State of Washington

DEPARTMENT OF FINANCIAL INSTITUTIONS

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ISGC-2005-020-DFI

TO: All Interested Parties

FROM: Joseph M. Vincent, General Counsel

RE: Debt Cancellation Contracts ("DCC") and Debt Suspension Agreements ("DSA")

DATE: November 21, 2005

1.0 Questions Presented

May a commercial bank organized pursuant to Title 30 RCW ("Bank"), a savings bank organized pursuant to Title 32 RCW ("Savings Bank"), *or* a credit union organized pursuant to Chapter 31.12 RCW ("Credit Union"), offer debt cancellation contracts ("DCC") and/or debt suspension agreements ("DSA") as a feature of its loan products, without being subject to license and regulation by the Office of Insurance Commissioner ("OIC") on account thereof?

If a Bank, Savings Bank or Credit Union is not subject to license and regulation by the OIC in its offering of DC and/or DSA, does the DFI still have authority to regulate the content, marketing and administration of DCC and DSA by Banks, Savings Banks and Credit Unions?

2.0 Summary Determination

The Washington State Department of Financial Institutions ("DFI") has determined that the offering of DCC and DSA by a Washington State-chartered Bank, Savings Bank, or Credit Union in connection with its loan products would be generally permissible, provided —

(1) The terms of the DCC and/or DSA are reasonable and fair to consumers;
(2) There are adequate disclosures made during the loan application process; *and*
(3) The program for offering DCC and/or DSA would not impair the safety and soundness of the Bank, Savings Bank, or Credit Union, as applicable.

The DFI's Division of Banks (on behalf of Banks and Savings Banks) and the DFI's Division of Credit Unions (on behalf of Credit Unions), respectively, are authorized to follow applicable federal guidelines and/or adopt their own state rules and/or guidelines to comply with the general conditions set forth above.

The DFI's position, notwithstanding a technical difference of opinion with the Office of Insurance Commissioner ("OIC"),[1] is that DCC and DSA do not constitute the offering of "insurance" under a proper interpretation of state insurance law,[2] and that Banks, Savings Banks, and Credit Unions are not, therefore, subject to licensing and regulation by the OIC when offering DCC and/or DSA in connection with their loan products.

However, the DFI ultimately bases this interpretive statement, not upon our view of what constitutes "insurance" (see Footnote 2 below), but rather upon (1) federal regulations regarding DCC and DSA and (2) the applicability of these federal regulations to Banks, Savings Banks, and Credit Unions pursuant to the exercise of so-called "federal parity" statutes.

3.0 Legal Discussion

3.1 Federal Regulations Affecting National Banks. The Office of the Comptroller of the Currency ("OCC") has determined, in its interpretation of federal statute and through specific rules (see 67 FR 58962), that national banks have the authority to enter into DCC and DSA with their customers as part of their *incidental powers*.

3.2 Federal Regulations Affecting Credit Unions. The National Credit Union Administration ("NCUA") has ruled that the issuance of DCC and DSA is within the scope of a federal credit union's *incidental powers* (see 12 CFR Part 721). This rule is supported by NCUA

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[1] As of this date, the OIC has not conceded that the nature of DCC and DSA is something other than "insurance," although the OIC has elected *not* to exercise "jurisdiction" over the offering of DCC or DSA by a Bank, Savings Bank, or Credit Union in connection with its loan products.

[2] Pursuant to the Washington Insurance Code, at RCW 48.01.040 —

> "Insurance is a contract whereby one undertakes to indemnify another or pay a specified amount upon determinable contingencies."

Estate of Eva B. Smiley, 35 Wn.2d 863, 867-868 (1950), is instructive as to how the Washington Supreme Court has generally viewed insurance (i.e., *indemnity contracts*):

> "Inherent in all life insurance is a general scheme to distribute actual losses among a large group of persons bearing similar risks, and as a consideration for the insurer's promise, the insured makes a ratable contribution to a general insurance fund, called a premium. Life insurance involves both risk-shifting and risk-distributing. A contract may be a risk-shifting device, but to be a contract of insurance, which is a risk-distributing device, it must possess both features, and unless it does it is not a contract of insurance whatever be its name or its form. *Helvering v. Le Gierse*, 312 U.S. 531, 85 L. Ed. 996, 61 S. Ct. 646; Vance on Insurance (2d ed.) 1, §§ 1-3."

Pursuant to *Estate of Eva B. Smiley*, *supra*, since each DCC or DSA contract does not involve a distribution of actual losses among a large group of borrowers, there is no general scheme of risk distribution that one would find in a contract of insurance (i.e., indemnity contract).

