

**AN OVERVIEW OF
DEBT CANCELLATION AGREEMENTS
AND
THE OPPORTUNITY
FOR
FINANCIAL INSTITUTIONS**

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DESCRIPTION

at is debt cancellation or debt deferment?

- Debt cancellation contracts or debt cancellation agreements ("DCCs/DCAs") are just as the name implies. Under a debt cancellation agreement, a creditor will cancel or discharge a debtor's indebtedness upon the occurrence of certain events. Current products in the marketplace protect against the more traditional events - life and disability, involuntary unemployment, and family leave protection. Products are currently being developed to protect against disability, LTC, ADAD and loss of collateral.

- Death or Dismemberment Protection cancels the amount due on the date of death or dismemberment. Certain conditions may be added, e.g. suicide exclusions.
- Disability or Unemployment Protection cancels or defers payment of the amount due on the date of disability or unemployment, or after a specified waiting period (e.g. 30 days) thereof.
- Family Leave Protection cancels or defers the amount due during the period of an unpaid approved family leave, typically after a specified waiting period (e.g. 30 days). Leave must be taken in accordance with Federal Family Leave Act.
- Loss of Collateral Protection cancels the amount due against which the lender has a security interest in the event of the loss of collateral securing the loan for certain specified events, i.e. theft, destruction, etc.
- In order to finance the debt cancellation losses, the creditor may incur the fee as part of its administrative expenses or internal rate of return, or alternatively, impose an additional charge to the consumer when making a loan. The inclusion of the debt cancellation payments in the customers' monthly payments has Regulation Z implications. The funds collected are used to create reserves to cover the creditor's interest in the loan should the indebtedness be reduced, deferred, or canceled by a contingency enumerated within the contract prior to repayment.
- From the creditor's perspective, the primary purpose of a debt cancellation agreement is to protect the creditor from the risk of a loan loss caused by the occurrence of a contingency that is covered under the contract in which the creditor otherwise bears as part of the loan transaction. Should such a contingency occur, debt cancellation coverage will provide for the cancellation of all or part of the debtor's liability for, with respect to collateral replacement coverage, the value of the collateral securing the obligation, or in the event of loss of life, health or income, or in case of an accident, for the amount of the indebtedness.
- The ability of the creditor to offer DCAs resides in national banking legislation that created certain inherent powers of banks and other federally chartered lending organizations. Protecting the lender from the contractual events is a lawful exercise of the inherent powers of a national bank and is a necessary function of the business of banking. Subsequent case law supports this ability.
- The cost of a debt cancellation or debt deferment program is expected to be less than traditional credit insurance charges for numerous reasons, including simpler and uniform disclosure requirements, greater ability to customize programs to specific consumer base, and removal of third party credit insurance expense.
- *Freeze or Froze or Deferment.* A variance to debt cancellation agreements is debt deferment or suspension products. These products do not cancel the indebtedness, but rather freeze the obligation during the existence of a protected event. That is, upon the occurrence of a protected event, e.g. a disability, no monthly payment will be due; no finance, late or other charge will accrue; no monthly suspension fee will be due; and the lender will not send any negative report to any credit agency due to the freeze. During the freeze, the cardholder will not be permitted to use the credit card for additional charges. Once the freeze expires, the credit card account will be reactivated and the cardholder will again be required to make the monthly payments.
- Guaranteed Auto Protection Plans ("GAP") are among the most common forms of debt cancellation agreements. Under a GAP plan, a vehicle purchaser pays an additional charge in exchange for which the creditor agrees not to hold the purchaser liable for the difference between the balance on the debt and the benefit paid under an automobile physical damage insurance policy in the event that the vehicle is totaled or stolen. Under Regulation Z, lenders may exclude the cost from the finance charge provided the requirements of 12 C.F.R. 226.4(d)(3) are satisfied. Those requirements as applied to new vehicle purchases are: (1) the purchase of the GAP Plan (the debt cancellation agreement) was not a condition to obtain a loan, lease, or specified finance terms; (2) the purchase of the GAP coverage was voluntary; and (3) the purchaser has acknowledged in writing that the purchase price and all program details were disclosed. These same requirements, as described in detail below, apply to all forms of debt cancellation agreements in order to be able to exclude the debt cancellation fees from the calculation of the finance charges.

BRIEF HISTORY

A. SUMMARY

Debt cancellation agreements were first authorized by the Office of the Comptroller of Currency ("OCC") in 1964. On March 10, 1964, the OCC issued a Private Letter Ruling stating that, "The use of debt cancellation agreements, the imposition of an additional charge, and the establishment of reserves as protection against losses arising out of such contracts is a lawful exercise of the powers of a National Bank. The exercise of such powers is necessary to and is a part of the business of banking." This letter ruling was subsequently codified in 12 CFR § 7.7495, currently § 7.1013.

Since 1964, the OCC has repeatedly stated its position that national banks may offer debt cancellation or deferment products as being integral to the bank's lending authority. Specific OCC and other regulatory positions are discussed in detail below in Section IV. Most recently, Congress passed the Gramm-Leach-Bliley Act that provides that the prohibition on national banks and their subsidiaries against providing insurance in a State as principal does not apply to "authorized products." The definition of "authorized products" includes products which, as of January 1, 1999, the Comptroller of the Currency had determined in writing national banks may provide as principal, or that national banks were in fact lawfully providing such product as principal¹. Both debt cancellation and debt deferment/suspension products were among the products the OCC had determined in writing that could be lawfully provided by banks as the principal prior to 1999.

The need for debt cancellation agreements continues to grow. In 1995, total consumer credit outstanding climbed past the \$1 trillion mark, and as of June 2000 stood at approximately \$1.465 trillion². From June 1999 to June 2000, total consumer credit outstanding grew 8.7%³. Total Revolving Credit Outstanding from June 1999 to June 2000 grew 9.3%, while personal income only grew at 6.2%⁴. As the demand for loans and consumer credit increases, creditors will tighten their standards, or, as an alternative, implement debt cancellation programs to alleviate some of the pressure on the tightening standards. Even assuming that a market correction is inevitable, and its likely impact on consumer debt, the debt cancellation marketplace permits some cushion for banks and lenders to be built into a downward correction via administrative fees, particularly those which can be fixed.

Interested parties may track these statistics and economic data at the Federal Reserve Board of St. Louis web site at <http://www.stls.frb.org/fred/>.

The following entities are the most likely lenders to be offering debt cancellation products.

- Banks issuing credit cards
- Banks/Finance companies issuing consumer debt
- Merchants with credit card programs
- Automobile dealers
- Equity lenders
- Credit unions
- Thrift institutions

B. DIFFERENCES BETWEEN CREDIT INSURANCE AND DEBT CANCELLATION/DEBT DEFERMENT PRODUCTS

1. INTRODUCTION

Credit insurance and debt cancellation products are similar in that they both protect against the creditor's risk in the loan transaction, and protect the debtor's credit rating in the event of the occurrence of a protected event, e.g. death of the debtor. However, unlike credit insurance, debt cancellation is an integral part of the loan transaction and is considered to actually be part of the loan agreement via an addendum thereto. In that the offering of debt cancellation agreements is within the bank's lending authority, an insurance company involvement is not required. However, the bank must offer debt cancellation agreements in a safe and fiscally sound manner, i.e. by the independent establishment of adequate reserves necessary to forgive the indebtedness.

Given the above distinction between DCAs and credit insurance products, the terminology is different. Attached as Exhibit A is a chart highlighting these differences.

2. ADVANTAGES AND DISADVANTAGES TO ISSUERS OF DEBT CANCELLATION AGREEMENTS IN COMPARISON TO CREDIT INSURANCE PROGRAMS

a. ADVANTAGES

1. Debt cancellation agreements are not insurance.
 - i. Uniformity/single product is possible for rates and forms (i.e. no state variations required).
 - ii. Licensing as an insurance agent not required.
 - iii. Insurance company involvement not required.
 - iv. Filing of forms with state insurance departments not required.
 - v. No current formal government approval process regarding development or issuance of debt cancellation agreements⁵.

2. Part of the loan transaction/not a separate transaction.
 - i. Added as an Addendum to loan agreement.
 - ii. Reg Z disclosures required to be followed.
 - iii. Greater latitude on benefit design.

b. DISADVANTAGES

1. Bank must establish reserves.
2. Lack of claim administration experience.
3. Need for additional accounting and tracking programs.
4. Bank is financially responsible for debt cancellation liabilities.
5. Loss of compensation structure via commission income and/or royalties for customer lists.
6. Creditor's financial liability at risk.
7. Loss of separation/buffer between insurance claims structure and creditor.
8. Requires use of bank capital to establish reserves for bank losses.
 - o Cost of Working Capital v. Invested funds.
 - o Capital v. Operating Capital.
9. Lack of actuarial/insurance principles as the justification for age and other underwriting standards.
10. Current ambiguity regarding tax consequences of discharge of indebtedness.

. LEGAL AUTHORITY FOR DEBT CANCELLATION PRODUCTS

Authority of national banks to offer debt cancellation agreements ("DCAs") is clearly stated in numerous cases and OCC opinion letters and, and most recently, in Gramm-Leach-Bliley Act ("GLBA").

