THE LONG AND WINDING ROAD: INSURING DEBT SUSPENSION AGREEMENTS AND DEBT CANCELLATION CONTRACTS UNDER THE NEW YORK INSURANCE LAW

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This article reviews regulatory developments over the past two years in the State of New York which have culminated in a determination by the New York Insurance Department (the "Department") that property-casualty insurers licensed to do business in the state may provide insurance coverage to a New York issuer of a debt cancellation contract ("DCC") or debt suspension agreement ("DSA"). Recent determinations made by the Department have removed long-standing barriers that prevented insurers from doing so, providing the basis for approval of related insurance product filings.

Recognized Types of Insurance in New York

The agreements in question are generally entered into between a lender and a borrower as part of a lending transaction and modify the original repayment terms under certain specified circumstances. A DSA involves a suspension of the borrower's obligation to make repayment, while a DCC cancels all or part of the repayment obligation. In each case, the lender's obligation to suspend or cancel is triggered by a fortuitous event that is specified in the DSA or DCC. Such events may include death, disability or unemployment as well as unpaid family leave or divorce. Unless otherwise noted, the discussion in this article is limited to DSAs or DCCs issued by a lending institution that is a bank or credit union.

Both national and state-chartered banks and credit unions have the power to issue DSAs and DCCs as activities ancillary to their basic banking authority.[1] Where these lending institutions issue DSAs and/or DCCs, they may seek to reduce their exposure to the resulting risk of nonpayment or delayed payment of the underlying loans by purchasing insurance coverage. In most states, such coverage would be viewed as a form of contractual liability insurance, with the policy insuring against the financial cost resulting from the triggering of the debt cancellation or suspension. However, certain provisions of the New York Insurance Law (the "Insurance Law") had heretofore been viewed as not only prohibiting a licensed insurer from writing this coverage, but also precluding the lending institution from issuing the underlying DCA or DCC.

Debt Suspension Agreements and Debt Cancellation Contracts

The Insurance Law permits insurers to become licensed for and to write or reinsure only the kinds of insurance that are specifically authorized in Section 1113(a). It does not have a "general" or "miscellaneous" line of insurance. The Department has historically taken the position that coverage that is not reflective of an authorized kind of insurance may not be written by a licensed insurer in New York. There is a limited exception to the foregoing restriction. Section 1113(a)(30) of the Insurance Law authorizes insurers to write a kind of insurance that has been determined by the Superintendent of Insurance to be "substantially similar" to another kind of insurance specifically authorized by Section 1113(a). However, the Department has exercised this authority sparingly in the past. Contractual liability insurance is not recognized as an authorized kind of insurance and is not viewed as "substantially similar" to one that is enumerated in Section 1113(a). Consequently, the Department has refused to approve policy forms in connection with such coverage, including coverage provided to issuers of DSAs and DCCs.

Section 1101(b)(1) of the Insurance Law defines certain actions that constitute "doing an insurance business" in the state. Such actions include the making of or proposing to make an "insurance contract." The quoted term is defined as an agreement whereby one party (the "insurer") is obligated to confer a benefit of pecuniary value upon another party (the "insured") that is dependent upon the happening of an event the occurrence or failure to occur of which is or is assumed to be substantially beyond the control of either party. A party that is "doing an insurance business" in the state is considered an "insurer" and must obtain authorization by becoming

licensed as such under the Insurance Law.[2]

Regulation of Insurance of DSAs and DCCs under the Insurance Law

In an August 4, 1964 opinion relating to the issuance of a DCC by a national bank that provided for cancellation of the underlying debt upon the death of the borrower, the Attorney General of the State of New York concluded that a debt cancellation contract of the kind in question was an insurance contract and that the bank's status thereunder was therefore that of an insurer.[3] The opinion stated that " . . . a national bank entering into a debt cancellation contract in this state must comply with the licensing and other relevant provisions of the Insurance Law of this state."[4] The Insurance Department's Office of General Counsel ("OGC") has consistently adhered to this position in its own subsequent interpretations on the issue.

The enactment of the Gramm-Leach-Bliley Act ("GLB") caused this position to be reconsidered. Although recognizing the states as functional regulators of insurance, GLB precludes state regulation of depository institutions or their affiliates to the extent such regulatory action would effectively prevent those entities from engaging in insurance activities authorized or permitted by GLB or any other provision of federal law.[5] The initial response of OGC to this enactment was to recognize this preemption with respect to the underwriting of DCAs or DCCs by national banks, but to indicate that determinations regarding whether application of state insurance laws and regulations to the sale of these contracts would "prevent or significantly interfere" within the meaning of Section 104(d)(2)(A) of GLB needed to be made on a case-by-case basis.[6] However, following issuance of regulations by the Office of the Comptroller of the Currency ("OCC") governing DCAs and DCCs issued by national banks,[7] OGC indicated that the Department would not regulate such contracts if sold by a national bank in connection with an extension of credit to a customer.[8]

A similar determination was subsequently made with respect to the making of such contracts by federal or New York chartered credit unions, which are not covered by the above described GLB preemption, based upon the similarity of their nature and functions to those of national banks, the authorization to conduct such activities under applicable banking laws and regulations, and the existence of appropriate regulatory and consumer protections thereunder.[9] This determination also applied to other state banking organizations and to foreign banking corporations licensed by the New York Banking Department.

