

## Insurance

As discussed in [Handbook Section 730, Related Organizations](#), related organizations can significantly affect the operations and overall financial condition of the parent thrift. The purpose of examining these entities is to determine the extent to which they pose a risk to the parent thrift. This Section is devoted to evaluating the risks associated with insurance activities conducted by a thrift's service corporation subsidiary.

Federal thrifts may establish or acquire a service corporation to conduct insurance activities in accordance with 12 CFR § 545.74(c), but are otherwise generally prohibited from directly engaging in the business of insurance. A service corporation's insurance operations can provide a parent thrift with the potential to increase consolidated earnings, cross sell services, and diversify its investments. Along with such benefits, insurance activities can also present substantial risk to the parent thrift.

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### LINKS

 [Program](#)

Throughout this Section, various aspects of insurance operations are highlighted as potential areas of risk that should be addressed by service corporation management through internal procedures and policies. The successful implementation of internal controls is essential for containing risk, maintaining profitability and ensuring compliance with applicable state and federal laws. The extent to which service corporations comply with statutory and regulatory requirements can materially affect a related organization's viability, the thrift's exposure to loss, and the public's overall perception of the parent thrift.

The states have the power to regulate as well as tax the business of insurance. The McCarron-Ferguson Act, 15 USC §§ 1011-1015, precludes the application of federal law where state law regulates the business of insurance and to the extent that federal law would invalidate, impair or supersede state law. This decentralization of insurance rules and regulations makes it impractical to describe the distinctions between states in their approaches to regulating insurance. Service corporation management must implement measures to ensure compliance with federal laws pertaining to thrift subsidiaries and state laws applicable to insurance activities.

In determining the level of risk presented to the parent thrift, the regulator must obtain an adequate understanding of the service corporation's activities and operations as discussed in [Handbook Section 730](#). This section supplements [Handbook Section 730](#) to provide regulators with an overview of insurance concepts and activities and guidance on how to identify and evaluate risk inherent in a service corporation's insurance operations. Specifically, this Section provides an overview of the following areas.

*Permissible Insurance Activities and Related OTS Requirements*

The OTS rules and regulations limit the types of insurance activities that federal thrifts may conduct through service corporation subsidiaries absent prior OTS approval. These restrictions and other applicable regulatory requirements (i.e., maintenance of separate corporate identities, conflicts of interest) serve to minimize the risk presented to the parent thrift and are detailed in the Overview Section. Certain of these standards are highlighted in this Section's discussion of the insurance subsidiary review. Thrift Bulletin (TB) 23-2, Interagency Statement on Retail Sales of Nondeposit Investment Products, also applies to sales of variable annuities and insurance products that have investment features, but not to pure insurance products such as credit life or term life insurance. TB 23-2 identifies safeguards that service corporation and thrift management should implement to address specific risks associated with sales of investment products on a thrift's premises or as a result of thrift customer referrals.

*Types of Insurance Activities*

The types of insurance activities typically conducted through service corporations (agency, brokerage, underwriting, reinsurance, and premium financing) are described along with suggested areas of review to determine the level of risk presented to the parent thrift. A discussion of "third party" arrangements is also provided. Service corporations may use third parties to market, sell, underwrite or otherwise provide insurance products and services, but must monitor these arrangements in a prudent manner. While the regulator is not responsible for ensuring that activities comply with state laws and regulations, the adequacy of management's internal controls in addressing potential areas of risk is an important aspect of the regulator's review.

*Insurance Products Sold Through Service Corporations*

A summary of certain types of insurance coverages typically sold through a federal thrift's service corporation is provided in the latter part of this Section. Insurance products must comply with the requirements of state insurance departments. Products such as variable annuities and variable life insurance must also comply with any applicable requirements of the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD).

The discussion and examination procedures that follow should be incorporated in the regulator's overall review in a manner consistent with the approach detailed in the Overview Section. Since the business of insurance is regulated at the state level, regulators should, in accordance with regional office policy, obtain examination reports and other relevant information maintained by state insurance departments. These records can be useful in identifying areas of risk during the examination scoping process.

**PERMISSIBLE INSURANCE ACTIVITIES AND RELATED OTS REQUIREMENTS**

For active related organizations, the examination scoping process involves determining whether the related organization complies with applicable regulations and related policies. The discussion that follows highlights certain regulations that generally apply to all service corporations and those that

apply specifically to the conduct of insurance activities. (Refer to Handbook Section 730 for a detailed discussion of service corporation requirements, estimating risk, and scope of review.)

### *Permissible Insurance Activities*

Section 545.74(c) provides that service corporations may, in accordance with the notification requirements established in 12 CFR § 545.74(b)(2), engage in “preapproved” insurance agency and brokerage activities for a limited scope of coverages (i.e., automobile, life, health, accident, and title insurance). Service corporations, however, are generally prohibited from offering private mortgage insurance.

A thrift may apply to the OTS for special permission to conduct additional “reasonably related” insurance activities through its service corporation subsidiary.

Some examples of activities that the OTS has approved on a case-by-case basis are:

- Investing in equity securities of a holding company that owns a private mortgage insurance company;
- Underwriting mortgage life and credit life insurance on the lives of borrowers and savers of the parent thrift and its subsidiaries;
- Incorporating and operating a wholly-owned reinsurance company to reinsure mortgage life, mortgage disability, credit life, and credit disability insurance purchased by customers of the parent thrift, its subsidiaries or any affiliates (the term affiliate is defined in 12 CFR § 563.41);
- Forming a second tier service corporation to provide administrative and managerial services to a financial organization engaged in underwriting credit-related insurance; and
- Underwriting life insurance for customers where such coverage was not related to the extension of credit.

