ARKANSAS STATE BANK DEPARTMENT
EXAMINATION POLICY

Policy Number	14-02
Effective Date	08/01/14
Supersedes	92-3
Approval	03/20/25

SUBJECT: **Debt Cancellation Contracts**

An increasing number of state-chartered banks are offering debt cancellation contracts as an alternative to the sale of credit life insurance. Debt Cancellation Contracts provide for losses arising from cancellation of outstanding loans upon the death of borrowers. These contracts contain an element of risk which may impact the safe and sound operation of a bank. Activity in this area should be examined to determine the degree of risk and to ensure that proper guidelines have been implemented to provide for safe and sound operations.

The United States Court of Appeals for the Eighth Circuit ruled on June 25, 1990, in First National Bank of Eastern Arkansas. A National Banking Association, vs. Ron Taylor, Commissioner of the Insurance Department for the State of Arkansas, that national banks can sell "Debt cancellation contracts". On November 13, 1990, the Supreme Court declined to hear the case, thus affirming the Eighth Circuit's decision. State chartered banks are authorized to provide for losses arising from the cancellation of outstanding loans upon the death of borrowers by means of a Resolution of the State Banking Board dated July 17, 1984.

A revised Policy Statement dated July 20, 2007, provides additional information regarding Debt Cancellation Contracts.

POLICY

State chartered banks engaging in the activity of issuing debt cancellation contracts must consider the following:

- The bank's Board of Directors shall have considered the risks inherent in such activity and determined by resolution that the issuance of debt cancellation contracts is an approved product to be provided to certain loan customers of the bank;
- The Board of Directors shall designate the bank's officers eligible to offer the contracts;
- A loan limit shall be established for which the debt cancellation contracts may be sold (it would appear that debt cancellation contracts should only be offered for personal and consumer type loans);
- The bank shall 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; and

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- The sale of a debt cancellation contract 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.

- The Board and management of the bank must establish and maintain effective risk management and control processes, including appropriate recognition and financial reporting of income, expenses, assets, and liabilities associated with the products and adequate internal control and risk mitigation measures.

In the event that the debt cancellation contract 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 the 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.

In the event that the debt cancellation contract is negotiated without a provision for rebate of a portion of the fee as a result of early payoff of the loan, all fees generated from the sale of the debt cancellation contracts shall be posted to non-interest income. Increases in the required reserve established to absorb losses shall be made by provision expense and posted to non- interest expense. Both the unearned portion of the fee and the reserve set aside for possible losses are to be recognized as liabilities and/or contra accounts on the bank's books.

Disclosure of the costs of debt cancellation contracts are subject to Section 226.4 of Regulation Z - Truth in Lending. This disclosure is required for any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or condition of the extension of credit.

Potential liability also exists for the bank customer due to liability to a third party who may become a beneficiary due to inheritance and the impact of inheritance taxes. The bank is encouraged to disclose this fact to customers who may wish to seek tax advice on this issue.

The unreserved portion of the outstanding balances of loans in excess of the reserve balance are not to be considered contingent liabilities and, as such, debt cancellation contracts will have no effect upon risk-based capital calculations.

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The evaluation of the practices employed by a bank and bank management in the sale of debt cancellation contracts is to inspect for safety and soundness. The product should be offered so as to minimize risk and limit liability. In the event that minimum safeguards are not employed, management and the board of directors are to be cited for violating prudent banking practices and, in instances where risk is more than ordinary, cease and desist orders will be issued.