As a result, federal and state banks and credit unions are now permitted to conduct these ancillary banking activities without being subject to regulation under the Insurance Law. It is important to note that, notwithstanding the consistent assertions on the part of depository institutions and credit unions that the issuance of DSAs and DCCs had historically been banking activities and therefore not insurance, the Department continues to view them as doing an insurance business within the meaning of Section 1101(b)(1) of the Insurance Law. The issuers are therefore technically "insurers" for the purposes of Section 1101, but exempt from regulation by the Department. Consequently, if a lender other than a bank or credit union engaged in issuance of DSAs or DCCs, the licensing and related regulatory requirements of the Insurance Law would continue to apply.

Insurer Product Filings

The Department's recognition that DSAs and DCCs could be issued in the State of New York by banks and credit unions without being subject to regulation under the Insurance Law shifted the focus of attention to the availability of insurance for these entities, which sought to manage and limit their exposure to loss resulting from debt cancellation and suspension activities through the purchase of some form of coverage. When the applicability of the GLB preemption was first recognized in OGC opinions in early 2002, parties sought guidance from the Department on what type of policy might be used to cover issuers of DSAs and DCCs for losses, since rates and forms could not be acted upon in the absence of a statutory basis for their approval under the Insurance Law. The immediate need to address this issue effectively precluded a legislative initiative creating an appropriate new line of insurance for this purpose, a process that could take several years to complete. Under the circumstances, regulatory consideration focused on finding authority for licensed insurers to write this form of insurance under the existing statutory provisions.

Various forms of policies intended to provide coverage for issuers of DCAs and DCCs were filed with the

Department, but ultimately disapproved because the type of insurance involved did not fit under Section 1113(a) of the Insurance Law. As noted above, contractual liability insurance policies were rejected because there is no comparable line of insurance in Section 1113(a). Attempts to classify such policies as "credit insurance" or "gap insurance" failed.

In terms of how such policies might be viewed for coverage purposes, the Department referred by analogy to stop loss insurance. By way of example, where the insured under a stop loss insurance policy is a self-insured employee benefit plan governed by ERISA, the insured entity would (like national bank issuers of DSAs and DCCs) be viewed as doing an insurance business within the meaning of Section 1101(b)(1) but exempted from the application of the Insurance Law. In such cases, the Department had viewed the coverage presented by the insurance policy in question as that represented by the underlying risk.[10] Applying this line of reasoning to insurance covering DSA and DCC issuers, it was concluded that such coverage would be considered substantially similar to the kind of insurance presented by the underlying event relating to the loss (i.e., credit life insurance under Section 1113(a)(1) of the Insurance Law where the triggering event was the death of the debtor, credit accident and health insurance under Section 1113(a)(2) where triggered by disability, and credit unemployment insurance under Section 1113(a)(24) where the trigger was unemployment).[11]

Although logical, this interpretation presented a number of problems in its application. In the first place, triggering events appearing in DSAs and DCCs, such as divorce or family leave, did not present a "risk" that necessarily corresponded to a recognized line of insurance. Furthermore, no single insurer could write a policy of insurance on DSAs and DCCs, even if the triggering events were limited to the four viewed by OGC as relating to lines of insurance in Section 1113(a), since a property-casualty insurer cannot write life insurance and a life insurer is prohibited from writing credit unemployment insurance or other property-casualty lines. In addition, there were inherent differences between the proposed coverage for DSAs and DCCs and the requirements of existing Department regulations governing credit life, credit accident and health and credit unemployment insurance. Under the circumstances, use of the "underlying risk" approach in determining the type of insurance represented by coverage of issuers of DSAs and DCCs effectively precluded issuance of one policy by one insurer that conformed to applicable regulatory requirements[12]

The only immediately available alternative for obtaining insurance for DSA and DCC issuers was a policy of insurance from an unlicensed insurer. Such a policy would have to be issued and delivered and have all relevant transactions take place outside New York, such that the policy form used would not be subject to filing in that state.[13] This was not viewed as a practical or workable solution, particularly for banks or credit unions with operations solely in New York.