The foregoing activities are generally limited in scope and must conform to applicable operating requirements and restrictions including those set forth in an OTS approval order. In determining whether service corporations of state-chartered thrifts may engage in similar activities, management should provide sufficient documentation confirming that such authority exists. Subsidiaries of state-chartered thrifts are generally limited to activities permissible for federal thrifts. (See [Handbook Section 730](#) for more detail on subsidiaries of state-chartered thrifts.)

Generally, requests to engage in activities, not listed as preapproved, will be denied when applications are incomplete or it has not been adequately demonstrated that the activities are reasonably related to the activities of federal savings associations. To date, the OTS has not approved the following insurance-related activities:

- Issuing (underwriting) directors’ and officers’ liability insurance;

- Issuing (underwriting) private mortgage insurance;
- Reinsuring life and disability insurance that would be offered to employees of the parent thrift and its subsidiaries;
- Underwriting or reinsuring non-credit-related whole life, universal life and annuities for borrowers and account holders of the parent thrift and its subsidiaries; and
- Investing in the capital stock of a proposed life insurance company.

The regulator should verify that the service corporation has commenced its insurance activities in accordance with OTS application or notification requirements. These requirements vary based on whether the activity is preapproved pursuant to § 545.74(c) and whether the parent thrift is eligible for expedited treatment in accordance with § 516.3.

### *Maintaining Separate Corporate Identities*

As detailed in the Overview Section, determining whether a thrift and its subsidiaries maintain separate corporate identities is an important aspect of the regulator's review. A separate corporate identity distinguishes the activities of the subsidiary and the parent thrift in a visible and obvious manner and, therefore, protects the parent thrift from the debts and other liabilities of its subsidiary. Section 571.21 contains five guidelines that provide minimum standards for the maintenance of separate corporate identities. A clear violation of § 571.21, for example, would occur if there is evidence that insurance is being sold by the thrift itself in connection with closing a loan, with no effort being made to explain to the customer that the insurance is being provided through a separate subsidiary.

A review of stationery and logos, and whether there is physical separation between the service corporation and its parent thrift will alert the regulator as to whether separate corporate identities are maintained. The following questions should be considered:

- Is it obvious to the casual observer that the insurance subsidiary, operating on the parent thrift's premises, is a separate corporate entity?
- Is there physical separation between the personnel offices, and desks of the parent thrift and the service corporation?
- Is a separate telephone number listed in the directory?
- Do signs and literature clearly indicate that products are sold by the service corporation and not the thrift?
- Do advertisements, literature, and other disclosures conspicuously state that the insurance/investment product is not FDIC-insured?

A review of internal controls and any agreements with the parent thrift or a third party may assist in determining whether separate corporate identities are maintained by subsidiaries. Thorough internal procedures may serve to prevent conditions that could give rise to a court finding that separate corporate identities have not been maintained.

### *Tie-in Prohibitions*

A parent thrift is prohibited from requiring customers to purchase products or services from its service corporation. For example, a thrift requiring credit life insurance on a specific loan must make clear to the customer that there is an option to purchase either the coverage offered by the service corporation, or similar coverage from elsewhere. Section 563.35 does not preclude a thrift or its subsidiary from refusing to make a loan if, based on reasonable grounds, its findings indicate that the insurance coverage obtained by the borrower is inadequate. [Note: In certain states it is not legal to require credit life insurance.]

### *Control Over Placing of Hazard Insurance*

In 12 CFR § 556.4, the OTS addresses the borrower's right to select a hazard insurer, as long as the coverage meets the reasonable requirements imposed by the parent thrift. The thrift must not permit standards for insurance coverage to be tailored to the products offered by a given service corporation, or limited to companies it represents.

### *Guidance on the Sale of Investment Products*

TB 23-2, Interagency Statement on Retail Sales of Nondeposit Investment Products, applies to sales of investment products (i.e., variable-rate, annuities, insurance products that have investment features, mutual funds) on the parent thrift's premises or as a result of customer referrals. TB 23-2 does not apply to the sale of pure insurance products such as term life insurance. The OTS's examination authority covers all sales of investment products on thrift premises, including those offered by service corporations, affiliates and third parties. Specifically, the guidance addresses:

**Safeguards to prevent customer confusion.** Sales of investment products in the offices of thrifts present a special risk that customers may confuse investment products with FDIC-insured deposits. The service corporation's internal controls should ensure that its activities are clearly distinguished from the parent thrift's operations.

**Sales techniques and disclosures.** Sales techniques and disclosures in advertising should not mislead customers regarding the characteristics of the investment products and should clearly identify the service corporation or a third party (not the parent thrift) as the seller. For example, the service corporation's use of the parent thrift's logo in its sales literature could lead customers to believe that the thrift is offering insurance services. Additionally, sales of investment products such as variable annuities should include sufficient disclosures indicating that, for example, the product's value may fluctuate.

**Compensation.** The service corporation's files should contain information on the responsibilities of employees that are authorized to sell investment products and other personnel that interact with customers. Compensation structures for each class of personnel should be documented and available

for review by the regulator. Any customer referral fees paid by the service corporation to thrift employees should be nominal and should not be dependent upon a sale of an investment product. [Note: The payment of referral fees should comply with applicable state law and securities rules and regulations.]

**Sales training.** The parent thrift and service corporation should ensure that personnel selling investment products are adequately trained. The training should be designed to prevent the misstatement of material facts, the use of overly optimistic or deceptive forecasts, the making of unsuitable recommendations, and the dissemination of any other information that is false or misleading. Also, management should ensure that sales representatives comply with any applicable licensing or registration requirements.

In summary, the service corporation's internal policies and procedures should serve to ensure that sales of investment products on the thrift's premises are performed in a prudent manner and in accordance with safe and sound operating procedures. Adequate records pertaining to all sales should be maintained in a manner that facilitates a prompt review by management and regulators. In addition, any agreements with third parties or the parent thrift (i.e., for leasing office space) should be approved by the service corporation's board of directors and be consistent with established internal policies and sound business strategies. The roles of any dual employees (employed by both the parent thrift and service corporation or a third party) should be documented along with the method of compensation. The service corporation's management should be required to explain any material variances from established policy and the potential effect of such actions on the parent thrift. (For a detailed discussion of TB 23-2 and related guidance, see "Policy on Sales of Investment Products and Referral Activity" in [Handbook Section 710, Networking Arrangements](#).)