FEDERAL REGULATORY OPINIONS

I. OCC

With respect to DCAs, the United States Comptroller of Currency ("Comptroller") has promulgated a regulation that states:

A national bank may provide for losses arising from cancellation of outstanding loans upon the death of borrowers. *The imposition of an additional charge and the establishment of necessary reserves in order to enable the bank to enter into such DCAs are a lawful exercise of the powers of a national bank and necessary to the business of banking.*

12 C.F.R. § 7.1013 (emphasis added).

Consequently, the Comptroller has declared that the issuance of DCAs is within the powers of a national bank and "necessary to the business of banking." Thus, a bank's issuance of DCAs is not "insurance" for purposes of Section 92 of the National Bank Act.

Numerous written opinions have been issued by the OCC prior to January 1, 1999, that clearly permit national banks to provide DCAs as principal. Pursuant to OCC Interpretative Letter 640, dated January 7, 1994, the Comptroller of the Currency provides that "pursuant to 12 U.S.C. § 24(Seventh), national banks may offer DCAs that cancel debt upon a borrower's disability and/or unemployment, as well as a borrower's death." Further, in this letter the Comptroller states that, while Interpretive Ruling 7.7495, 12 C.F.R. § 7.7495 only addresses DCAs that cancel debt upon the death of the debtor, the same rationale underlying the ruling that DCAs are incidental to a bank's express loan-making authority would apply to DCAs involving the borrower's disability or unemployment. Therefore, DCAs that protect against death, disability, or unemployment are clearly permitted.

Other events may also be protected against. In OCC Interpretative Letter 827, dated April 3, 1998, the OCC approved the offering by national banks of debt suspension contracts that would "freeze" the cardholder's account "in the event that the cardholder becomes involuntarily unemployed, is unable to work due to disability, goes on an approved family leave, is hospitalized for more than a specified number of days, or becomes temporarily unable to continue to make payments on the account for certain other reasons;" The Comptroller stated that "like DCAs, a debt suspension agreement helps protect the borrower against the risk of financial hardship in times of adversity. From the bank's perspective, a debt suspension contract provides a mechanism for the bank to manage and obtain compensation for the credit risk that it undertakes in making a loan. Thus, it is a very logical outgrowth of the bank's express lending authority." (emphasis added). Not only does this opinion specifically authorize debt suspension and DCAs that protect against events other than death, disability or unemployment, but it also confirms that the OCC views any debt suspension or DCA product that protects against the credit risk undertaken by banks in making a loan, regardless of the event, as an inherent part of a bank's express authority to make loans.

2. OFFICE OF THRIFT SUPERVISION

The Office of Thrift Supervision ("OTS") regulates Federal Savings Associations and, in the past, the Chief Counsel for the OTS has specifically authorized the offering of debt cancellation agreements as within the authority of the Federal Savings Associations' power. On September 15, 1993, the OTS specifically stated that Federal Savings Associations have authority to include debt cancellation agreements in their consumer loan contracts⁶. On December 18, 1995, the OTS reaffirmed this opinion and provided that Federal Savings Associations may offer debt cancellation clauses in the loan contracts directly without utilizing an operating subsidiary⁷.

In the 1993 Opinion, the Acting Chief Counsel's opinion is based on the assumption that reserve levels will be determined on the basis of conventional actuarial analysis so as to not subject the Federal Savings Association to solvency concerns⁸. As indicated above, the 1995 OTS Opinion further provides that in order for a Federal Savings Association to offer debt cancellation agreements, it must either obtain insurance to cover its risk of loss or establish reasonable actuarial reserves or some combination of reserves and insurance⁹.

The 1993 Opinion also states:

We also wish to emphasize that Federal Savings Associations that initiate debt cancellation programs must do so in a safe and sound manner. These programs will be reviewed during examinations to confirm, inter alia, that savings associations have adequate management expertise to support the scope of the programs being offered and that adequate reserves are being maintained¹⁰.

Thus, in addition to the reserve requirement, the Federal Savings Association must have proper management expertise in place. Logically, if the risks inherent in the debt cancellation agreements are insured through a sound insurance company through a contractual liability policy, the management of the insurance company may be relied upon for at least some of the necessary expertise.

Finally, the OTS provides that if a separate fee is charged to the borrowers for the debt cancellation agreements, then the coverage must be voluntary and cites Regulation Z (12 C.F.R. 226 et. seq.) for necessary disclosures. These disclosure requirements are discussed in greater detail in Section V. below.

3. NATIONAL CREDIT UNION ADMINISTRATION

In response to an inquiry from an insurance company, the National Credit Union Administration ("NCUA") issued a letter dated September 12, 1997, stating the following:

As long as a federal credit union ("FCU") is not engaged in a form of self insurance as discussed below, it is our opinion that debt cancellation agreements or GAP Waivers are not insurance products and an FCU may use them.

The NCUA further states:

An FCU cannot sell a debt cancellation agreement under a GAP program in which the FCU, in reality, is engaged in a form of self-insurance. Self-insurance is defined as a "plan in which the insured (e.g. business) places aside in a fund sufficient sums to cover liability losses that may be sustained." BLACK'S LAW DICTIONARY 806 (6th ed. 1990). An FCU would be engaged in self-insurance if, for vehicles subject to a debt cancellation agreement, the FCU established a special reserve to fund any resulting loan deficiencies instead of purchasing GAP insurance coverage from an insurance vender.

The NCUA then clarifies that it is its opinion that debt cancellation agreements or GAP Waivers are not insurance products, citing *First National Bank of Eastern Arkansas v. Taylor*, 907 F.2d 775, 780 (8th Cir. 1990), *cert. denied*, 498 U.S. 972 (1990). Accordingly, the NCUA states an FCU would not be engaged in the business of insurance by entering into debt cancellation agreements or GAP Waivers with its members.

Following the passage of the Gramm-Leach-Bliley Act and given that the OTS and the OCC have clearly stated that the financial entities within their respective jurisdiction did not need to purchase insurance, but rather could directly establish reserves for the anticipated payments under the debt cancellation agreements, an opinion should be sought from the NCUA regarding its current position on this matter.

Finally, on November 26, 1999, 64 FR 66413-01, the NCUA requested comments on expanding the authority of a FCU to offer group purchasing activities. In this request, the NCUA specially notes how the "incidental powers" of banks have been expanded and, as an example, references the Taylor case regarding DCAs.

CASE LAW

The offering of DCAs by national banks has also been approved in federal court. In *First Nat'l. Bank v. Taylor*, 907 F.2d 775 (8th Cir. 1990), the Eighth Circuit concluded that a bank, engaged in the business of issuing DCAs, was not subject to state insurance regulation. In *Taylor*, First National bank ("FNB") issued DCAs to its consumers with loans of \$10,000 or less. The contracts provided that FNB would cancel the unpaid balance of the loan in the event of the borrower's death, regardless of how the death was caused. Although the customer had to pay an additional charge for the contract, the charge did not vary with the borrower's age or medical condition¹¹.

The *Taylor* court noted that the Comptroller had declared the issuance of DCAs to be an incidental power of banks under the National Bank Act, and further remarked that the Comptroller's view was to be accorded significant deference by the reviewing court:

It is settled that courts should give great weight to any reasonable construction of a regulatory statute adopted by the agency charged with the enforcement of that statute. The Comptroller of the Currency is charged with the enforcement of banking laws to an extent that warrants the invocation of this principle with respect to his deliberative conclusions as to the meaning of these laws. See *First National Bank v. Missouri*, 263 U.S. 640, 658, 68 L. Ed. 486, 44 S. Ct. 213 [1924]; *Clarke v. Securities Indus. Ass'n*, 479 U.S. 388, 403-04, 93 L. Ed. 2d 757, 107 S. Ct. 750 (1987) (quoting *Investment Co. Institute v. Camp*, 401 U.S. 617, 626-27, 28 L. Ed. 2d 367, 91 S. Ct. 1091 (1971)). The Comptroller's determination as to what activities are authorized under the National Bank Act should be sustained if reasonable. See *Clarke*, 479 U.S. at 406, 409.

First Nat'l. Bank v. Taylor, 907 F.2d 775 at 777-778 (8th Cir. 1990).

Having found the issuance of DCAs to be an incidental power of a bank, the *Taylor* court proceeded to address, and reject, the insurance commissioner's argument that said contracts constitute the "business of insurance" under McCarran-Ferguson. In doing so, the court noted that: (1) McCarran-Ferguson was not intended to grant States any regulatory power in excess of that which they possessed prior to the U.S. Supreme Court's decision in *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533, 88 L. Ed. 1440, 64 S. Ct. 1162 (1944); (2) prior to *South-Eastern Underwriters*, the regulation of banks was within the exclusive domain of the federal government; and (3) DCAs differ significantly from traditional contracts of insurance.

Another case relevant to this issue is *Steele v. First Deposit National Bank et al*, (Oct. 1999, AL. Ct. of App.) In that case, which was another DCA case, the courts said:

Generally, where federal law and state law conflict, a federal law preempts a conflicting state law. U.S. Const., art. IV, cl. 2; *American Deposit Corp. v. Schacht*, 84 F.3d 834 (7th Cir. 1996), cert. denied, U.S. 117 S. Ct. 185 (1996).

The plaintiff in the *Steele* case specifically argued that the credit protection offered by the banks was actually insurance and that the DCA was therefore subject to state regulation pursuant to the McCarran-Ferguson Act, 15 U.S.C. § 1012. Although that case involved the offering of DCAs by a national bank, it is important to look at the court's discussion and focus of the issues.