As a result, the Department began to focus on whether such coverage could be viewed as "substantially similar" to another recognized kind of insurance as permitted by Section 1113(a)(30). It again concluded that contractual liability insurance had no corresponding line in the Insurance Law and would not therefore meet the test. Moreover, it was determined that issuers of such contracts had no "liability" exposure to insure, because the debtor's liability was cancelled or deferred. The proposed coverage was also viewed as falling outside the scope of credit insurance and financial guaranty insurance. However, since the insurance extended to the loss of a lender resulting from a waiver of an amount due from a debtor, it was ultimately determined that it was substantially similar to "non-motor vehicle lessor/creditor gap insurance" under Section 1113(a)(26)(C).[14] In order to write the coverage, an insurer must be licensed for this form of gap insurance in the State of New York. In addition, the waiver of the debt may not be contingent upon financial default of the debtor or loss to any underlying property.

The basic filing and approval requirements applicable to gap insurance coverage will be applied to the rates and policy forms for this newly authorized coverage. However, there is a recognition by the Department that there are differences between "true" gap insurance and the "substantially similar" version covering issuers of DSAs and DSCs that must be taken into account in reviewing form filings. For example, the definition of "gap amount" in Section 107(a)(52) of the Insurance Law, which takes the actual cash value of the underlying property into account, need not be reflected in filings covering DSAs and DCCs, where there is no coverage for the property. In addition, since the issuers of these agreements would necessarily be entities that are not subject to regulation under the Insurance Law, any requirements imposed on them by that law would not be applied in the context of policies covering losses arising out of issuance of DSAs and DCCs. As a result, the requirements of Section 1101(b)(3) and certain requirements of Section 3427 of the Insurance Law that specifically apply to entities engaged in making gap

waivers will not need to be reflected in filings for the "substantially similar" coverage provided to DSA and DCC issuers.[15] This is the case because the bank or credit union that issues a DSA or DCC in the state consistent with its ancillary banking powers will be viewed as conducting activity that is not subject to regulation under the Insurance Law.

Conclusion

At this point, the process appears to be entering its final stages, with policy form filings yet to be approved. It remains to be determined whether this type of coverage will encounter any additional impediments in order to be successfully marketed in the State of New York. However, this matter provides a good example of how the willingness of Insurance Department staff to seek and implement creative solutions to regulatory issues has the potential to benefit both insureds and insurers.

Endnotes

[1] The issuance of such agreements has been viewed as an incidental power of national banks and federal and state credit unions. See 12 U.S.C. §24 (Seventh), 12 CFR Part 37 (national banks); 12 U.S.C. §1757(17), 12 CFR Part 721 (national credit unions); New York Banking Law §96(1), §454(34).
[2] *See* Insurance Law §1102(a).
[3] 1964 Op. Att'y. Gen. 31.
[4] Ibid. at 32.
[5] 15 U.S.C. §6701(e)(3).
[6] OGC Opinion, "Bank Issuance of Debt Suspension and Debt Cancellation Contracts in connection with its Customers' Credit Card Account at the Bank" (April 2, 2002).
[7] 12 CFR Part 37.
[8] OGC Opinion, "Bank sales of Debt Suspension Agreements and Debt Cancellation Contracts" (April 4, 2003).
[9] OGC Opinion, "The Making of Debt Cancellation Contracts and Debt Suspension Agreements by Financial Institutions" (June 17, 2004).
[10] Stop loss insurance issued to a self- funded employee benefit plan providing health coverage is viewed as a form of accident and health insurance. *See* New York Insurance Department Circular Letter 1982-7 (April 13, 1982), Insurance Law §4237-a.
[11] OGC Opinion, "Debt Cancellation Lender/Creditor Insurance" (June 27, 2002).
[12] Credit life insurance and credit accident and health insurance are governed by New York Insurance Department Regulation No. 27A (11 NYCRR Part 185), while credit unemployment insurance is governed by New York Insurance Department Regulation 27-C (11 NYCRR Part 187). Each regulation contains detailed provisions relating to rate and form requirements that are specifically applicable to the form of insurance in question.
[13] OGC Opinion, "Debt Cancellation Lender Insurance Issued by Unauthorized Insurer Outside of New York" (February 20, 2003).
[14] OGC Opinion, "Debt Cancellation Contract or Debt Suspension Agreement Insurance" (May 18, 2004).
[15] Section 1101(a)(3) of the Insurance Law contains requirements with respect to making gap waiver agreements, mandating that the entire gap amount be waived, the waiver apply only in the event of total loss of property due to theft of physical damage, and that the cost of insurance purchased by the maker of the waiver not exceed the charge to the debtor for the waiver. Section 3427(j) requires that the maker of the gap waiver make certain disclosures regarding insurance coverage where a charge is imposed for the waiver.