### *Usurpation of Corporate Opportunity*

Section 556.16 states that federal thrifts are prohibited from referring insurance business to a service corporation insurance agency under certain circumstances. When a thrift is making every possible attempt to obtain state approval to establish a service corporation as a provider of insurance, insurance business may be referred by thrift employees to an agency that is temporarily owned by the parent thrift's officers or directors. The intent is to allow such activity only when the situation is not permanent. This is an effort to ensure that officers and directors do not usurp corporate opportunity. (Refer to "Conflict of Interest Considerations," [Handbook Section 730](#).)

## TYPES OF INSURANCE ACTIVITIES IN SERVICE CORPORATIONS

In addition to ensuring compliance with regulatory requirements, policies and application approval standards, service corporation management must conduct insurance activities in a safe and sound manner. An effective system of internal controls ensures the integrity of operations and attempts to limit fraud or manipulation of an organization's records. Internal controls should also adequately address the monitoring of services performed by third parties.

Service corporations may rely on third parties to market, sell, underwrite or otherwise provide insurance products. These arrangements can provide service corporation management with expertise and services

that otherwise would have to be developed in-house or purchased. Third parties that establish joint ventures with service corporations range from marketing organizations to brokerage houses, consulting groups, and insurance companies. The range of products and services they offer is very broad, and can be tailored to the specific needs of the service corporation. A third party can, for example, provide or develop a wide array of life and property/casualty insurance products for a service corporation. A third party may consider the service corporation to be a conduit to sales, or may offer administrative and managerial services on a fee basis. Services provided by a third party may include:

- Training existing personnel, or recruiting and placing its own employees in a service corporation;
- Offering data processing, sales management, billing and accounts receivable or other services; or
- Managing the entire operation.

There are numerous types of arrangements involving third parties and service corporations. While service corporations can realize certain benefits from these arrangements, the regulator should be familiar with, among other concerns, the following risks:

**The risk that the venture will fail.** This risk can be minimized with appropriate market studies and with an objective evaluation of the third party.

**Noncompliance with statutory and regulatory requirements.** The service corporation should initially and periodically review the record of regulatory violations by third parties and any of their employees.

**Improper representations and disclosures.** Improper representations and disclosures by a third party may lead customers to misunderstand the actual nature of the product or service. This can result in a belief that the thrift has been a party to a sale made under pressure or through misrepresentation. Thus, the risk is that customers are often not sufficiently sophisticated in matters concerning insurance and investments to recognize, for example, that the interest rate on a fixed-rate annuity is not competitive.

**Misleading advertisements.** Advertisements, for example, should not refer to annuities as “Certificates of Deposit (CDs) offered by an insurance company.” These investments, unlike traditional CDs, are not insured by the FDIC or any other government agency, and should not be represented as being so. Some organizations have signs and use forms to ensure that the customer does not make that assumption. (Refer to the discussion of “Guidance on the Sale of Investment Products” in this Section.)

Third party arrangements should be documented in a written agreement between the service corporation (not the parent thrift) and the third party providing the services. Regulators should review these agreements and the service corporation’s systems to ensure that third parties comply with contractual provisions and safe and sound practices.

Insurance activities, whether conducted directly by a related organization or as a joint venture with a third party, present certain safety and soundness concerns that can affect the parent thrift's exposure to loss. The following section discusses the most common types of insurance activities, their related risks and regulatory concerns.

### Agency Brokerage

An insurance agent represents one or more insurance companies, while a broker represents an individual or an organization seeking coverage. Despite this difference, many of their operations and associated risks are similar. The following discussion refers primarily to agents, but also applies to brokerage operations.

Insurance agents are regulated by state or territory insurance departments. These departments administer qualifying exams to prospective agents, issue licenses, and suspend or revoke the licenses in the event of violation of the state insurance code. State insurance departments also conduct hearings regarding various forms of misconduct, and regulate the business of the agency, sometimes through examinations or audits. The state insurance department is a source that the regulator may consult when reviewing a service corporation's insurance activities.

While a review of state examination reports can be helpful in identifying areas of risk during the pre-examination analysis, the regulator should, nevertheless, conduct the appropriate level of review for evaluating the effect of agency and brokerage activities on the parent thrift. A review of the following aspects of these activities can reveal potential operating weaknesses:

**Trust account balances.** Perhaps the most important element of examining an insurance subsidiary is a review of trust account balances. Regulators should be able to verify that all monies owed to the insurer or insureds are identified in the trust account, and that the account is in balance. Procedures for deposit and payout should be reviewed to determine if they are appropriate. The regulator should also analyze intercompany transactions for reasonableness and the basis upon which the producer (agent) is remunerated.

**Liability to customers.** This is a major area of concern in any agency relationship. An agent has an obligation to provide a customer with products that are best suited to his or her needs. In third party arrangements between a service corporation and an insurance provider, the contract may include a provision whereby the third party assumes such liability. This protects the service corporation as well as the parent thrift from the actions of the third party, and is desirable although not required. In addition to determining whether such contractual protection exists, the regulator may want to consider whether the service corporation carries fidelity insurance in amounts adequate to protect it from inappropriate actions of its employees. Such "errors and omissions" insurance is very desirable, but often not available.

**Premium payment procedures.** When insureds are not directly billed by the insurer, the insurer and the regulator must be alert to the dangers of the agent withholding premium payments for a period of time before forwarding them to the insurer. Inadequate audits and controls have allowed unscrupulous agents to make use of the payment funds for their own purposes, such as placing them in interest-



bearing accounts. On occasion, however, an agent might obtain permission to hold insurer funds, and thereby legally earn interest on the “float.”