The *Steele* Court looked at three issues: "(1) whether the pertinent sections of [Alabama's insurance code] were enacted 'for the purpose of regulating the business of insurance;' (2) whether [credit protection] is properly considered 'the business of insurance;' and (3) whether the pertinent provisions of the Bank Act 'specifically relate to the business of insurance.'" Citing *American Deposit Corp. v. Schacht*, 84 F.3d 834, 838 (7th 1996).

The court took note of prior case law which provides that the question of whether a product is insurance for the purposes of the McCarran-Ferguson Act is a federal question. Citing *OCC Interpretative Letter No. 623* (May 10, 1993); *Sec. & Exch. Comm'n v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1958); and *First Nat'l Bank of Eastern Arkansas v. Taylor*, 907 F.2d 775, 780, n.8 (8th Cir. 1990). ("[S]tate law defining insurance is not controlling on the issue of whether an activity falls within the 'business of insurance' as that term is used in the McCarran-Ferguson Act.")

After concluding that DCAs did not constitute "the business of insurance," the court then gave great weight to the regulatory authority's determination. In that case, because it was a nationally-chartered bank, the court gave great weight to prior OCC opinions and its interpretation of the National Bank Act:

It is settled that courts should give great weight to any reasonable construction of a regulatory statute adopted by the agency charged with the enforcement of that statute. The Comptroller of the Currency is charged with the enforcement of banking laws to an extent that warrants the invocation of this principle with respect to his deliberative conclusions as to the meaning of these laws. See *First National Bank v. Missouri*, 263 U.S. 640, 658 [44 S. Ct. 213, 215, 68 L. Ed. 486] [1924]; *Clarke v. Securities Industry Ass'n*, 479 U.S. 388, 403-04, 107 S. Ct. 750, 759-60, 93 L. Ed. 2d 757 (1987) (quoting *Investment Co. Institute v. Camp*, 401 U.S. 617, 626-27, 91 S. Ct. 1091, 1097, 28 L. Ed. 2d 367 (1971)). The Comptroller's determination as to what activities are authorized under the National Bank Act should be sustained if reasonable. See *Clarke*, 479 U.S. at 406, 409, 107 S. Ct. at 761, 762. *First Nat'l Bank of Eastern Arkansas v. Taylor*, 907 F.2d 775, 777-78 (8th Cir. 1990) (emphasis added). See also *Smiley v. Citibank* (South Dakota), N.A., 517 U.S. 735, 739 (1996) ("It is our practice to defer to the reasonable judgments of agencies with regard to the meaning of ambiguous terms in statutes that they are charged with administering. . . . [T]hat practice extends to the judgments of the Comptroller of Currency with regard to the meaning of the banking laws.")

GRAMM-LEACH-BLILEY ACT

The Gramm-Leach-Bliley Act, passed by U.S. Congress and signed by the President in November 1999, provides that the prohibition on national banks and their subsidiaries against providing insurance in a state as principal does not apply to "authorized products."¹² The definition of "authorized products" includes products which, as of January 1, 1999, the Comptroller of the Currency had determined in writing national banks may provide as principal, or that national banks were in fact lawfully providing such product as principal. As stated above, not only were banks offering DCAs as principal prior to January 1, 1999, but the OCC clearly authorized the offering of such by banks in writing prior to January 1, 1999, and thus removed the regulation of DCAs from insurance jurisdiction.

STATE OPINIONS

There are numerous state attorneys general and insurance department opinions that the issuance of DCAs constitutes "the business of insurance." However, the question of whether a bank's issuance of DCAs constitutes "the business of insurance" is a matter of federal statutory interpretation. Likewise, the question of whether such activity is incidental to the business of banking raises an issue of federal law. Consequently, the application of state regulations to a bank's activity is, first and foremost, a federal question, to be decided by the federal courts under federal case law. As the federal courts are the proper arbiters of the questions raised, the various opinions of a state's regulatory body may be persuasive authority, but they are not controlling.

Further, opinions of the state government bodies are subject to the general tenets of federalism. Pursuant to the Supremacy Clause, federal law must prevail over any contrary state measure. There are, however, exceptions to this general rule of preemption. In this case, the McCarran-Ferguson Act provides that:

(a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

(b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, *unless such Act specifically relates to the business of insurance*

15 U.S.C. § 1012.

Thus, in order for a state insurance department to have jurisdiction over the offering of DCAs by banks, a court would have to find that the offering of DCAs fell within an area of law expressly reserved to the state insurance agencies. Such a position would have to overcome at least two legal challenges. First, case law expressly provides that the offering of DCAs is not within the "business of insurance." Because credit protection does not constitute the "business of insurance," the McCarran-Ferguson Act does not apply. See *First Nat'l. Bank v. Taylor*, 907 F.2d 775 (8th Cr. 1990); *Steele v. First Deposit National Bank et. al* (Oct. 1999, AL Ct. of App.); *American Deposit Corp. v. Schacht*, 84 F.3d 834, 838 (7th 1996). Second, GLBA specifically relates to the business of insurance and, therefore, removes DCAs from the pre-emption application of McCarran-Ferguson.

Case law has specifically stated that the determination of what constitutes insurance is a federal issue and whether a certain product or business practice constitutes insurance should be decided pursuant to federal law. The United States Supreme Court has expressly held that, in determining what constitutes the business of insurance for purposes of the McCarran-Ferguson Act, "how the States may have ruled is not decisive. For, as we have said, the meaning of 'insurance' and 'annuity' under these Federal Acts is a federal question." *SEC v. Variable Annuity Life Insurance Co.*, 359 U.S. 65, 69, 3 L. Ed. 2d 640, 79 S.Ct. 618 (1959); See also *Manasen v. California Dental Services*, 424 F. Supp. 657 (N.D. Cal. 1976), *rev'd. on other grnds.*, 638 F.2d 1152 (9th Cir. 1979). ("The interpretation of what constitutes the 'business of insurance' as that term is used in the McCarran-Ferguson Act is a federal question and federal interpretations supersede those of state courts.")

In *SEC v. VALIC*, the court, in determining whether or not an insurance company must register with the SEC with respect to the sale of variable annuity contracts, had to determine whether the sale of annuities constituted insurance. If the sale of variable annuity contracts constituted the sale of insurance, then VALIC, acting as an insurance company, was exempt under McCarran-Ferguson from federal regulation requiring SEC registration. The court specifically stated that while states have traditionally regulated the business of insurance, their characterization of particular contracts is not conclusive, since the construction of the exemption provisions of the federal acts (McCarran-Ferguson) presents federal questions. *Id.*, at 68-69.

The court further stated that it "is reluctant to disturb state regulatory schemes that are in actual affect, either by displacing them or superimposing federal requirements on *transactions that are tailored to meet state requirements.*" *Id.* (emphasis added). Thus, whether the transaction in question is subject to state insurance regulation will be determined in part to what extent states have expressly regulated the transaction, thereby causing the transaction to be tailored to meet state regulations. In *SEC v. VALIC*, the court took note of the fact that some states deny "annuity" contracts that have a status of "insurance" and others accept them under their "insurance" statutes. Thus, the court stated that it is apparent that there is no uniformity in the rulings of the states on the nature of "annuity" contracts and, therefore, it cannot be said that states have clearly exercised authority over this area. Consequently, it cannot be said that the transactions in question (annuities) have been tailored to meet state requirements. The *VALIC* court went even further and stated that "[e]ven if a state had experienced regulatory authority, how the states may have ruled is not decisive. For, as we have said, the meaning of 'insurance' or 'annuity' under these federal acts is a federal question." *Id.*

As with the sale of annuities, a review of the states' treatment of DCAs shows an inconsistent and non-uniform pattern of regulation. While some states have indicated that DCAs are considered "insurance," the majority of states have not ruled on the issue, and even other states have clearly taken the opposite position⁴. Thus, as with the treatment of annuities, it cannot be stated that a consistent and uniform state regulatory scheme is in actual affect with respect to the treatment of DCAs. Therefore, it cannot be said that the states have clearly exercised authority over the treatment of DCAs. Consequently, DCAs have not been tailored in the past to meet state requirements, but to the contrary have been developed to be a clear and distinct alternative to credit insurance subject to state regulation. Accordingly, as with the *VALIC* case, a federal court would not be faced with disturbing existing state regulatory schemes over DCAs and, therefore, a court should not be reluctant to subject DCAs, and the offering thereof, to banking regulation as opposed to insurance regulation.

Another case in which the issue of whether an activity is considered the "business of insurance" was determined to be a federal question is *Manasen v. California Dental Services*, 424 F. Supp. 657 (N.D. Cal. 1976), *rev'd. on other grnds.* 638 F.2d 1152 (9th Cir. 1979). In this case, the court recited § 2(b) of McCarran-Ferguson Act, which provides that "federal law may not be construed to invalidate, impair, or supersede any law enacted by any state for the purpose regulating the business of insurance *unless the federal act specifically relates to the business of insurance.*" (emphasis added.) Therefore, the court stated, this section preserved federal jurisdiction over certain specified conduct regardless of whether such activity is also subject to state regulation if the federal act specifically relates to the "business of insurance."

