated risk profile of the bank. In this regard, supervisory information on these entities may be discussed or requested by examiners during routine meetings with bank management and through regular reviews of existing bank reports.

The implementation of functional supervision provisions of GLBA will of course require greater cooperation and communication between the OCC and functional regulators -- namely the Securities and Exchange Commission (SEC), state insurance regulators, and the Commodities Futures Trading Commission (CFTC). The specific limitations and requirements on our dealings with functional regulators are set forth in OCC Memorandum MM-00-1 and in material available at the financial modernization homepage on the OCCnet at http:*//occnet.occ/cco/financial.htm.* Please review these materials and ask questions of the identified experts if you are in doubt about any part of these conditions.

We do not expect significant problems to arise from our implementation of GLBA, but it is critically important that we conduct our supervision in such a way that we do not inadvertently violate the law's intent. To guard against this possibility, and to ensure consistency nation-wide, we are establishing a process for determining when and how to make or respond to requests for reports of examination or to conduct examination activities involving functionally regulated entities. Specific operational guidance will be issued shortly. In the interim, any requests for information from or by functionally regulated entities should be discussed with Ned Pollock, Senior Advisor to the Senior Deputy Comptroller for Bank Supervision Operations.

C. Coordination with Other Federal Banking Agencies

The OCC responsibilities for supervisory coordination with the other Federal banking agencies were largely unaffected by GLBA. Both the FDIC and the FRB continue to have legitimate interests in national bank activities and both will continue to need specific information about national banks from time to time. As in the past, examiners should endeavor to be fully responsive to these legitimate needs. Certain provisions of GLBA, however, do alter the relationship among the banking agencies, especially between the OCC and the FRB. As is discussed more fully below, these provisions reinforce the role of the OCC as primary regulator of national banks.

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Section 111 of GLBA states that the FRB is to give significant deference to bank examinations conducted by the primary regulator in performing its responsibilities as holding company regulator. Specifically, this provision of GLBA requires the FRB (1)"to the fullest extent possible," to limit the focus and scope of their holding company examinations to the holding company and to those non-bank subsidiaries that could have a materially adverse effect on the bank subsidiary; and (2) "to the fullest extent possible," to use the examination reports prepared by a bank's primary regulator when seeking information. As is noted in the OCC legal memorandum provided in Appendix B, this instruction to the FRB to defer to the appropriate Federal banking agency is stronger than prior statutory language.

While recognizing that there may be situations where the FRB has information needs not available through OCC sources, we believe existing OCC reports of examination, memoranda and work papers should generally address the FRB's supervisory information requirements with respect to national banks. OCC district and large bank staff should continue to routinely share completed reports of examination and other supporting materials with their FRB and FDIC counterparts. In addition, you should continue to inform your counterparts of significant events and information regarding national banks and non-functionally regulated subsidiaries during the interim between scheduled examinations.

The legal memorandum provided in Appendix B discusses GLBA's parenthetical reference to the FRB as "umbrella" supervisor. While we are aware that some FRB staff have promoted the impression that GLBA gave the FRB comprehensive new powers over banks, our direct discussions with senior FRB officials here in Washington confirm that is not the FRB's official position. Certainly, the single "umbrella" reference in GLBA did not materially alter the FRB's pre-existing examination authority over national banks; nor should it affect OCC's overall relationship with the FRB. Examiners should continue to assist the FRB in assessing the overall risk associated with the national bank's parent company, and to the extent appropriate and practical, should coordinate examinations of areas of mutual interest in the bank, the parent company, or non-functionally-regulated affiliates.

Comptroller Hawke has met with FRB representatives and stated the OCC's position, with which they agreed, that before FRB examiners make any direct contact with a national bank seeking information, they should first consult and coordinate with the OCC's EIC and determine the extent to which their needs can be satisfied through the use of information in our possession.

If examiners encounter situations that are inconsistent with the deference GLBA provides to the OCC as primary regulator of national banks, they should immediately contact their Deputy Comptroller.