**Inadequate controls.** When a review of operations discloses inadequate controls, the regulator should determine the average age of accounts receivable, and whether there are adequate reserves for uncollectables and for charge offs. Problems in collections may be indicated by a high average age of accounts receivable, and frequent carryovers in accounts payable may be an indication of poor management or funding problems.

**Systems for managing the flow of premiums.** When the service corporation/insurance agency acts as a premium collector/remitter, the regulator should take every reasonable measure to ascertain that the agency’s business is being conducted in a sound and legal manner. It would be appropriate to obtain copies of the insurer’s financial statements and recent examination reports to evaluate overall viability and identify any deficiencies in underwriting and claims practices. Care should be taken so that such requests are not perceived as extraordinary measures that could jeopardize the goodwill between the agency and insurer.

The findings revealed in examination reports and records on file with state insurance departments can be helpful in identifying risk inherent in a subsidiary’s insurance activities. Additionally, state insurance departments and insurers represented by the agency can provide information on consumer complaints against the agency, and whether there is any pending action that might affect profitability or the ability to continue insurance operations.

#### *Adequacy of Records and Related Safety and Soundness Concerns.*

The service corporation’s management and board of directors should maintain adequate records and reports with respect to monitoring the entity’s operations and performance. These records should include the following:

**Financial statements.** A review of the agency’s operating statements for the last three years should reveal any material trends. For example, a continually decreasing commission income might be related to area demographics, to increased competition or other factors in the insurance environment, or to poor management.

Weak operating results require further analysis to identify the specific cause of this level of performance. Poor earnings can, for example, be attributable to overstaffing. Generally, each employee should generate sufficient premium volume for an agency to be viable as detailed in the service corporation’s business plan along with estimates pertaining to gross volume. Management should be able to explain substantial variances from projections and any deteriorating trends.

**Insurer soundness.** The insurers represented by the agency are indicators of soundness, and their stability and financial condition reflect the agency’s stability and soundness. The regulator can consult Best’s Ratings, which evaluates underwriting and management considerations, policyholder surplus, and other financial indicators of major insurance carriers. Another source of information is the National Association of Insurance Commissioners’ (NAIC) Insurance Regulatory Information System (IRIS). The IRIS provides ratios relating to an insurer’s operations. While it is true that state guaranty funds

may partially or fully protect an agent from an insurer's insolvency (except for surplus lines), public knowledge of an agent's association with an insolvent insurer can lead to negative publicity and loss of business.

**Representation.** Service corporation insurance agencies usually represent more than one insurer. It is considered healthy for a small agency to represent a minimum of three insurers and for a medium-sized agency to represent from three to six insurers. Representing too few insurers does not allow the agent to offer alternatives. While representing too many insurers increases potential income, it does not allow the agency to represent all insurers effectively.

**Customer base.** The agency's management should analyze the composition of its customer base to identify significant changes. Major changes in the demographic makeup—age, sex, marital status, location—should be related to such factors as area demographic changes, changes in marketing strategy, and so forth. Similarly, renewal rates of policyholders from one year to another should be tracked to determine whether the customer base fluctuates in a manner that places the service corporation at risk of sudden loss of business and, therefore, loss of income.

**Products.** Material variances in the agency's product mix may represent a change in the corporation's strategic objectives or inadequate control over the agency's direction. A newer agency will typically limit its operations to established personal lines such as automobile and homeowners coverages. More experienced and established agencies might become involved in commercial accounts. This might tie into the parent thrift's strategy to embark into commercial lending.

**Account mix.** Some agencies have a few very large accounts that comprise 5% or more of the total revenues. A large number of such accounts or a large proportion of premiums derived from these accounts is a source of concern since it leaves the agency vulnerable to rapid attrition.

### *Objectionable Practices*

Certain acts by insurance agents are considered unethical, and in many states are illegal. The regulator should be alert to such practices. While state regulatory authorities are responsible for discovering and taking action regarding such activities, illegal or unethical behavior can result in an agency being subjected to heavy fines, adverse publicity and even being closed down. The following examples of objectionable practices could potentially subject the parent thrift to economic and legal liabilities:

**Self-dealing.** Controlled business in most states is limited by law or by regulation. It consists of business that an agent sells to oneself, or principally to friends and relatives.

**Misrepresentation.** Misrepresentation occurs when an agent makes statements that are untrue or misleading when describing insurance policy terms. The agent also should not misrepresent the applicant to the insurer.

**Rebates and gifts.** Rebating is the granting of any form of inducement, favor or advantage to the purchaser of insurance when that inducement is not made available to all purchasers. In some states this is a penal offense for both the agent and the person accepting the rebate, and the agent's license

may be suspended or revoked. The agent also must not accept gifts as an inducement to provide insurance protection.

**Twisting practices.** Twisting occurs when an agent induces a policyholder to terminate a policy with one company and to take out a policy with another company when it is not to the insured's benefit to do so. An agent has a responsibility, however, to advise a client to accept another policy if the terms of the new policy are appropriate and more favorable. Thus, insurance should not be sold on the basis of gain to the selling agency, but on the basis of best coverage at the best price with the best service and without regard to commission income.

Untimely and unfair claims distributions. Agents who have claims authority are required to abide by state fair claims practice statutes and regulations. These statutes generally require claims to be paid promptly (generally within a specified time period) and in accordance with the provisions of policy contracts.

## Underwriting

A service corporation that underwrites insurance business is an insurance company. Underwriting involves balancing the quality of a prospective risk with the appropriate rate, terms and conditions. In most types of insurance, rates and surcharge/discount plans are developed by the actuaries, and underwriters apply them to the risks. Underwriters may also seek modification to the risk, such as with increased deductibles or lower limits of liability, in an effort to produce better-than-average loss ratios by requiring the insured to assume a greater part of the risk.

