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Bank Owned Life Insurance (BOLI): Interagency Guidelines - OCC Bulletin 2004-56

In 2004, the Office of the Comptroller of the Currency (OCC) issued Interagency Guidelines regarding the purchase and risk management of life insurance by banking institutions. These guidelines apply to banks regulated by the OCC, FDIC and Federal Reserve Board. These regulatory bodies all recognize that life insurance holdings can serve a number of appropriate business purposes. In doing so, regulators want to ensure banks utilize safe and sound banking practices in connection with purchases of BOLI.

The following guidelines provide a framework for senior management when considering BOLI. We will specifically discuss the pre-purchase analysis, specific risks and rewards and post-purchase risk assessment. To begin, let's quickly summarize why BOLI cannot be purchased:

- For Speculation
- To provide funds to acquire shares of stock from the estate of a major shareholder upon the shareholder's death for the purpose of controlling the distribution of ownership in the institution
- As an estate planning tool for insiders of the bank, unless the benefit is part of a reasonable compensation package.
- To generate funds for normal operating expenses other than employee compensation and benefits.

In this issue of the Nolan Financial Report, we will not discuss the specific differences between the three types of BOLI (General Account, Separate Account and Hybrid Account), but there is an important regulation for Separate Account BOLI that needs to be understood. Banks can only hold Separate Account BOLI (Variable) insurance policies for the purpose of economically hedging their equity-linked obligations under employee benefit plans. The bank must demonstrate that it has a specific, equity-linked obligation; and at the time of purchase and, on an ongoing basis, changes in the value of the equity-linked variable life insurance policy are highly correlated with changes in the value of the equity-linked obligation. Oftentimes, this equity-linked obligation can be a nonqualified executive benefit plan that has a variable component.

Supervisory Guidance

Before entering into a BOLI contract, institutions should have a comprehensive risk management process for purchasing and holding BOLI. A prudent risk management process includes:

- Effective senior management and board oversight
- Comprehensive policies and procedures, including appropriate limits
- A thorough pre-purchase analysis of BOLI products
- An effective ongoing system of risk assessment, management, monitoring, and internal control processes, including appropriate internal audit and compliance frameworks

Senior Management and Board Oversight

Bank management and board members must understand the advantages, risks and intended role of this life insurance asset as a part of the bank's overall business strategy. Understandably, the board works closely with senior management during the decision making process and can choose to delegate authority related to BOLI transactions. However, the board remains ultimately responsible for ensuring that the purchase and holding of BOLI is consistent with interagency guidelines.

Policies and Procedures

It is best practice for each bank to establish internal policies and procedures governing its BOLI holdings. Specifically, they must be aware of limiting the aggregate cash surrender value (CSV) of policies with any one insurance company as well as the aggregate CSV of policies from all insurance companies. When establishing these internal CSV limits, an institution should consider its legal lending limit, the capital concentration threshold, and any applicable state restrictions on BOLI holdings. Generally, it is not prudent for an institution to hold BOLI with an aggregate CSV that exceeds 25 percent of the institution's capital (Tier 1 Capital). Additionally, banks should not hold more the 15% of their Tier 1 and Tier 2 Capital with any one institution (including insurance companies). This guideline can change from state to state, requiring that banks are aware of local regulations. If these guidelines are exceeded bank management and board members should expect increased scrutiny from examiners and be prepared to justify why BOLI holdings are in excess of guidelines.

Management first needs to make sure that the Board is aware of the interagency guidelines. They must also be reminded of the illiquid nature of the insurance asset and advise them of the potential adverse financial impact of early surrender. The insurance products utilized are generally Modified Endowment Contracts, which place a 10% penalty and the corporate tax rate on gains extracted from the policies. Lastly, they must identify any other significant risks associated with BOLI.

Pre-purchase Analysis

The purpose of the pre-purchase analysis is to help ensure that the bank understands the risks, rewards, and unique characteristics of BOLI. A well-managed BOLI program has a well-documented pre-purchase analysis, usually including documentation of the purpose and amount of insurance needed.

An effective pre-purchase analysis involves the following management actions:

1) Identify the need for insurance & determine the economic benefits and appropriate insurance type.

- An institution should determine the need for insurance by identifying the specific risk of loss to which it is exposed or the specific costs to be recovered.

2) Quantify the amount of insurance appropriate for the institution's objectives.

- An institution should estimate the size of the employee benefit obligation or the risk of loss to be covered and ensure that the amount of BOLI purchased is not excessive in relation to this estimate and the associated product risks.

- When using BOLI to recover the cost of providing employee benefits, the estimated present value of future net cash inflows from BOLI, should not exceed the estimated present value of the expected after-tax employee benefit costs.