In *Manasen*, the plaintiff argued that the "business of insurance" as that term is used in the McCarran-Ferguson Act is to be defined by state statutes enacted for the purpose of regulating insurance. The court disagreed with the plaintiff and stated that the business of insurance should be defined by reference to federal, not state, law. The court stated, "[t]he interpretation of what constitutes the 'business of insurance,' as that term is used in the McCarran Act, is a federal question and federal interpretations supercede those of state courts." Citing *SEC v. Variable Annuity Life Insurance Company*, 359 U.S. 65, 69, 3L. Ed. 2d 640, 79 S.Ct. 618 (1959); *Fry v. John Hancock Mutual Life Insurance Company*, 355 F. Supp. 1151, 1154(N.D. Tex. 1973). Whether something is in fact "insurance" is a question to be decided solely by federal courts since they alone decide whether the McCarran-Ferguson Act is applicable. Citing 7 Von Kalinowski, *Antitrust Laws and Trade Regulation* P47.02(2)(b) at 4732.

The *Manasen* court took note of the fact that prior cases have provided that it was "of interest, although hardly despositive" that title insurance was regulated under California insurance code¹⁵. Once the practice in question is constituted to be the "business of insurance," then and only then does McCarran-Ferguson Act require that the challenge conduct be regulated under state law (unless a federal act has been enacted specifically to the contrary). *Id.* at 25.

Accordingly, under *Manasen*, a court would first have to reach the conclusion that the practice in question (the offering of DCAs) is considered to be the conducting of the "business of insurance." Case law clearly provides that the offering of DCAs does not constitute the "business of insurance." This would be true whether offered by a state bank or a federal bank. Additionally, as explained below, even if DCAs were considered to be an insurance product, Congress specifically removed the application of McCarran-Ferguson to DCAs with the passage of GLBA.

Clearly, national or federally chartered banks or financial institutions can offer DCAs and, as such, are not within state insurance department jurisdiction. Legal authority also provides the groundwork for support for the offering of DCAs by state-chartered banks outside of state insurance department jurisdiction. That is, it is unlikely that state insurance opinions would overcome or supersede the express federal rulings that DCAs are not insurance products, which is true regardless of whether the offering of DCAs is by a federal or state-chartered financial institution. If state insurance laws are not applicable, jurisdiction with respect to state banks would lie with the state banking authority. Accordingly, state banking laws will govern the offering of such by state-chartered banks, and the activities of the state banks will be governed by the state banking authority and not the insurance commissioner.

As stated above, federal courts must interpret federal law in deciding whether the bank's activities will be deemed the business of insurance rather than the business of banking. Further, the transaction of insurance is considered to be interstate commerce, which again is a federal issue to be decided in federal courts. See *United States v. South-Eastern Underwriters Association*, 322 U.S. 533, 64 S.Ct. 1162, 88 L.Ed/440 (1944), which applied federal antitrust laws to insurance companies engaged in interstate commerce. It should be noted that the *South-Eastern Underwriters* case raised fears that because insurance was now considered interstate commerce, which was within the federal domain, states would no longer have the authority to regulate insurance. For this reason, Congress enacted McCarran-Ferguson. However, McCarran-Ferguson only grants jurisdiction to the states over those laws enacted by Congress that do not specifically relate to insurance. Congress recently passed GLBA which clearly relates to insurance and expressly permits banks to offer DCAs as the principal, not subject to preemption by state insurance laws. This conclusion is supported by *Humana Inc. v. Forsyth*, 525 U.S. 299, at 308, (1999). In *Humana*, the U.S. Supreme Court states that Congress did not, under McCarran-Ferguson, intend to cede the entire field of insurance regulation to the states. Rather, when federal law does not directly conflict with state regulation and when application of the federal law does not frustrate any declared state policy or interfere with a state's administrative regime, McCarran-Ferguson does not apply. Given the non-uniform treatment on DCAs by the states and the express declaration by federal courts that DCAs are not insurance, permitting the offering of DCAs by state-chartered banks, subject to the jurisdiction of the state banking authorities, would not directly conflict with state insurance regulation and clearly would not frustrate any or an uniform declared policy among the states.

In summary, if given the choice of choosing to follow the opinion in *Taylor*, or alternatively adopting the opinions of the states, a federal court will likely follow *Taylor*. First, the states that have expressed an opinion on DCAs largely rested their conclusions by finding that DCAs fit within their respective state definition of insurance. They have not, as *Taylor* and *Steele* have, evaluated DCAs against the meaning of the "business of insurance" under McCarran-Ferguson.

Second, the majority of the states' opinions address DCAs by themselves, and do not attempt to wrestle with the fact that federal regulations authorize a bank to issue DCAs. Thus, the relevancy of many of the states' opinions is further reduced. Although *Taylor* is not controlling in all circuits, a federal court is more likely to turn to a decision of its sister court than rely on the marginally relevant opinions of the state insurance departments or attorneys general offices.

Third, in order to find in favor of state insurance regulation, a court must overcome a number of significant obstacles. In order to find in favor of state insurance regulation, a federal court must find that a bank's issuance of DCAs is, in fact, the "business of insurance." This, in turn, requires the reviewing court to hold that what the Comptroller and some state bank officials¹⁶ have deemed to be the business of banking is actually the "business of insurance." To do so, the court must either invalidate 12 C.F.R. § 7.7495 as being outside the Comptroller's authority, invalidate the banking director's opinions in various states, or alternatively conclude that an overlap exists between the "business of insurance" and the "business of banking." None of these approaches is likely to be embraced.

As noted in *Taylor*, a reviewing court must place "great weight" on the Comptroller's determination of what is authorized by The National Bank Act, and may not invalidate such a regulation unless it is unreasonable. Similar weight would be given to state banking directives. Given the number of seemingly non-banking activities which have historically been upheld, it appears unlikely that a reviewing court would declare the issuance of debt cancellation agreements as not being authorized by The National Bank Act or other states' laws granting similar powers to state-chartered banks.

In addition, finding an "overlap" between the McCarran-Ferguson and the National Bank Act inevitably places subsequent courts on the slippery-slope of delineating where the "overlap" begins and ends, and may nonetheless result in 12 C.F.R. § 7.7495 being declared invalid. Section 92 of the National Bank Act implicitly prohibits a bank from issuing insurance in towns with a population in excess of 5,000 people. To hold that DCAs are both "banking" and "insurance" creates the risk that 12 C.F.R. § 7.7495 impermissibly allows a bank to engage in insurance in contravention of Section 92.

In determining whether a state statute is intended to regulate the "business of insurance," federal cases have also looked at whether the law is one "aimed at protecting or regulating [the] relationship between the insurer and insured, directly or indirectly." See *SEC v. National Securities*, 393 U.S. 453 at 460 (1969). DCAs are issued as part of the banking relationship between the bank and its borrowers with regard to the risk inherent in the loans made by the bank. This risk belongs primarily to the banks. Any regulation by a state to preclude the offering of DCAs cannot be said to be aimed at protecting the relationship between the borrower (as the insured) and the bank (as the insurer) because the bank, and not the borrower, carries the primary risks being protected against.

As further evidence of the legal hurdles a state insurance regulator will have to address in attempting to preclude or otherwise place unreasonable restrictions on a bank's offering of DCAs, it is useful to look at the impact of the recent crop insurance case brought by an insurance group against the Office of the Comptroller ("the crop insurance case")¹⁷. In that case, the agent's group sued the OCC for granting to banks the general marketing authority to sell crop insurance. The court stated that such general agent/marketing authority goes beyond the express powers of The National Bank Act ("NBA") on the same grounds as stated in prior cases. The court continues that the "incidental powers as necessary to carry on the business of banking" do not include the power of banks to allow the *general sale of insurance* under the NBA. 12 U.S.C.A. §§ 24, 92.

The court put a lot of weight on the fact that, unlike credit insurance payable to the bank, crop insurance protects the farmers and does not guarantee repayment to lenders like a traditional security device. Nor is the sale of crop insurance, unlike other activities referenced above, *incidental* to the business of banking, or a new way of transacting traditional banking activities. Rather, the court stated, the sale of crop insurance would permit banks to engage in the general marketing of insurance which is not within the bank's *incidental powers* of The NBA.¹⁹ (emphasis added).

Although the argument can be made that this case restricts the broad granting of insurance authority to banks, it does not go beyond that. That is, this case is primarily a discussion of permissible insurance marketing practices by banks under the NBA and does not impact or affect a bank's ability to provide debt cancellation products to its customers. Further, the case is of little precedential value given the differences in the nature of crop insurance vs. debt cancellation products and, as stated in the case itself, as a result of the passage of the Gramm-Leach-Bliley Act.

In the crop insurance case, the court states that "[n]ational banks, being creatures of statute, possess only those powers conferred upon them by Congress." Citing *Texas & Pac. Ry. Co. v. Pottorff*, 291 U.S. 245, 253, 54 S.Ct. 416, 78 L.Ed. 777 (1934); *First Nat'l Bank of Charlotte v. National Exch. Bank of Baltimore*, 92 U.S. 122, 128, 23 L.Ed. 679 (1875). As part of the power conferred upon banks, the NBA provides that national banks have all such incidental powers as necessary to carry on the business of banking. 12 U.S.C.A. § 24(Seventh). The court then discusses the numerous areas that have been found to be within the incidental powers of the

business of banking on the grounds that the product in question was merely a new way of conducting the very old business of banking. These include the following: leasing of personal property is the functional equivalent of offering a secured loan²⁰, offering municipal bond insurance is the functional equivalent of a standby letter of credit²¹, offering credit insurance as integral to the offering of personal secured loans²², and most importantly, offering debt cancellation agreements as an integral part of the loan transactions²³.