An integral part of underwriting involves monitoring the risk on an ongoing basis. This might involve a policy file review subsequent to losses of a certain magnitude, or an occasional review of various consumer reports, motor vehicle reports, and so forth. A deterioration of the risk may be grounds for cancellation in extreme cases, or nonrenewal when the current policy term expires. Alternatively, the underwriter may choose to apply premium surcharges to a deteriorating risk.

Ownership of an insurer as well as the functions of underwriting are not preapproved service corporation activities. On a case-by-case basis, the OTS has deemed the underwriting function to be a "reasonably related" activity following a review of an application filed by the parent thrift. Therefore, the regulator must determine whether the OTS has authorized the activity in the form of an approval order.

Once established, insurance underwriting operations fall within the jurisdiction of state regulatory authorities. State insurance departments, however, may be unable to perform complete audits and examinations of every domestic insurance company due to resource limitations. Also, states typically do not take responsibility for examining foreign or alien insurers, unless a specific problem is being investigated. The distinctions between domestic, foreign and alien insurers are as follows:

- Domestic insurers are chartered by the state in which they do business;
- Foreign insurers are chartered by another state, but are licensed in the particular state to do business; and

- Alien insurers are chartered outside the United States.

The state responsible for regulating the insurer is the state in which it is chartered. Often, however, state regulators limit their inquiries to reviews of the pricing mechanism, and to the resolution of consumer complaints. Thus, while the OTS should obtain as much information as possible from state regulators, an independent review of the service corporation should be conducted to determine whether it poses any significant risks to the parent thrift. The regulator should also obtain a copy of the insurer's annual public audit.

### *Reviewing Underwriting Practices and Procedures*

Some of the primary areas that are typically addressed in state examination reports are outlined below. Findings revealed through the review of these areas should be considered in evaluating the level of risk presented to the parent thrift.

**Unfair trade practices.** As mentioned above, insurers are expected to live up to professional and ethical standards, often promulgated by law or regulation. Violation of these standards can result in heavy fines as well as adverse publicity. The NAIC has a model Unfair Trade Practices Act that has been adopted in part or in whole by many states. The Act, for example, prohibits terminating coverage due solely to an insured's mental or physical impairment. All states generally require that the insured be given written notice before a policy is canceled or non-renewed. State laws often specify the amount of time and the form of the notice, and even the class of mail to be used.

Among other issues, the Act considers it an unfair trade practice for an agent or other producer to rebate part of the sales commission to the applicant, and places severe restrictions on various types of discrimination. The concept of underwriting implies discrimination in the selection of insureds. Underwriting involves grouping people, businesses and properties into like classes. While it is important for an insurer to identify those likely to suffer losses and to charge a premium commensurate with the loss potential, an insurer must not discriminate unfairly.

Unfair discrimination involves applying different standards to people or groups who have the same potential for loss. The laws of most states specifically identify, define as unfair, and prohibit discrimination, on the basis of age, sex, marital status, occupation, physical impairment, location (this is called "redlining"), blindness, and other factors. The regulator may review a sampling of rejected applications to ensure that they are not refused on the basis of unfair discrimination.

While the insurer must not discriminate unfairly against applicants or insureds, the company has an obligation to its owners for adhering to its published guidelines with few exceptions. An insurer that is too liberal or non-selective in placing business on the books will eventually suffer excessive underwriting losses. Consequently, the regulator's review of state examination reports may indicate whether exceptions to underwriting guidelines are being made for valid reasons.

**Unfair claims practices.** Most states have adopted legislation or regulations prohibiting insurers from participating in unfair claims practices. Many of these are based on the NAIC's Model Fair Claims Practices Act that identifies certain activities an insurer should not participate in. The Act, which has been adopted at least in part by many states, requires insurers to acknowledge receipt of a claim within

a specified number of days following a receipt of notification. It requires insurers to respond to a claimant within a reasonable time as to whether the claim is to be honored or denied. It also considers it an unfair practice for an insurer to settle a claim for less than what “a reasonable man” would consider appropriate under the circumstances. An insurer, however, cannot afford to interpret insurance contracts too liberally such that the insured benefits beyond the loss experienced and covered under the policy.

**Pricing.** In pricing, it is also important that the insurer adhere to state laws. For example, a number of states have enacted “unisex” legislation such that insurers may not charge different rates for males and females. Furthermore, any surcharges, discounts, debits or credits should be applied in accordance with a state-approved rating structure. Rate filings with the state insurance authorities should be based on sound statistical evidence that clearly indicates the need for premium increases or decreases.

**Financial condition.** The financial condition of the insurer is of great interest to the regulator. The primary objective of audits conducted by state regulators is to determine the solvency of the insurer. The IRIS, maintained by the NAIC, monitors and identifies insurers that are in or approaching financial trouble. It computes ratios based on data from the insurers’ financial statements to assess operations (i.e., liquidity, solvency, profitability, reserve and surplus levels).

When reviewing financial records, the regulator should verify that funds are not being infused from the parent thrift or an affiliate to support an ailing insurance operation. Yet, such funds may be necessary to keep the operation viable so as to facilitate a sale.

**Accounting issues.** Insurers use the statutory accounting system, rather than Generally Accepted Accounting Principles (GAAP) for most purposes. For insurance companies, solvency is defined through Statutory Accounting Principles (SAP) rather than through GAAP. The statutory method is more conservative than GAAP in that its objective is to promote the solvency of insurers. Insurers view profitability or loss from two perspectives: (1) from underwriting operations (pure insurance) and (2) from investments. Insurers should not accept underwriting losses on the assumption that these losses can be more than compensated for through investment profits.

The interpretation of financial statements such as the Annual Statement, the Insurance Expense Exhibit in the Annual Statement and supporting documentation, requires a recognition of at least the major differences between GAAP and statutory accounting. Since SAP will vary among states, state insurance departments can be contacted for determining the differences between SAP and GAAP.