This view of insurance is materially the same as that of the California Legislature and the California appellate courts. The definition of "insurance" under California statute (California Insurance Code § 22) is identical to Washington's statutory definition. Moreover, California case law, dealing specifically with DCC and DSA (rather than standard indemnity contracts such as life insurance), is nevertheless in accord with the reasoning in *Estate of Eva B. Smiley* in reaching the conclusion that, since a scheme of risk distribution is non-existent with DCC and DSA, DCC and DSA do not constitute the offering of "insurance." *Automotive Funding Group, Inc. v. Garamendi*, 114 Cal. App. 4th 846, 851-853, 7 Cal. Rptr. 3d 912 (2003), citing *Truta v. Avis Rent A Car System, Inc.* 193 Cal. App. 3d 802, 812-814, 238 Cal. Rptr. 806 (1987), and *Transportation Guar. Co. v. Jellins* (1946) 29 Cal.2d 242, 248, 174 P.2d 625 (1946).

While there is no formal opinion from the Washington State Attorney General on this point, we note, significantly, that in relation to a similar question posed in Oregon, the Attorney General of that state opined formally that DCC and DSA are not "insurance." *Oregon Attorney General Opinion*, 49 Op. Atty. Gen. Ore. 200, 1999 Ore. AG LEXIS 9, 20-22 (Ore. AG 1999).

legal opinions that have specifically discussed the ability of federal credit unions to offer these Products.[3]

3.3 Federal Case Law Respecting Incidental Powers and the Preemption of State Law. In addition to state case law (see again, Footnote 2), federal case law, including significant Supreme Court cases, has held that DCC and DSA are not forms of "insurance." However, in addition to determining that DCC or DSA is not an "insurance contract" under state law, these cases have also turned on federal *preemption* of state law. See *First Nat'l Bank v. Taylor*, 907 F.2d 775, 780 (8th Cir., 1990), citing *Merchants Home Delivery Service, Inc. v. Frank B. Hall & Co., Inc.*, 50 F3d 1486, 1488-89 (9th Cir. 1995); see also *United Labor Life Ins. Co. v. Pireno*, 458 U.S. 119, 129, 73 L. Ed. 2d 647, 102 S. Ct. 3002 (1982), cited by *Merchant Home Delivery*, *supra*. In *First Nat'l Bank v. Taylor*, *supra* at pp. 778-779, for example, the Eighth Circuit Court of Appeals held that *because* the DCC offered by a national bank fell within the *incidental powers* granted by the National Bank Act,[4] they did not constitute the "business of insurance" under the McCarran-Ferguson Act.[5]

3.4 Exercise of "Federal Parity" by a Bank or Savings Bank. A Bank or a Savings Bank may invoke the powers of a national bank pursuant to RCW 30.04.215(3)[6] and RCW 32.08.153,[7] respectively. These are powers specifically granted to a Bank and a Savings Bank by the Washington State Legislature. Thus, by invoking so-called "federal parity" with OCC regulation (see Subsection 3.1 above), a Bank or a Savings Bank may assume the *incidental powers* of a national bank that are pre-empted from regulation by the OIC. A Bank or Savings Bank may invoke and rely upon the determination of the OCC that the offering of DCC and DSA is an *incidental bank power* not subject to state *insurance* regulation otherwise mandated under the McCarran-Ferguson Act and re-affirmed under the Gramm-Leach-Bliley Act.[8]

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[3] See NCUA Opinions dated September 12, 1997, December 23, 2002, and January 28, 2004.

[4] The National Bank Act, at 12 U.S.C. §§ 21-216d.

[5] The McCarran-Ferguson Act, 15 U.S.C.S. § 1012, is not directed at the activities of national banks. It is designed to preserve traditional state regulation and taxation of insurance companies, and to provide insurance companies with a partial exemption from federal antitrust laws. The McCarran-Ferguson Act was passed by Congress in response to the Supreme Court's decision in *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944), which held that the insurance industry was subject to regulation by Congress under the Commerce Clause, and that insurance company activities were subject to federal antitrust laws. *Id.* at p. 553. The McCarran-Ferguson Act was designed to preserve traditional state regulation and taxation of insurance companies, and to provide insurance companies with a partial exemption from federal antitrust laws. *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 217-18, 59 L. Ed. 2d 261, 99 S. Ct. 1067 (1979); *Union Labor Life Ins. Co. v. Pireno*, 458 U.S. 119, 129, 73 L. Ed. 2d 647, 102 S. Ct. 3002 (1982).