D. Future Efforts

OCC representatives have already participated in several GLBA-related meetings among the federal banking regulators, SEC, CFTC, and banking and insurance regulators from the states

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for the purpose of developing information-sharing and general coordination. We remain committed to keeping you informed as these and similar matters are resolved. If you have any questions, please do not hesitate to contact us.

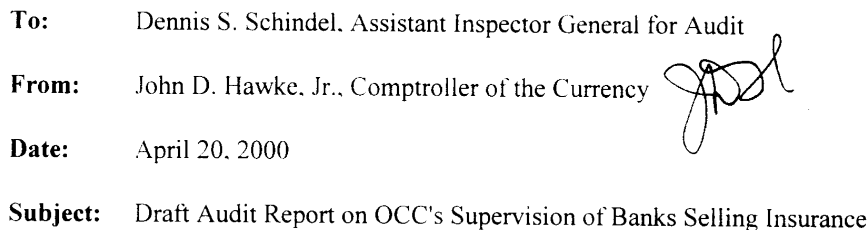
Attachments

-4-

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219



To: Dennis S. Schindel, Assistant Inspector General for Audit

From: John D. Hawke, Jr., Comptroller of the Currency

Date: April 20, 2000

Subject: Draft Audit Report on OCC's Supervision of Banks Selling Insurance

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We have received and reviewed your draft audit report titled *Office of the Comptroller of the Currency's Supervision of Banks Selling Insurance*. The purpose of the self-initiated review was to determine if OCC supervision of national bank insurance activities adequately addressed bank safety and soundness and protected consumers. You concluded that the OCC is over-relying on state supervision and that the OCC needs to reassess its focus of bank insurance supervision. The report makes five recommendations to address these concerns.

We find that the report, in large part, relies on dated fieldwork, an earlier legal framework for insurance activities, and past OCC supervisory initiatives -- all having little relevance to the current environment. We strongly urge that the report be revised to correctly reflect the new legal framework mandated by the Gramm-Leach-Bliley Act of 1999 (GLBA). We also suggest that you focus on the OCC's actions in implementing GLBA, including the coordination with state insurance regulators who are the primary regulators of insurance activities.

GLBA Does Not Authorize New Risky Insurance Activities.

The report expresses concern that GLBA will result in significant growth in banks' insurance activities, expose banks to new and unfamiliar products and services, and present significant risks to bank safety and soundness. The report fails to recognize that GLBA does not authorize new types of insurance activities for national banks and, instead, imposes significant restrictions.

National banks have been authorized to conduct insurance **agency** activities under 12 U.S.C. 92 since 1916, subject to certain geographic restrictions. GLBA authorizes national banks to engage in insurance **agency** activities without those geographic restrictions, provided the activity is conducted in a "financial subsidiary." The insurance **agency** activities authorized under 12 U.S.C. 92 and GLBA are identical and do not involve significant safety or soundness risks for national banks. In addition, "financial subsidiaries" are subject to restrictions that are designed to protect the

parent banks from risk. For example, parent banks must be well-capitalized and well-managed and assure that the assets of financial subsidiaries do not exceed certain levels. In addition, a national bank with a financial subsidiary is required to have policies and procedures in place that preserve the separate corporate identities of the bank and its subsidiary.

GLBA prohibits national banks and their subsidiaries from engaging in new insurance **underwriting** activities. Only those types of insurance that national banks that were lawfully **underwriting** as of January 1, 1999, or that the OCC had approved for national banks to underwrite as of that date, may be underwritten by national banks or their subsidiaries. These products are generally credit-related insurance that involve risks similar to lending risks with which banks are familiar and that the OCC has extensive experience supervising. These underwriting activities have not been a source of supervisory concern.

GLBA Curtails OCC Authority for Insurance Activities.

GLBA establishes the states as the paramount and, in many respects, exclusive authority to supervise and regulate insurance activities of national banks and their subsidiaries. The law establishes a "functional regulation" framework under which banking activities are regulated by banking regulators, securities activities by securities regulators, and insurance activities by state insurance regulators. GLBA unequivocally restricts the ability of the OCC to examine or regulate insurance entities.