## Reinsurance

As individuals and businesses purchase insurance to protect themselves from the consequences of loss, so do insurers. The product they purchase is reinsurance which, in effect, is the sharing of risk by the primary insurance company with other insurers. The company accepting the exposure is the reinsurer. Thus, reinsurance is insurance for insurers. Reinsurers are primary insurers, but there is no specific license that they must obtain.

Traditionally, reinsurance has not been regulated as strictly by the states as has primary insurance. One major reason for this is that often the customers of the primary insurer are less sophisticated with

regard to insurance, and can be taken advantage of rather easily. Insurers, however, are better able to determine for themselves what their needs and risks are, and how to handle them.

As with primary insurance, laws regulating reinsurance vary widely between the states, particularly with regard to foreign or alien companies, as well as nonadmitted (not licensed) companies. In some states, reinsurance by nonadmitted companies is prohibited, while in others such arrangements are allowed, but restrictions are generally placed on reserves or operations.

Reinsurance as a business venture may be of interest to service corporations for the following reasons:

- Reinsurance offers a valuable service to primary insurers and a ready market for the product exists;
- As a consequence of a generally less restrictive regulatory environment, reinsurance offers service corporations a way of participating in underwriting activities without having to bear the expense of purchasing or forming a primary insurance operation;
- The nature of the business is such that it can be entered on a limited basis and can grow as expertise in particular markets is developed; and
- A captive reinsurance company can be an organization formed solely to provide reinsurance services to a controlled group of organizations. As such, it allows the benefits of insurance company activities without the expenses associated with a complete insurance operation.

Reinsurance is not a preapproved activity under 12 CFR § 575.74(c). For a service corporation to engage in reinsurance operations, the parent thrift must apply to the OTS for prior approval. On a case-by-case basis, the OTS has approved reinsurance operations as reasonably related to the financial operations of thrifts. For example, a service corporation has been permitted to underwrite, as a reinsurer, life and disability insurance policies that are directly related to the extension of credit by the service corporation or the parent thrift. OTS approval orders, however, often establish operating restrictions and limit the business to certain insurance carriers.

In addition to the benefits described above, there are a number of potential risks that may be inherent in reinsurance operations. Since the reinsurer is further removed from the subject of insurance, losses can be difficult to determine or predict. An insurer will often reinsure a policy or a block of business knowing that the chance of substantial loss is high. Thus, the risk falls upon the reinsurer, who must be alert to the possibility of higher than average loss when determining acceptability and appropriate premiums. In technical areas, this requires the use of very specialized personnel on the part of the reinsurer.

Occasionally, reinsurance market transactions can become so complex that a primary reinsurer will not be aware that it is holding a portion of a given risk more than once, in several layers. This can be true in coverage for space satellites, for example, where a reinsurer may transfer a portion of a risk, and a portion of that same risk is transferred back in another package. A company making such transfers to a captive reinsurance company may not get credit for reinsurance at the time of a loss, because the notification of a loss may not come for years after the loss occurs.

While the foregoing risks are real and must be considered, they affect primarily large reinsurance operations. Reinsurance is an international business and the complexity of reinsured risk on top of reinsured risk in the international marketplace can be staggering. Most reinsurance transactions that involve service corporations, however, are considerably simpler and narrower in scope than those in international markets.

### Premium Financing

The premium financing business is a natural one for service corporations that are affiliated with an insurance agency or brokerage because of the synergy that exists between the two businesses. Premium financing allows persons who otherwise could not afford it to purchase insurance. This is accomplished by spreading premium payments over a longer period of time which allows the agent to sell more insurance. Premium financing is typically used in such lines as non-standard auto insurance, where premiums are high for young drivers or other persons with questionable driving records. Premium financing can also be used effectively with many other types of insurance. This does not suggest that the practice is without risk.

Premium financing is regulated at the state level by the insurance department or by the department of finance or commerce. While applicable laws and regulations vary among states, certain states may not have premium financing laws. A service corporation's interests as a premium financing lender would not be protected by statute or regulation in these states. In creating premium finance statutes, state legislatures usually attempt to meet the objective of a better insured public while protecting society from hazardous lending practices.

Financing of insurance policies must be approved rapidly because insurers require premiums to be paid at policy inception. This results in a system that does not require credit approval. Statutes allow the premium finance company to write the contract without prior credit approval because the ultimate user (the insurance company) must act in a prescribed manner if the insured defaults. In such cases, the insurer must cancel the insurance policy and return unearned premiums to the finance company. The lender retains the unearned premium, the earned portion of the finance charge, a late charge and a cancellation charge. This protects the interests of the lender. [Note: Premium finance interest rates and related charges (i.e., late or cancellation) are generally controlled by the states.]

If a borrower gives a premium payment to an agent, the law of agency stipulates that the effect is as if the money had been given to the insurer. Should the agent disappear, the premium finance company is protected by law and must be indemnified (paid) by the insurer. This protection does not exist when the agency and premium finance company are jointly owned.

### *General Areas of Risk*

Premium finance companies face numerous risks against which they must establish safeguards. Some of the major areas of potential risk include:

**Fraud.** This is a major area of risk and measures should be taken to guard against it. While fraud is often perpetrated by only one individual, such as the insurance agent, occasionally there is collusion with a borrower.

Agents may, under the law or otherwise, be authorized to sign the finance agreement on behalf of the borrower/insured which leads to numerous opportunities for fraud. A common ploy has been for the agent to give the finance company a wrong mailing address for the insured, particularly a post office box. Another common ploy is for an agent to use fictitious insured names.

**Hazard associated with customer profile.** Premium financing entails risk because it involves lending funds to individuals who otherwise cannot afford to pay their insurance premiums. Therefore, the regulator should review the financing company's lending guidelines and consistency in applying these standards.