Applying this same analysis to debt cancellation agreements reaches a different conclusion than that reached by the *IIAA* case regarding crop insurance. It is indisputable that the courts, Congress and the OCC have expressly found that (1) debt cancellation products are not considered to be insurance or within the business of insurance, and (2) offering debt cancellation products falls within the incidental powers of banks²⁴. Thus, it is highly improbable that a court today would overrule this clear precedent, which a court would have to do to reach the same conclusion reached in *IIAA v. OCC*. That is, first, the court would have to rule that debt cancellation products are insurance. Second, the court would have to find that expanding the scope of debt cancellation products to include other products, e.g. collateral replacement protection, goes beyond the bank's authority and would actually be considered to be the general marketing of insurance prohibited under NBA and GLBA. Although there is some risk that a court could find that expanding the scope or structure of debt cancellation products beyond death, disability, unemployment, and family leave protection to include new products, e.g. collateral replacement, exceeds the authority granted to banks, it is unlikely that such a position would succeed, particularly with the passage of GLBA.

Unlike crop insurance, debt cancellation collateral replacement products are a logical outgrowth of the authority granted to banks in the OCC opinions, court cases, NBA and, most recently, GLBA. Finally, as with the result in *IIAA v. OCC* case, even if a court were to find that a new type of debt cancellation product constitutes insurance, this issue would be moot given the passage of GLBA that now expressly permits national banks to sell insurance.

It is also fair to apply the above tenets to state law interpretation of state banking laws.

In the matter of *New York State of Life Underwriters, Inc. et al. v. New York State Banking Department, et al.*, 83 N.Y. 2d 353; 6632 N.E. 2d 876 (March 30, 1984), the court discusses the authority of a state bank under a state law which specifically provided for or included in the general powers of a state-chartered commercial bank the ability to "exercise all such incidental powers as shall be necessary to carry on the business of banking." The facts of the case were that New York State Bankers Association requested an opinion from the New York State Banking Department as to whether state-chartered commercial banks had comparable authority to broker financial investment instruments such as annuities under New York state law, as the OCC had found in Interpretive Letters No. 494 and No. 499 for federal banks. The State Banking Department found that such authority existed under New York bank law § 96(1) which includes the ability to "exercise all such incidental powers as shall be necessary to carry on the business of banking." The court concluded that the state-chartered commercial banks had the authority to purchase and sell annuities directly or through a subsidiary. The court further stated that the bank agency's determination that the sale of annuities by state-chartered banks was within its incidental powers of the business of banking was not unreasonable or irrational.

The *New York State of Life Underwriters* case is particularly interesting in that the court gives credence to the fact that the OCC has specifically granted such powers to national banks under federal statutory "incidental powers" language, which is similar to the language found in the New York banking law. The court stated, "it must be cognizant that the business of banking is not static but rather must adjust to meet the needs of customers to whom banking organizations provide a valuable service. Care should be exercised not to cripple banking organizations and break down their usefulness by the narrow and unreasonable construction of the statutes which will result in unwisely limiting their usefulness in the transaction of business under modern conditions." Thus, this case clearly establishes precedent for giving deference to the ability of a state-chartered bank to exercise its "incidental" authority consistent with the interpretation given by federal courts to the exercise by a federal bank of its "incidental" authority under similar statutory language.

Furthermore, numerous states have enacted statutes that give banks parity authority of national banks to permit the state banks to remain competitive with the federal charters²⁵. In general, these laws enable state banks to exercise authority to the same extent as the authority granted by federal regulators and laws to federal banks. These parity or "wild-card" statutes have been relied upon by state-chartered banks to sell insurance to the same extent as national banks do, i.e. in small towns with populations under 5,000 pursuant to Section 92 of The National Bank Act (12U.S.C. 92). Similarly, in such states, clearly the argument exists that state banks have the authority to offer debt cancellation under its *incidental powers* to the same extent that federal banks have that ability. This has recently been found to be true in South Dakota when the South Dakota Banking Director issued a memorandum to the Chief Executive Officers of S.D. chartered banks granting the authority to offer DCAs. (copy attached as [Exhibit D](#)).

Gramm-Leach-Bliley Act also decides this issue in favor of authorizing a state-chartered bank to offer DCAs. The McCarran-

Ferguson Act provides that insurance is to be regulated by the states except when Congress has enacted statutes specifically relating to the business of insurance. Numerous statutes have been enacted by Congress that clearly impact and address the business of insurance, including the Employee Retirement Income Security Act, 29 USC § 101(a), et seq., and the Title III of the Americans With Disabilities Act, 42 USC § 12181, et seq. Most recently, Congress enacted the Gramm-Leach-Bliley Act, PUB. L. No. 106-102 § 103(a), 121, 113 stat. 1338, 1342-50, 1373-81(1999). Numerous sections of the GLBA specifically address the business of insurance, i.e., Congress enlarged bank powers by allowing financial subsidiaries of "well capitalized and well managed" national banks to engage in a wide variety of insurance activities, both as an agent and as a broker. Further, under Title III, Subtitle A, § 302 of Gramm-Leach-Bliley, Congress clearly permits national banks to provide DCAs as an "authorized product" and that such activity is not to be considered the transaction of insurance by a bank as principal. Thus, McCarran-Ferguson does not pre-empt GLBA so as to grant authority over DCAs to the state insurance agencies, but rather the opposite is true.

Another issue related to the offering of DCAs by state-chartered institutions is whether one state may preclude the offering of DCAs by an out-of-state bank whose domicile state has clearly permitted the offering of such. In addition to the reasons set forth above as to why a state attempt would not likely succeed legal challenge, there are other legal grounds that would prohibit a state from prohibiting the offering of DCAs. It is established in case law that state regulation may not impermissibly infringe upon interstate commerce. See *United Waste Systems of Iowa, Inc., v. Wilson*, 189 F.3d 762 (Eighth Circuit 1999); *Pic-A-State, Inc. et al., v. Commonwealth of Pennsylvania*, 42 F.3d 175 (Third Cir. 1994). In *United Waste Systems*, the court provides that "[when] evaluating a challenged regulation that impacts at least incidentally an interstate commerce, a court first must determine if the regulation fosters protectionist discrimination by favoring local businesses over out-of-state companies. 42 F.3d at 767, citing *C.A. Carbone, Inc. v. Town of Charleston*, 511 U.S. 383, 392-94 (1994). If such protectionist discrimination exists, the regulation is per se invalid, save a narrow class of cases in which the [state] can demonstrate, under rigorous scrutiny, that it has no other means to advance a legitimate local interest." *Id.*

Clearly, if a state, e.g. South Dakota, permits its state-chartered banks to offer DCAs but then prohibits an out-of-state bank from offering DCAs to SD residents, it would be engaging in discriminatory protectionism and impermissibly infringing on interstate commerce. The reverse is also true. If another state, particularly one of the 40 which have enacted a parity statute were to prohibit a South Dakota bank from offering DCAs to residents of its state, the state would be impermissibly infringing on interstate commerce. This is even truer if the state otherwise permits the South Dakota bank to offer loans, consumer financing and other banking activities to the residents of the state.

It must be noted that the U.S. Supreme Court has held that McCarran-Ferguson expressly authorized states to regulate the "business of insurance," even if such regulation might burden interstate commerce. *Prudential Ins. Co. v. Benjamin*, 328 U.S. 408, 431 (1946). However, in order for Prudential to be applicable to the offering of DCAs across state lines, a court would first have to find that DCAs fall within the "business of insurance." As stated above, this would be a difficult legal road to take. Second, it can be said that Congress has specifically acted in the area of the transaction of DCAs pursuant to GLBA, which as stated above, specifically authorizes the offering of DCAs by banks as principal. Where Congress has acted in a particular area of interstate commerce, inconsistent state regulation is barred and precluded. *Pic-A-State v. Commonwealth of Pennsylvania*, 42 F.3d 175, at 179 (1994); citing *Cloverleaf Butter Co. v. Patterson*, 315 U.S. 148, 155-56 (1942); *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977); *Pennsylvania v. Nelson*, 350 U.S. 497, 480 (1956); and *Southern Ry. Co. v. Reid*, 222 U.S. 424, 440 (1912).

Finally, since the passage of GLBA, banking associations have specifically requested that the OCC consider whether certain provisions of state insurance laws regulating bank insurance sales are preempted by GLBA. In West Virginia and Massachusetts, the respective banking associations have asked the OCC to preempt insurance laws that, among other things, bar non-licensed bank personnel from referring customers to a licensed agent unless the customer initiates the inquiry, bars non-licensed bank personnel from receiving any compensation for referrals even if the compensation is not conditioned on the sale of insurance, and a waiting-period provision that bars a bank from soliciting insurance in connection with a loan until after the loan has been approved. The basis for the banking associations' position is that the insurance laws go beyond the specific safe harbors set forth in GLBA that protect state insurance laws from preemption. Specifically, the banking association claims that the safe harbors of GLBA only limit compensation to unlicensed personnel if the referral includes a discussion of policy terms and conditions and are based on the purchase of insurance. Further, the banking association alleges that GLBA does not provide a safe harbor for waiting period legislation at all. Insurance agent groups in both states have filed or will file comments with the OCC. It remains to be seen if suits will follow by whichever party does not receive a position from the OCC in its favor.

