A Roadmap for the Purchase and Risk Management of BOLI

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Overview

On December 7, 2004, the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("FRB"), the Federal Deposit Insurance Corporation ("FDIC"), and the Office of Thrift Supervision ("OTS") issued the "Interagency Statement on the Purchase and Risk Management of Life Insurance."[1] This new interagency bank-owned life insurance ("BOLI") guidance replaces previous BOLI guidance in OCC Bulletin 2000-23 (for national banks) and OTS Regulatory Bulletin 32-26 (for state- and federally chartered thrifts). Providing greater clarity and specificity on the federal bank regulatory agencies' expectations regarding BOLI program implementation, operation, and ongoing risk assessment than the now rescinded OCC Bulletin 2000-23, the new BOLI guidance reaffirms the legitimacy of BOLI as a favorable cost-recovery tool, stating that "life insurance can serve a number of appropriate business purposes" and "can be an effective way for institutions to… provide employee compensation and pre- and post-retirement benefits." The interagency BOLI guidance regarding pre-purchase analyses was effective immediately for BOLI purchases occurring on or after December 7, 2004, and the guidance for ongoing management of BOLI is effective immediately for all BOLI investment regardless of the purchase date.

Pre-Purchase Activities

Risk Management Process. The interagency BOLI guidance states that "before entering into a BOLI contract, institutions should have a comprehensive risk management process for purchasing and holding BOLI." The risk management process necessarily entails development of a <u>detailed BOLI</u> investment policy describing, at a minimum:

(1) senior management and board oversight of the BOLI investment;
(2) the single insurer and aggregate insurer BOLI investment limits established by the institution;
(3) the institution's pre-purchase analysis of BOLI products and alternatives; and
(4) the institution's risk assessment, management, monitoring, and internal control processes, as well as the appropriate internal audit and compliance functions.

A detailed BOLI investment policy will assist a financial institution's board in documenting the complex risk characteristics of the BOLI investment and in explaining the role BOLI is intended to play in the institution's overall business strategy

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[1] The Interagency Statement on the Purchase and Risk Management of Life Insurance may be found in OCC Bulletin 2004-56 for national banks, OTS Thrift Bulletin 84 for state- and federally chartered thrifts, Supervisory Letter SR 04-19 for state-chartered, FRB-regulated commercial banks, and FIL-127-2004 for state-chartered, FDIC-regulated commercial banks and savings banks. Uniform in all versions, the document is available in the OCC version at www.occ.treas.gov/ftp/bulletin/2004-56.doc.

Establishment of Internal BOLI Limits. The interagency BOLI guidance states that each institution should establish internal policies and procedures that limit the aggregate cash surrender value of policies from any one life insurance company, as well as the aggregate cash surrender value of life insurance policies from all life insurance companies. When establishing these internal BOLI limits, an institution must consider its legal lending limit, the capital concentration threshold, and, in the case of state-chartered bank and thrift institutions, any applicable state restrictions on BOLI holdings.

With approximately 70% of the nation's FDIC-insured banks and thrifts being state-chartered entities, compliance with state bank regulatory standards can be just as important as a bank's efforts to satisfy federal bank regulatory BOLI supervisory purchase standards. Approximately one-third of the states provide more restrictive BOLI purchase standards than the interagency BOLI guidance, including restrictions on the creation of executive officer and director compensation plans, an important consideration for community banks where BOLI is often used as an informal financing mechanism for new director and officer nonqualified deferred compensation and benefit obligations.

Alone among the four federal bank and thrift regulatory agencies in its supervisory approach regarding the rigidity of BOLI investment limits, the OTS has since July, 2002, required thrifts to request permission before investing more than 25% of core capital in BOLI. For the 274 OTS-chartered thrifts in the 12-state OTS Northeast Region, the OTS Northeast Regional Director stated in a Fall 2004 letter that thrifts intending to purchase BOLI at or above 20% of capital should discuss such purchases with the OTS prior to consummation of the transaction.