**Insolvency of the insurer.** This situation occurs infrequently, since the financial condition of insurers is closely monitored to protect the public. Further, the premium finance company is protected by the various state guaranty funds to the extent that the funds cover unearned premiums. The risk to the premium finance company is that in the event of insurer insolvency, the company will end up holding unsecured paper.

### *Safeguards for Minimizing Loan Losses*

A premium finance company faces the potential for loan losses and should establish guidelines to guard against such risk. These guidelines should include standards for determining down payment amounts that adequately reflect the level of risk involved.

The service corporation's management should be able to demonstrate that the standards, at a minimum, take into account industry practices and "rules of thumb" regarding specific types of risk in this area. The following are examples of safeguards to be considered:

**Cancellation risks.** Typically, an insurer will cancel a policy on a pro rata basis, and some states require them to do so. If a policy can be canceled on a short-rate basis, the premium finance company should require a greater down payment. Similarly, if a third party, such as a lienholder on an automobile, is listed on the policy, additional notice must be given to the lienholder. In these cases, the lender should also require a greater down payment.

**Auditable premium policies.** On an auditable premium policy, the lender should generally require at least a 30% down payment; more if the case is deemed riskier. An auditable premium policy is one where the deposit premium is not the annual premium, rather it is determined by an audit of the actual results. This is the case with workers' compensation insurance. These policies are not collateralized, and the premium finance company should not finance such a policy unless it is collateralized with a payment guarantee bond.

**Seasonal business policies.** Financing policies on seasonal business generally involves insurance policies with shorter terms. The premium financer should develop a system to recognize that the equity reflects a shorter earning period.

**Minimum earned premium policies.** When a policy states that no matter when it is canceled, there is a minimum earned premium (stated as a dollar amount or a percentage of the total premium), the



minimum down payment should be the minimum premium plus an appropriate percentage of the total annual premium. This is often the case with workers' compensation, and excess and surplus lines.

**Non-financeable policies.** Policies that are essentially non-financeable should not be accepted as collateral by the lender. These include bonds, event policies (i.e., policies covering a fund-raising bazaar), policies underwritten by non-insurance companies, and life insurance policies (if a life insurance policy is canceled, no premium is returned). Horse mortality insurance is another non-financeable policy. The premium finance company should be named as loss payee in the first position. Otherwise, should the horse meet an early demise, there is no reason to pay the insurance, and the premium is fully earned.

To facilitate the regulator's review of the service corporation's guidelines, management should be able to provide supporting documentation that practices and policies are adequate for minimizing or containing exposure to loss.

## INSURANCE PRODUCTS SOLD THROUGH SERVICE CORPORATIONS

In addition to understanding the aspects of various service corporation insurance activities, the regulator should be aware of certain types of insurance products typically sold through these entities. A thrift's service corporation that has a licensed agency may sell life, health and property insurance products to a variety of audiences, including the thrift and its employees, its customers, the general public and other business entities. [Note: The OTS generally prohibits the sale of private mortgage insurance and directors' and officers' liability insurance.]

The extent to which state-chartered thrifts may own insurance producing service corporations varies by state. Depending on the type of insurance products offered, the service corporation and its agents must have a valid life insurance agent's license or a property/casualty license. Service corporations often sell one or more of the insurance products discussed below.

### Mortgage Life, Disability and Unemployment

These policies either make payments for a specified period of time or provide a lump-sum payment depending on the terms of the contract. Term life insurance, for example, is often used in conjunction with a home mortgage. Such a policy expires when a mortgage is paid off and offers protection to a surviving spouse or other dependent. On the other hand, disability insurance is designed to replace a portion of a worker's income when disabled by a covered cause. Similarly, unemployment insurance provides a portion of income, for a limited period of time, to a policyholder that subsequently becomes unemployed.

### Credit Life on Consumer Loans

These policies pay off consumer loans if the borrower dies before repayment. They are usually offered on a group basis, as in the case of mortgage life, and in some states may be sold by licensed employees of service corporations even if no agency exists. The regulator should verify that management's internal controls serve to ensure compliance with state regulatory limitations and requirements. A federal thrift's

service corporation may offer credit-related life insurance to borrowers and term life to non-borrowers in the absence of contrary state regulation. However, credit life requirements on loans from thrifts should not impair the borrower's freedom of choice as to providers.

### Life Insurance for Savers

The following types of insurance are typically available for savings customers and may be sold in most states by licensed service corporations.

**Term insurance.** Term insurance is often referred to as pure life insurance. It is a basic type of insurance that offers temporary protection and no cash value or savings element. Policies are typically issued for periods of one, five or ten years, or until the insured reaches a certain age. Most term life insurance policies are renewable and convertible. Convertible policies can be exchanged for some form of cash value policy (i.e., whole or universal life insurance) without the insured having to show evidence of insurability.

**Whole life insurance.** As with term insurance, there are a number of forms of whole life insurance. Most types provide lifetime protection to age 100. If the insured is still living at that time, the policy "endows" with the guaranteed cash value equaling the face amount of the policy.

The primary attractions of whole life insurance are that the policy affords life-time protection and that it saves money, while term insurance does not. Whole life policies accumulate cash values. The policy can be surrendered for its cash value or the cash can be borrowed under the policy's loan provisions. Generally, premiums for these policies are level throughout the life of the policy.

**Universal life.** This coverage has overshadowed the traditional whole life policy because the latter offers limited interest rates in its savings component. Universal life has a pure insurance component and a professionally managed investment component. This form of coverage is extremely flexible and complex, and demands a well-trained sales staff.

**Variable life.** This is similar to universal life, except that instead of requiring the cash value portion of the policy to be invested in a portfolio, it may be placed in the insured's choice of stock, bond or money market funds. The policy allows for appreciation of the fund to be tax deferred and pays for part of the insurance with pre-tax dollars. Generally, a security broker's license, as well as an insurance agent's license must be obtained to sell variable life insurance policies.