LEGAL REQUIREMENTS

REGULATORY BODIES

1. *FEDERAL REGULATORS*

a. *OCC*

- Charged with statutory supervision of banking activity (Section and general recitation of what charge is).
- First ruling 1964. Letter ruling stating banks have right to issue debt cancellation agreements on loans issued through the bank in return for a fee and that this practice is incidental to the business of banking. 12 C. F. R. § 7.7495.
- Subsequent rulings: Interpretive Letter # 827, May 1998 12 U.S.C. 24 (7); Interpretive Letter # 749, First National Bank of Eastern Arkansas v. Taylor, 907 F.2d 77t (8th Cir. 1990); 12 C.F.R. § 7.1013. Cert. Denied, 489 U.S. 972 (1990).

b. *OTHER FEDERAL AGENCIES*

- Office of Thrift Supervision
- National Credit Union Administration
- Federal Reserve Board
- Federal Deposit Insurance Corporation

2. *STATE AGENCIES*

- a. State Banking Authority
- b. State Attorney General Office

DISCLOSURE REQUIREMENTS.

1. REG. Z REQUIREMENTS

Regulation Z (Truth in Lending) - 12 C.F.R. Part 226.

Debt cancellation agreements are regulated under Regulation Z (12 C.F.R. 226 et seq.) that implements the Federal Truth In Lending Act (15 U.S.C. 1601 et seq.). The purpose of Regulation Z is "to promote the informed use of consumer credit by requiring disclosures about its terms and costs." 12 C.F.R. 226.1(b). It applies to individuals or businesses that offer to extend credit when all of the following conditions are met: (1) the credit is offered or extended to consumers, (2) the offering or extension of credit is done regularly, (3) the credit is subject to a finance charge or is payable by a written agreement in more than four installments, and (4) the credit is primarily for personal, family, or household purposes. 12 C.F.R. 226.1(c)(1). Please note that certain provisions of Regulation Z are applicable to credit card transactions even where the four requirements are not satisfied. 12 C.F.R. 226.1(c)(2).

As defined in Regulation Z, a finance charge is the cost of consumer credit as a dollar amount and includes any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of the credit. Charges imposed uniformly in both credit and cash transactions are not finance charges²⁶. 12 C.F.R. 226.4(a). Debt cancellation fees are expressly *included* among the examples of finance charges listed in the regulation. They are defined as "[c]harges or premiums paid for debt cancellation coverage written in connection with a credit transaction whether or not the debt cancellation coverage is insurance under applicable law." 12 C.F.R. 226.4(b)(10). However, if certain disclosures are made, debt cancellation fees may be properly excluded from the finance charge.

Under 12 § 226.4(d)(3)(i) charges or fees paid for debt cancellation coverage may be excluded from the finance charge if the following written disclosures are made: (1) the debt cancellation agreement or coverage is not a condition for the extension of credit by the creditor, (2) the fee or premium for the initial term of coverage, and (3) the term of coverage if it is less than the term of the credit transaction. After receiving the disclosures specified above, the consumer must sign or initial a written request for coverage.

It should be noted that for the charges or premiums associated with debt cancellation agreements to be excluded from the finance charge, the enrollment by the borrower must be voluntary.

The comments to 12 C.F.R. 226.4(d)(3) currently indicate that although Regulation Z treats debt cancellation coverage and credit insurance similarly for purposes of cost disclosures, state law will determine whether a creditor may represent that the debt cancellation coverage is insurance or treat such coverage as insurance. Obviously, these comments need to be revisited following the passage of GLBA and in fact, in 2000, the OCC requested comments on its treatment of DCAs. As of October 2000, such comments have not yet been published. Finally, it is arguable that the comments only state that a creditor, *if it wishes to do so*, may represent DCAs as insurance if state law permits such.

2. On February 15, 1995, the OCC, OTS, FRB, and the FDIC, in response to a request and application from the American Bankers' Association, issued the Interagency Statement on Retail Sales of Nondeposit Investment Products ("the Interagency Statement"). Basically the Interagency Statement was issued to provide uniform guidance for the retail sale of nondeposit investment products, e.g. mutual funds and annuities, recommended or sold in the offices of FDIC insured financial institutions. Although not specific to debt cancellation products, guidance can be found by the agencies' requirements regarding the sale of nondeposit investment products. The guidelines require that the sale of these products should be clearly differentiated from insured deposits in a clear and conspicuous manner. If any sales activities include written or oral representations concerning insurance coverage provided by an entity other than the FDIC, then clear and accurate written or oral explanations of the coverages must also be provided to customers. Thus, with respect to DCAs, it should be made clear to the consumers that the protection payments provided under the DCA are not FDIC insured.

. ADMINISTRATIVE ISSUES

Before implementing or transferring to a DCA program, the Lender must consider the issues related to offering DCAs. For example, the Lender must consider its capability and capacity to perform the following tasks:

- Assess demographics of debtors, including market potential, market actual, and payment patterns.
- Skills to market program to debtors.
- Reports and information development.
- Underwriting expertise, including capability to determine if risks are consistent with projected actuarial/risk. For example, one state bank department has promulgated rules requiring banks to establish a reasonable reserve based on a five year average of mortality losses experienced with past credit life insurance underwriters or other such method deemed acceptable by the State Bank Commissioner. The reserves shall be evaluated at least quarterly for adequacy, and records supporting the justification for the reserve balance shall be maintained for examiner inspection. The sale of debt cancellation agreements cannot be a condition to the approval of a loan application and should be offered along with similar products that may be available from other sources. In the event that the debt cancellation agreement is negotiated with the provision that a rebate will be made to the customer if the note is paid in full prior to maturity, the fee income shall be periodically recognized in proportion to the bank's performance under the contract. The bank's performance under the contract is the coverage of the risk associated with each contract. Thus, for those contracts in which the coverage is provided evenly during the term of the contract period, the income should be recognized evenly during their term of the contract. In the event the amount of coverage of the contract declines during the term of the contract, the fee should be recognized in proportion to the coverage during the term of the contract. Without rebate, all fees generated from the sale of the debt cancellation agreements shall be posted to non-interest bearing income. See *AK, Banking Department Examination Manual, Policy Number - 92-3, 5/5/92*.
- Ability to clearly disclose the costs of debt cancellation agreements, as stated above, is subject to Section 226.4 of Reg Z. The disclosure is required to avoid inclusion of the debt cancellation charges in the finance rate charged by the lender in the subject loan. Ø New product development. Ø Pricing calculation and determination of need for and amount of sufficient reserves. Ø Administer program to determine acceptable loss development. Ø Comply with general unfair trade practice acts and requirements of controlling regulatory agencies. Ø Claim processing and administration.

With respect to lenders who are currently offering credit insurance coverages, the following issues must be considered when converting to a debt cancellation program.

- Proper cancellation procedure of existing relationship with credit insurer under master policies and agreements.
- Credit products typically have 30-day cancellation provisions to debtors.
- Preparation of DCA.
- Preparation of marketing material.
- Use of skill and creative marketing personnel and testing to determine best approach to maximize potential. Create effect brand image of

- product/lender.
- Preparation of tax information. Send out 1099's for forgiveness of debt.
- Training of bank staff. Use of existing personnel with extensive experience to train bank personnel in how to create need, penetrate customer base, and administer program.
- Legal sign off.

I. OTHER ISSUES.

A. TAX CONSEQUENCES TO DEBTORS

The amount paid or used to discharge an indebtedness by the financial lender must be reported to the IRS. However, whether the amount must be included in the borrower's gross income depends on a number of factors.

Pursuant to 26 U.S.C. § 6050P(a), financial entities must report the discharge of indebtedness greater than \$600.00 to the I.R.S., regardless of whether the amount must be included in the borrower's gross income. In determining whether the borrower must include the amount discharged, the general rule is yes. 26 U.S.C. § 61 defines gross income as all income from whatever source derived, including but not limited to, income from the discharge of indebtedness. However, in evaluating the above issue, it is important to note that the answer may vary based on each type of coverage. Also, it is arguable that because the debt cancellation agreement was received for a fee, the bargained-for exchange exists and, therefore, the amount of debt cancelled should not be included in the borrower's gross income.

LIFE

If debt cancellation agreements meet the definition of insurance under the federal tax law, then it should escape state taxation. Pursuant to 26 U.S.C. § 101(a)(1), gross income does not include amounts received under a life insurance contract if such amounts are paid by reason of death of the insured. Given the similarities between credit life insurance and the life provisions of debt cancellation agreements, the same treatment should be afforded.

PROPERTY

Unfortunately, research did not disclose any case law, commentary or I.R.S. rulings addressing the treatment of credit property insurance or similar products. However, pursuant to 26 U.S.C. § 2054, the value of a taxable estate is determined by deducting the value of those losses as a result of fires, storms, ship wrecks, or other casualties or from theft, *when such losses are not compensated for by insurance* or otherwise. Therefore, if an item is covered by insurance, then it is included in the person's taxable estate. If the property is protected by credit insurance (or in this case, debt cancellation agreements) is included in the person's taxable estate, the insurance or debt cancellation proceeds themselves relieving the debt should not be included in the taxable estate.