To the fullest extent possible, GLBA directs that the OCC forego conducting an examination and instead review reports of examination prepared by the functional regulator of the entity. The OCC may examine a functionally regulated subsidiary or affiliate of a national bank engaged in insurance activities only if: 1) the OCC has reasonable cause to believe that the entity is engaged in activities that pose a "material risk" to the bank; 2) after reviewing reports from the entity's functional regulator, the OCC determines that an examination is necessary to evaluate financial and operations risks that pose a threat to the national bank's safety and soundness and to evaluate intercompany systems for monitoring or controlling such risks; or 3) based on the functional regulator's reports or other available information, the OCC has reasonable cause to believe that the entity is not in compliance with a law that the OCC has "specific jurisdiction to enforce." GLBA envisions that the OCC's requests will be unusual rather than routine.

The OCC is Implementing GLBA.

On March 3, 2000, the OCC promulgated final regulations implementing section 121 of the GLBA concerning financial subsidiaries.

The OCC currently is working with the other federal banking agencies on drafting regulations required by section 305 of GLBA to implement various consumer protections in connection with sales of insurance by banks and thrifts.

The OCC has undertaken a number of initiatives to enhance cooperation and communication with state insurance commissioners as functional regulators, including meeting regularly with state

insurance commissioners to establish open lines of communication, develop effective working relationships and establish information-sharing arrangements.

In addition, the OCC has provided guidance to OCC staff on implementing the functional regulation provisions of GLBA. Because the OCC still has an interest in risk assumed by national banks, regardless of the source, the OCC expects examiners to assess the consolidated risk profile of national banking companies providing insurance products. They are to use, to the extent possible, reports developed by the state insurance commissioner or other information available from bank management. In performing such a review, examiners are directed to focus on a national bank's effectiveness in monitoring and controlling operational and financial risks and intercompany transactions, and compliance with laws under the OCC's specific jurisdiction. Consistent with the directives of GLBA, the OCC is not attempting to duplicate or supplement the insurance regulatory function of the state insurance regulators.

The Report's Recommendations Are Inconsistent with GLBA.

In light of the fact that GLBA does not authorize new insurance activities for national banks; that the OCC has experience with the risks posed by the types of insurance activities that are permitted; and that the Congress clearly mandated that the states, rather than the OCC, supervise these insurance activities, the recommendations that the OCC pursue strong new initiatives in this area are mostly inappropriate.

Recommendation 1-1 states that the Comptroller of the Currency should assess each state's insurance supervision and determine the degree of reliance OCC will place on state supervision of consumer protection and safety and soundness issues related to national bank insurance activities.

The report expresses concerns about the consistency of state insurance supervisory efforts. However, Congress was aware of the states' insurance regulatory framework when it mandated that the states would regulate national banks' insurance activities in the same manner as other insurance providers. GLBA does have specific provisions directing the states to adopt uniform laws and regulations pertaining to licensing standards for selling insurance products. Because there are no provisions for federal supervision of insurance activities or for federal oversight of state insurance regulators, and Congress has specifically directed the bank and thrift regulators to defer to state insurance regulators, the OCC will not implement this recommendation.

Recommendation 2-1 states that the Comptroller of the Currency should establish, maintain and make available to OCC personnel a universe of national banks engaged in insurance activities including the types of products and services, to identify the agency's risks, manage its workload and identify staff development needs.

We agree that the OCC should maintain information about national banks' insurance activities and, as you report, we have begun to collect it with implementation of our new supervision data system, Examiner View. The universe should be available and maintained "real time" by year-end.

3

Recommendations 2-2 through 2-4 state that the Comptroller of the Currency should increase the agency's expertise, develop a supervisory strategy, and develop supervisory and examination procedures to ensure adequate, consistent and uniform coverage over national banks' insurance activities.

As written, these recommendations are inconsistent with the functional regulation approach embraced in GLBA and inappropriate in light of the limited insurance activities permitted for national banks. Accordingly, we do not plan to implement them. We will, however, provide guidance to our examiners on how best to implement GLBA's functional regulation approach, while still adequately assessing the consolidated risk profile of the national banking company providing the insurance products.

MAJOR CONTRIBUTORS

Appendix 6

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