**Annuities.** These contracts provide for periodic distributions to an annuitant for a specified period or for life. They may be funded with a single premium or with a series of payments. The accumulation of value may be tax deferred, but withdrawals against the tax deferred accumulated value are subject to taxation by the federal government. Also, early withdrawals are typically subject to a penalty. Annuities may be fixed or variable. In most states, an agent must have a security's license to sell variable annuities.

All or part of an annuity may be based on common stock investments, or may be related to such indices as the cost of living index. There is great latitude between various annuities. For example, some income payments are fixed and guaranteed. With other plans, income payments vary with the value of the investment on which they are based. Some plans allow for a combination of the two.

**Deferred compensation programs.** Profit sharing or stock bonus plans allow the employee to defer taking income in cash until a later time, presumably after retirement. Under these plans, the employee's deferred income is not taxed. The deferred income will be taxed at disbursement, but if this is after retirement, taxation will usually be based on a lower income. Under "401(k)" plans, contributions can be withdrawn with no penalty in the event of financial hardship, or when the employee leaves the company. These withdrawals are subject to taxation. An individual retirement account (IRA), however, usually imposes a penalty for early withdrawal. An employee leaving a company sponsoring a plan may roll the money over into another approved 401(k) plan or into an IRA, or keep the money and have it subject to federal taxation.

### Property-Casualty Insurance in General

Automobile and homeowners' policies as well as other forms of property and casualty coverage are commonly sold through insurance agencies.

### Life-Health Insurance in General

Various forms of life and health insurance (medical, hospitalization, physicians' fees) may be sold through service corporation agencies. Health insurance can be grouped into the two broad categories of medical and disability insurance.

### Insurance on the Institution and its Employees

An institution obtains a variety of insurance coverages on its employees and on itself. Such coverages include:

- General liability insurance for the thrift and its employees;
- Hazard insurance on owned property;
- Workers' compensation insurance (if allowed by state law);
- Errors and omissions insurance;
- Directors' and officers' (D&O) liability insurance;
- Life, accident and health insurance for employees; and
- Various types of fidelity coverages.

Many states consider these to be examples of controlled business and, therefore, limit the amount of such business that a service corporation may write.

### Title Insurance

This type of policy is designed to protect lenders or borrowers from defects in real estate titles that are undiscovered at the time the policy was issued. Mortgage lenders often require mortgagors to obtain title insurance to protect the mortgage. Many states, however, preclude lenders' involvement in selling these coverages.

In summary, the insurance products described above are only some of the insurance products available through service corporations. Numerous other products, some of which are very similar to the policies described above, include (some of these are trade names): mortgage life, credit life, disability and unemployment; accidental death and dismemberment; bonus or complementary accidental death; graded benefit life; automatic travel; and travel accident. Several of these products are linked to a client's estate planning and are designed to meet long and middle term needs.

Insurance products must comply with applicable state insurance department requirements. Products such as variable annuities and variable life insurance must also comply with any applicable securities laws and regulations.

### OVERALL RISK ASSESSMENT

In determining the overall risk presented to the parent thrift by a service corporation, the basic aspects of insurance activities and management controls for containing risk, as discussed in this Section, should alert the regulator to potential unsafe and unsound practices to be evaluated during an examination. Given the great number of possible forms of organization and the manner in which service corporations may wish to provide coverages and services, the discussion has necessarily focused on general activities (i.e., agency, brokerage, underwriting, premium financing) and various risks that can increase the parent thrift's potential exposure to loss.

While the procedures that follow relate primarily to the insurance function, the regulator should also address general business concerns and the areas of review detailed in [Handbook Section 730](#). The extent to which individual procedures are performed will depend on a number of factors, including the specific type of insurance operations (i.e., agency, underwriting, reinsurance), the specific product(s) offered, size of business, date of last state regulatory review, and those factors described in the Overview Section, especially the materiality of the parent thrift's service corporation investment.

### REFERENCES

#### United States Code (12 USC)

##### *Home Owners' Loan Act*

§ 1464(c)                      Loans and Investments

## *Federal Deposit Insurance Act*

§ 1828(m)            Activities of Thrifts and Subsidiaries

§ 1831(e)            Activities of Savings Associations

## Code of Federal Regulations (12 CFR)

### *FDIC Rules and Regulations*

§ 303.13(d)        Equity Investments

§ 303.13(f)        Notice of Acquisition or Establishment of a Subsidiary or the Conduct of New Activities Through a Subsidiary

§ 303.13(g)        Notice by Federal Associations Conducting Grandfathered Activities

## OTS Rules and Regulations

### *Subchapter A: Organization and Procedures*

§ 516                Application Processing Guidelines and Procedures

§ 516.3             Definitions (Expedited and Standard Treatment)

### *Subchapter C: Regulations of Federal Savings Associations*

§ 545.74            Service Corporations

§ 545.74(c)(6)     Permitted Activities (Other Services)

§ 545.81            Operating Subsidiaries

§ 545.126          Referral of Insurance Business

### *Subchapter D: Regulations Applicable to All Savings Associations*

§ 556.4             Control Over Placing of Hazard Insurance

§ 556.16            Insurance Agencies-Usurpation of Corporate Opportunity

§ 563.35            Tie-in Prohibitions

§ 563.37            General; Operation of a Service Corporation, Liability of Savings Associations for Debt of Service Corporation

§ 563.37(b)        Service Corporation Debt

§ 563.170 Examinations and Audits; Appraisals; Establishment and Maintenance of Records

Part 567 Capital

§ 567.1(h) Eligible Savings Association (Definition)

§ 567.1(i) Equity Investments (Definition)

§ 567.1(aa) Subsidiary (Definition)

§ 567.9(c) Deductions from Capital (Investments in Nonincludable Subsidiaries)

§ 571.21 Maintenance of Separate Corporate Identities

## Office of Thrift Supervision Bulletin

TB 23-2 Interagency Statement on Retail Sales of Nondeposit Investment Products