3) Assess vendor qualifications.

- Depending on the role of the vendor, the vendor's services can be extensive and may be critical to successful implementation and operation of a BOLI plan.

4) Review the characteristics of the available insurance products.

- An institution should understand the product it is considering purchasing, and select those with the characteristics that best match the institution's objectives, needs, and risk tolerance.

5) Select carrier(s)

- Management should review the product design, pricing, and administrative services of proposed carriers and compare them with the institution's needs.

- Management should also review the insurance company's BOLI experience, ratings, and reputation.

6) Determine the reasonableness of compensation provided to the insured employee if the insurance results in additional compensation.

- Before an institution enters into a split-dollar arrangement or otherwise purchases insurance for the benefit of an officer, director, or employee, the institution should identify and quantify its compensation objective and ensure that the arrangement is consistent with that objective and that the insured's total compensation, including the compensation provided by the split-dollar arrangement, is not excessive.

7) Analyze the associated risks and the ability to monitor and respond to those risks.

- The interagency guidelines suggest that institutions can control compliance and reputation risks by obtaining informed employee consent and limiting death benefit amounts to a reasonable multiple of an employee's salary.

- Institutions can control credit, interest rate, liquidity, and transaction risks by limiting the aggregate CSV of policies from any one insurance carrier, as well as limiting the aggregate CSV of policies from all insurance carriers.

8) Evaluate alternatives

- An institution should analyze the risks and benefits of acquiring BOLI compared to alternative methods for recovering the costs associated with the loss of key persons, providing pre- and post-retirement employee benefits, or providing additional employee compensation, as appropriate.

9) Document decision

- An institution should maintain documentation supporting its comprehensive pre-purchase analysis, including an analysis of both the types and design of products purchased and the overall level of BOLI holdings.

Accounting

Generally Accepted Accounting Principles (GAAP) apply to accounting for insurance assets in banking institutions. Specifically, Financial Accounting Standards Board (FASB) Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*, discusses how to account for holdings of life insurance. An institution should report the carrying value of its BOLI holdings as an "other asset" and the earnings on these holdings should be reported as "other noninterest income."

Monitoring Risks

We have discussed much of what is involved prior to a BOLI transaction. The interagency guidelines also require monitoring BOLI on an ongoing basis. Management should review the performance of the institution's insurance assets with its board of directors, at least annually. More frequent reviews are appropriate due to circumstances such as a BOLI purchase or changes in financial conditions of an insurance carrier. Reviews should include:

- A comprehensive assessment of the specific risks associated with BOLI.

- Identification of which employees are, or will be, insured (e.g., vice presidents and above, employees of a certain grade level).

- Assessment of death benefit amounts relative to employee salaries.
- Calculation of the percentage of insured persons still employed by the institution.
- Evaluation of the material changes to BOLI risk management policies.
- Assessment of the effects of policy exchanges.
- Analysis of mortality performance and impact on income.
- Evaluation of material findings from internal and external audits and independent risk management reviews.
- Identification of the reason for, and tax implication of, any partial surrenders.
- Peer analysis of BOLI holdings.

Lastly, it is expected that liquidity risk, transaction/operational risk, tax and insurable interest risk, reputation risk, credit risk (insurance carrier), interest rate risk, compliance/legal risk and price risk are taken into account.

*All of the risks discussed in this section are applicable to permanent insurance. In contrast, because temporary insurance does not have a savings component or a CSV, it does not expose an institution to liquidity, interest rate, or price risk. These risks need not be evaluated in the comprehensive assessment of the risks of temporary insurance.

Final Thought

In summary, BOLI is an asset that can provide numerous advantages to banks that evaluate, implement and monitor it appropriately. The interagency guidelines provide all the components of the proper risk management process the agencies expect institutions to employ. Acquiring BOLI that approaches or exceeds regulatory concentration levels will generally lead to examiners more closely scrutinizing the bank's risk management process and documentation. Banks should be aware that the vendor's financial benefit from the sale of insurance may provide the vendor with an incentive to emphasize the benefits of a BOLI purchase to the institution without an explanation of the associated risks. The guidelines specifically point out that reliance solely upon pre-packaged, vendor-supplied compliance information does *not* demonstrate prudence with respect to the purchase of insurance. If ineffective controls over BOLI asset levels and risk exist, the appropriate agency may take supervisory action, including requiring the institution to divest affected policies, irrespective of tax consequences.

By utilizing a high-quality, experienced vendor and following interagency guidelines banks can leverage the benefits of BOLI to truly help their overall business strategy. If you have additional questions regarding these interagency guidelines or BOLI in general please contact:

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**See OCC Bulletin 2004-56 for additional information*