UNEMPLOYMENT

In I.R.S. Letter Ruling 893006, dated April 21, 1989, the I.R.S. ruled that unemployment benefits payable under a credit insurance policy are taxable income to the debtor with respect to payments made for \$600 or more in any calendar year. In that Letter Ruling, the I.R.S. noted that it is well settled the taxpayer cannot avoid tax by anticipatory assignments of income²⁷. The I.R.S. further states that a taxpayer receives income when a debt or obligation is satisfied by a third party.²⁸ The I.R.S. treats unemployment credit insurance policies as analogous to the private voluntary benefit plans for unemployment benefits, such as a union unemployment benefit plan. Therefore, the benefits paid pursuant to a credit insurance policy are included in the gross income of the insured, but only to the extent that the benefits exceed the premiums paid to obtain the policy.²⁹ It is reasonable, therefore, that the discharge of indebtedness due to unemployment under a debt cancellation agreement would have to be included in the borrower's gross income to the extent that the amount discharged exceeds the fees paid under such contract. This is also consistent with 26 U.S.C. § 108(e) which sets forth general rules regarding including discharge of indebtedness in gross income. This section provides that the amount taken into account with respect to any discharge shall be properly adjusted for unamortized premiums and unauthorized discount with respect to the indebtedness discharged. *See also* 26 U.S.C. § 453B and 26 U.S.D. § 691 (a), discussed below.

ACCIDENT AND HEALTH

Unfortunately, research did not reveal any discussions regarding credit disability insurance or other situations similar to the

cancellation of a debt pursuant to a debt cancellation agreement for disability or accident & health coverage. However, under 26 U.S.C. § 104(a), in general, gross income does not include amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness. Thus, discharge of indebtedness due to accident or health reasons should also not be included in a taxpayer's gross income.

BARGAINED FOR EXCHANGE

Some guidance can be found looking at the I.R.S.'s treatment of installment loans that terminate upon the borrower's death. In general, the I.R.S. has ruled that the cancellation of an installment loan at other than its face value will result in a reportable gain or loss to the extent of the difference between the basis of the obligation and its fair market value. *Frane v. Commissioner of Internal Revenue*, 72 A.F.T.R. 2d 93-5268, 93-2 U.S.T.C. P 50, 386 (July 6, 1983) (discussing a note given to family members which terminated upon death of the transferor and its treatment under 26 U.S.C. 453B). 26 U.S.C. § 453B provides that if an obligation is satisfied at other than its face value or distributed, transmitted, sold or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (a) the amount realized in the case of satisfaction of other than face value or a sale or exchange or (b) the fair market value of the obligation at the time of distribution, transmission or disposition in the case of a distribution, transmission or disposition other than by sale or exchange. Pursuant to 26 U.S.C. § 453B(f), if any installment obligation is cancelled or otherwise becomes unenforceable, the obligation shall be treated as if it were disposed of in a transaction other than a sale or exchange, and if the obligor and obligee are related persons, the fair market value of the obligation shall be treated as not less than its face amount. The court also references 26 U.S.C. § 691(a), which provides that the cancellation of an installment obligation due to the debt of the taxpayer shall be treated as recognizable income to the decedent in the face amount of the obligation less its basis in the hands of the decedent.

Although the above supports the general rule that requires inclusion of a debt cancellation in the borrower's gross income, in Revenue Ruling 86-72, Regarding Death Terminating Installment Sales, 1986 WL 373070(IRS), June 28, 1985, the Associate Chief Counsel states the following: "TREAS. REG. § 25.2512-8 states transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for consideration to the extent that the value of the property transferred by the donor exceeds the value in money or monies worth of the consideration given therefore. However, a sale, exchange or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arms length, and free from any donative intent), will be considered as made for adequate and full consideration in money or monies worth." The Chief Counsel continues, "under an installment sale, a gift tax will not be imposed if the sale price and length of payment are reasonable in light of the facts and circumstances of the case." Thus, it can be argued that a tax should not be imposed when reasonable and arms-length consideration is paid for the indebtedness.

This is consistent with the tax court's ruling in *Estate of Moss v. Commissioner*, 74 T.C. 1239 1980WL 4487, (1980), acq. in result 1981-1 CB 2. In that case, the tax court determined that death terminating installment notes that have been issued to the decedent were not includable in the decedent's gross estate. A close review of this case indicates that the cancellation provision in that case was part of the bargained-for consideration provided by the decedent for the purchase price of the stock. 74 T.C. 1239 at 1242. The court distinguishes between a situation where the payee attaches a statement to a note stating that the payor is to be given a gift by cancellation of the obligation on the payee's death and the situation in which a note contains a cancellation provision as part of the terms agreed upon for its issuance. The former would require inclusion of the cancellation in the borrower's estate, whereas the later would not.

Further support can be found in IRC §§ 104(a)(3) and 105 and Rev. Rul. 58-90 providing that disability income is *not* taxable if the individual paid the premiums on the disability policy. Disability income is taxable if the employer contributes to a funded plan or pays the policy's premiums for the employee, but only to the extent not attributable to the employee's contributions. IRC § 85 further provides that unemployment benefits received from a private fund are taxable after they exceed the taxpayer's voluntary contributions to the fund.

It is arguable that this reasoning applies to debt cancellation agreements resulting from a bona fide, arms-length transaction. However, given the I.R.S.'s ruling in Letter Ruling 893006 regarding credit unemployment insurance, which was also a "bargained-for transaction," there is no clear precedent. For this reason at a minimum, enrollment material used by a lender for debt cancellation agreements should include a disclosure similar to the following:

IMPORTANT NOTICE:

The income tax treatment of the benefits illustrated above may significantly affect their magnitude. Competent tax

advice should be secured to clarify income tax implications.

REPORTING OBLIGATIONS OF FINANCIAL INSTITUTION

As stated above, any discharge under a DCA should be reported by the lender to the IRS on Forms 1099-C regardless of the taxability of such to the borrower. Pursuant to 26 U.S.C. § 6050P, financial entities that discharge, in whole or in part, the indebtedness of any person must file a return setting forth the name, address, and tax identification number of each person whose indebtedness is discharged, the date of the discharge, and the amount of the indebtedness discharged, and such other information as the Secretary of the Treasury may prescribe. 12 C.F.R. § 1.6050P-1 provides that a financial entity that discharges an indebtedness of a person of at least \$600.00 during a calendar year must file an information return on Form 1099-C with the Internal Revenue Service. A discharge of indebtedness is deemed to have occurred if there is an "identifiable event." Pursuant to 12 C.F.R. § 1.6050P-1(b)(2)(F), "identifiable event" includes "a discharge of indebtedness pursuant to an agreement between an applicable financial entity and a debtor to discharge indebtedness at less than full consideration." The discharged indebtedness must be reported regardless if the debtor is subject to tax on the discharged debt. In the commentary to 26 C.F.R. § 1.6050P-1, the Treasury Department references the fact that the legislative history to 26 U.S.C. § 6050P states that, "information returns are required whether the debtor is subject to tax on the discharged debt."³⁰ Accordingly, the Treasury states that it is their belief that Congress intended for discharges resulting in excluded income to be reported. Therefore, "any discharge of indebtedness should not be narrowly construed to exclude those instances in which a debt is ordered to be discharged or is discharged by operation of law."³¹ The Treasury believes that the obligation to report under 26 U.S.C. § 6050P should not result in an undue burden on financial entities to undertake a determination regarding whether discharge results in income to debtors.³² The Treasury further states that, with respect to discharge under an agreement between the applicable financial entity and the debtor to discharge indebtedness, the discharge is deemed to occur when the last event necessary to effectuate the discharge has occurred.³³ Thus, the lender is required to report the discharge when the indebtedness is actually discharged.

It is also important to note that under 26 C.F.R. § 1.6050P-1(d)(3), with respect to revolving credits and lines of credit, the discharge of an amount *other than stated principal* is not required to be reported.

Based on the above, financial institutions should file Form 1099-C for each obligation discharged under a debt cancellation agreement, in accordance with 26 U.S.C. § 6050P and 12 C.F.R. 51.6050P-1. Given the uncertainty surrounding the tax consequences to the borrower, independent tax counsel advice should be secured by each lender and a disclosure should be added to the enrollment material. Further, consideration should be given to seeking an opinion from the I.R.S. to confirm (1) whether the payments are taxable, and (2) whether the lender must file a return under 26 U.S.C. § 6050P with respect to debt cancellation agreements which are bargained for and for which arms-length consideration has been paid.

B. ROLE OF INSURANCE COMPANIES

In addition to providing expertise in implementing and administering credit insurance programs, which are naturally transferable to debt cancellation programs, insurance carriers have the ability to provide the financial protection to the lender which it will need when it offers debt cancellation programs: As stated above, the offering of DCAs must be done in a safe and fiscally sound manner. The OCC has ruled that banks can insure the risk of adverse underwriting and claims administration by securing insurance coverage. This coverage can be in the form of stop loss coverage, participation of loss layers, a pool participation or contractual liability coverage.

C. OTHER ISSUES TO CONSIDER

1. Fair Credit Reporting Act and the Equal Credit Opportunity Act (12 CFR § 202 et. seq. - Regulation B) which prohibits discrimination in credit based on sex, marital status, race, color, religion, natural origin or age. However, as stated below, the OCC has stated that certain age and health standards may be developed in making debt cancellation contracts available to borrowers in order to protect the stability and financial soundness of the financial institution.
2. Age Discrimination - Federal laws. Legality of age limits or age banding. On March 10, 1964, the OCC stated, "the bank may, in its discretion, determine whether to adopt standards such as age and health of the borrower, in making debt cancellation products available to its customers". It is still uncertain whether such a practice would violate the Fair Credit Reporting Act standards against age discrimination.
3. Sex Discrimination - Federal laws. Legality of gender?based underwriting under credit laws.
4. Underwriting Concerns - With credit transactions, legality of health based exclusions or conditions of eligibility.
5. State Challenges. Although legal grounds exist to withstand challenges by states to govern DCAs as insurance, states still want to make DCAs an insurance product requiring filing for form and rate approval. On January 3, 1995, a private letter

issued by the Wisconsin Insurance Division states, "The Division takes the view that such contracts [DCC] are insurance and must be approved by the Division of Insurance." *Opinion of Wisconsin Office of Commissioner of Insurance (July 3, 1996)*. ("Debt cancellation agreements are insurance contracts" because they have "the attributes of credit insurance" and "[t]he purpose of the statutory scheme regulating credit life insurance is clearly invoked" by these agreements). Id.