[6] RCW 30.04.215(3) declares, in part: "Notwithstanding any restrictions, limitations, and requirements of law, in addition to all powers, express or implied, that a [state-chartered] bank or trust company has under the laws of this state, a [state-chartered] bank or trust company shall have the powers and authorities conferred as of August 31, 1994, or a subsequent date not later than July 27, 2003, upon a ***federally chartered bank*** doing business in this state." [Emphasis added.]

[7] RCW 32.08.153 declares, in part: "Notwithstanding any restrictions, limitations, and requirements of law, in addition to all powers, express or implied, that a mutual savings bank has under the laws of this state, a mutual savings bank shall have the powers and authorities that ***national banks*** had on July 27, 2003." [Emphasis added.]

[8] The Gramm-Leach-Bliley Act essentially "re-affirmed" the McCarran-Ferguson Act, *albeit*, consistent with *Barnett Bank of Marion Cty., N. A. v. Nelson*, 517 U.S. 25, 30, 134 L. Ed. 2d 237, 116 S. Ct. 1103 (1996). Even though the Gramm-Leach-Bliley Act preserved for the states regulation of insurance law (see 15 U.S.C. § 6711), the Act specifically codified the U.S. Supreme Court's holding in *Barnett* that state insurance commissioners may not invoke their regulatory authority over the *incidental powers* of a national bank with respect to insurance sales. See Gramm-Leach-Bliley Act, at 15 U.S.C. § 6701(d)(2)(A).

3.5 Exercise of "Federal Parity" by a Credit Union. A Credit Union may invoke the powers of a federal credit union pursuant to RCW 31.12.404(1).[9] These are powers specifically granted to a Credit Union by the Washington State Legislature. Thus, by invoking "federal parity" with NCUA regulation (see Subsection 3.2 above), a Credit Union may assume the *incidental powers* of a federal credit union that are pre-empted from regulation by the OIC. A Credit Union may invoke and rely upon the determination of the NCUA that the offering of DCC and DSA is an *incidental power* not subject to state *insurance* regulation.

3.6 DFI Regulation of DCC and DSA. The DFI has been invested by the Washington State Legislature with the plenary authority to regulate and examine Banks, Savings Banks and Credit Unions to assure their safety and soundness[10] and to protect their customers, including review of how each of them exercises their respective incidental powers.[11]

Therefore, the DFI (as opposed to the OIC) still has authority to regulate the content, marketing and administration of DCC and DSA in the interest of safety and soundness and protecting customers. The Division of Banks and Division of Credit Unions will, in the exercise of its examination authority, consider a Bank's, Savings Bank's or Credit Union's offering and administration of DCC and DSA programs to assure that (1) the terms of any DCC and/or DSA are reasonable and fair to customers,[12] (2) there are adequate disclosures made during the loan application process,[13] and (3) the programs for offering DCC and/or DSA do not appear likely to impair the safety and soundness of the Bank, Savings Bank or Credit Union. The DFI may address these concerns in future pronouncements from the Division of Banks and Division of Credit Unions, as deemed necessary.

4.0 Concluding Remarks

The standards for making this interpretation are uniformly applicable for any Bank, Savings Bank or Credit Union, as applicable. However, this interpretive statement is limited to answering the questions posed in Section 1.0 above and is not intended as a definitive pronouncement of the respective details of DCC and DSA policy, which will be articulated in the future by the Division of Banks and Division of Credit Unions.

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[9] RCW 31.12.404(1) declares: "Notwithstanding any other provision of law, and in addition to all powers and authorities, express or implied, that a credit union has under the laws of this state, a credit union has the powers and authorities that a ***federal credit union*** had on December 31, 1993, or a subsequent date not later than July 22, 2001." [Emphasis added.]

[10] This includes the moderation of legal, operational and reputational risk incurred by Banks, Savings Banks or Credit Unions in the exercise of their powers.

[11] See, for example: RCW §§ 43.320.010 and 43.320.011 (DFI general authority); RCW §§ 30.04.060 and 32.04.211 (Division of Banks authority); and RCW §§ 31.12.003, 31.12.516, and 31.12.545 (Division of Credit Unions authority).

[12] For instance, DCC or DSA with adhesionary clauses or "loopholes" in enforceability could constitute, in our view, an "unfair and deceptive act and practice" under the Washington Consumer Protection Act, at RCW 19.86.020.

[13] At a minimum, *adequate disclosures* should be made to consumers about the features inherent in DCC and DSA. These disclosures should be made part of the loan application process. The same holds true for consumer loan companies and mortgage brokers, acting on behalf of a Bank, Savings Bank or Credit Union, which may offer DCC and DSA.