In addition to direct regulation by states as an insurance product, state insurance departments may exercise regulatory powers over national banks' debt cancellation agreements to the extent those regulations do not conflict with national banking powers. *See, First National Bank of Eastern Arkansas v. Taylor*, 907 F.2d 775 (8th Cir.) *cert. denied*, 498 U.S. 972 (1990). This could lead to licensing and disclosure issues.

6. Current NAIC consideration and review of existing practices and the issue of state jurisdiction.
7. Producer licensing as a limited lines authority.
8. Consumer Group Complaints/Concerns. The focus of consumer group objections to date has been on debt suspension contracts and not debt cancellation agreements. Consumer groups have recently expressed their concerns in the following article.

Debt Suspension: The Latest Dodge in the Credit Card Issuers' Corral, by Libby Wells at <http://www.bankrate.com>. In this article, the author compares debt suspension to credit insurance and states that while an insurance policy covers the payment, thereby paying down the balance while you are sick or unemployed, debt suspension only postpones the bill. The interest clock freezes, you cannot use the card, and the obligation is on hold until you are able to resume payments or the deferral period expires.

Consumer watchdogs say it's the greater of two evils. "Credit insurance is generally a pretty poor deal for consumers, but compared to that, debt suspension is abominable," says Birny Birnbaum, an adviser with the Center for Economic Justice in Austin, Texas. "It doesn't provide as much coverage and there is no regulation, so banks can charge a lot more." The article also quotes Phillips Business Information in www.ectoday.com which estimates credit insurance accounts for up to 40 percent of card issuers' fee income, and that by switching to debt suspension, profits could increase 50 percent to 60 percent. With no insurance regulations to follow, card companies can offer a one-size-fits-all product that is not subject to the price and marketing restrictions of the 50 states.

According to this article, the insurance industry's argument is that debt suspension is a form of insurance and should be regulated by the states. A debt suspension probe by the National Association of Insurance Commissioners ("NAIC") is slated for this year. Tim Mullen, senior regulatory services manager for the NAIC, says the group's legal team will be investigating that question this year. "These products appear to be insurance to me," he says. "Our focus will be on whether states should retain that authority or will the (Comptroller of the Currency) override that. If we do find that it is insurance, I suspect it will spur further action by the NAIC."

However, the article also notes that debt suspension has been upheld in courts and by federal regulators. American Bankers Insurance Group Inc. of Miami, the largest underwriter of credit insurance, sued the Federal Reserve Board of Governors in 1998 over debt suspension, but lost when the District Court of Washington ruled in favor of the Fed.

² Title III, Insurance, Subtitle A--State Regulation of Insurance, SEC. 302.

Source: G.19 Release - Federal Reserve Board of Governors, Total Consumer Credit Outstanding Seasonally Adjusted.

Source: G.19 Release - Federal Reserve Board of Governors, Total Revolving Credit Outstanding Seasonally Adjusted; U.S. Department of Commerce, Bureau of Economic Analysis - Personal Income.

Base note that a bank's DCA practice may be included in the bank's standard examination requirements/ procedures with banking regulators.

¹ S Op. Acting Chief Counsel, September 15, 1993

² S Op. Chief Counsel, December 18, 1995.

³ S Op. Chief Counsel, September 15, 1993, at 1.

TS Op. Chief Counsel, December 18, 1995, at 3.

TS Op. Chief Counsel, September 15, 1993, at 3.

ne facts of Taylor are important, as subsequent courts have distinguished Taylor on its facts. See *Norwest v. Sween*, 916 F. Supp. 1494 (D. Minn. 1996).

title III, Insurance, Subtitle A--State Regulation of Insurance, SEC. 302.

ne State by State Summary of Treatment of DCAs attached as [Exhibit B](#).

iting *Mitgang v. Western Title Insurance Company*, *CCH Trade Regulation Reports* P75, 322 (N.D. Cal. 1974).

ne Alabama, Illinois and South Dakota in [Exhibit B](#).

dependent Insurance Agent of America, Inc., et al. v. Hawke, Comptroller of the Currency and the Office of the Comptroller of the Currency, 211 F.2d 638 (D.C.Cir. 2000).

ne *Saxon v. Georgia Ass'n of Indep. Ins. Agents, Inc.*, 399 F.2d 1010 (5th Cir.1968) ("Saxon"); *American Land Title Ass'n v. Clarke*, 968 F.2d 150 (9th Cir.1992) ("ALTA"), in which the OCC tried to unilaterally expand a bank's power to engage in general marketing of insurance to cities greater than 5,000 inhabitants.

pecifically the court stated: "[s]tatute granting national banks 'all such incidental powers as shall be necessary to carry on the business of banking' does not include the power of banks to sell crop insurance; broad reading of the statute to allow the general sale of insurance by national banks would render meaningless other provisions expressly granting national banks located in small towns general power to sell insurance as agent and authorizing incidental subsidiaries established by 'well capitalized and well managed' national banks to '[i]nsur[e] ... against loss, harm, damage, illness, disability, death' as agent or broker." National Bank Act, 12 U.S.C.A. §§ 24, 92; Bank Holding Company Act of 1956, § 4, as amended, 12 U.S.C.A. § 1843. See *&M Leasing Corp. v. Seattle First National Bank*, 563 F.2d 1377 (9th Cir. 1977).

American Ins. Association v. Clarke, 865 F.2d 278, 281-82 (D.C.Cir. 1988).

dependent Bankers Ass'n of America v. Heimann, 613 F.2d 1164 (D.C.Cir. 1979).

First National Bank of Eastern Arkansas v. Taylor, 907 F.2d 775 (8th Cir.), cert. denied, 498 U. S. 972 (1990).

OCC Interpretative Letter 640, dated January 7, 1994, the Comptroller provides that "pursuant to 12 U.S.C. § 24(Seventh), national banks may not issue DCAs that cancel debt upon a borrower's disability and/or unemployment, as well as a borrower's death." In OCC Interpretative Letter 827, dated April 3, 1998, the OCC approved the offering by national banks of debt suspension contracts that would "freeze" the cardholder's account "in the event that the cardholder becomes involuntarily unemployed, is unable to work due to disability, goes on an approved family leave, is hospitalized for more than a specified number of days, or becomes temporarily unable to continue to make payments on the account for certain other reasons;" (emphasis added). The Comptroller stated that "like debt cancellation agreements, a debt suspension agreement helps protect the borrower against the risk of financial hardship *in times of adversity*..From the bank's perspective, a debt suspension contract provides a mechanism for the bank to manage credit risk and obtain compensation for the credit risk that it undertakes in making a loan. Thus, it is a very logical outgrowth of the bank's express lending authority." (emphasis added). On February 6, 1996, in 61 FR 4849, the Office of the Comptroller of the Currency responded to comments made on regarding 12 CFR § 7.1013 to include triggering events other than life and disability. Although the OCC did not expand the specific language of § 7.1013, it clearly stated that other triggering events were permitted, subject to a case by case review, provided it was done in a safe and sound manner.

In 1990, the Eighth Circuit Court of Appeals held that a national bank may offer debt cancellation agreements pursuant to the incidental powers granted by The National Bank Act, and that these contracts do not constitute the "business of insurance" that may be regulated by the state under the Carran-Ferguson Act. *First National Bank of Eastern Arkansas v. Taylor*, 907 F.2d 775 (8th Cir.), cert. denied, 498 U. S. 972 (1990).

Generally, Gramm-Leach-Bliley Act provides that the prohibition on national banks and their subsidiaries against providing insurance in a state as principal does not apply to authorized products. The definition of "authorized products" includes products which, as of January 1, 1999, either (1) the Comptroller of the Currency had determined in writing that national banks may provide as principal, or (2) national banks were in fact lawfully providing as principal. Clearly, DCAs fall within the definition of "authorized products."

ist state parity statutes attached as [Exhibit C](#).

axes, license, and registration fees or charges for service policies, auto club memberships, or an insurance policy against latent defects are examples of charges imposed on both credit and cash purchasers alike, and would not be included in the finance charge.

iting *Lucas v. Earl*, 281 U.S. 111 (1930).

iting *Old Colony Trust Company v. Commissioner*, 279 U.S. 716 (1929).

R.S. Letter Ruling 893006, April 21, 1989.

FED. REG. 3, 262 (1996). 26 C.F.R. 11.1.6050P-1(a)(3). Also H.R.Conf.Rep.No. 213, 103rd Cong., 1st Session 1,672\1 (1993), provides the following: For purposes of reporting the amount of indebtedness discharged, the regulations provide that indebtedness is any amount owed to an applicable financial entity, including principal, interest, penalties, administrative costs, and fines, to the extent the amount constitutes an indebtedness under section 61(a)(12). The amount of indebtedness discharged may represent all, or only a part, of the total amount owed to the applicable financial entity. The legislative history makes it clear that reporting is required whether or not the amount of debt discharged is includible in the debtor's gross income.

FED. REG. 3, 263 (1996).