Commission Splitting with BOLI Broker Essentially Prohibited. For the first time, the federal bank regulatory agencies also discuss in the BOLI guidance the notion of "fee-splitting," *i.e.*, the splitting of BOLI commissions between a vendor and the institution's own subsidiary or affiliate insurance agency. The guidance notes that the insurance laws of most states prohibit the payment of inducements or rebates to a person as an incentive to purchase life insurance. Accordingly, when an insurance vendor splits its commission with a bank's insurance agency (or worse yet, a bank's employee or director not licensed as a life insurance agent) that was not otherwise involved in the BOLI financing, such a payment may constitute a prohibited inducement or rebate. For this reason, financial institutions with an insurance agency that are not actively participating in the BOLI transaction, as well as financial institutions that do not have an affiliated or subsidiary insurance agency, should not receive or accept any unearned BOLI commissions. The implicit, but unstated, meaning of the federal bank regulatory agencies' discussion of "fee-splitting" is that financial institutions should be extremely wary of purchasing BOLI based solely upon any commissions that might be earned and shared. Regardless of whether fee splitting can be structured as lawful under state insurance law, the potential for "fee-splitting" should not interfere with the financial institution's duty to seek out and purchase the most appropriate type of BOLI product. More often than not, a financial institution interested in receiving BOLI commission is taking its eyes off the proverbial ball.

Tax and Insurable Interest Implications. The interagency BOLI guidance also discusses the tax and insurable interest implications associated with BOLI. To benefit from the favorable tax treatment of life insurance, a BOLI policy must be a valid insurance contract under state insurance law and under applicable federal tax law.

Given the heightened interest of bank regulators, the plaintiffs' bar, and the IRS in business-owned life insurance, insurable interest, and executive compensation, the method by which an institution determines both the existence and extent of insurable interest in its employees should be thoroughly documented and capable of clear articulation by bank management. Judicial case law and state statutes

determine under what circumstances a purchaser of insurance has an insurable interest and, if such an interest exists, to what extent insurance may be purchased on the life of the insured. Failure to recognize quirks of state insurable interest law (such as the method prescribed to solicit employee participation in a BOLI program or limits upon the death benefit commensurate with the loss to the insured upon the insured employee's death) could seriously undermine the effectiveness of a BOLI financing. Whether through exposing the bank to litigation risk from the insured's heirs claiming the policy death benefit or through unanticipated and adverse federal tax treatment applicable to premature surrender of a BOLI policy.

Relying on assurances from insurance carriers that lack of insurable interest will be waived is not a viable alternative to obtaining employees' informed consent. The insurance carriers' waivers are generally not sufficient to satisfy IRS requirements for a valid insurance contract, and would not eliminate potential claims to the insurance proceeds raised by the insureds' estates.

Post-Purchase Activities

Annual BOLI Risk Management Assessment. In addition to conducting a risk assessment as part of a thorough pre-purchase analysis, financial institutions must also monitor BOLI risks on an ongoing basis. The interagency BOLI guidance provides that an institution should review the performance of its BOLI assets with the board of directors at least annually. This annual review should include, but is not limited to, the following elements:

(1) a comprehensive assessment of the liquidity, transaction/operational, tax and insurable interest, reputation, credit, interest rate, and compliance/legal risks associated with the BOLI investment;
(2) identification of which employees are or will be insured;
(3) an assessment of death benefit amounts relative to employee salaries;
(4) a calculation of the percentage of insured persons still employed by the institution;
(5) evaluation of the material changes to BOLI risk management policies;
(6) an assessment of the effects of policy exchanges;
(7) an analysis of mortality performance and impact on income;
(8) an evaluation of material findings from internal and external audits and independent risk management reviews;
(9) identification of the reason for and tax implications of any BOLI policy surrenders; and
(10) a peer group analysis of BOLI holdings.

The requirement that institutions perform an annual review of their BOLI assets is a significant compliance obligation that must be planned for.

It is important to recognize that many of these post-purchase tasks and responsibilities are already performed as a function of the normal administrative services provided by BOLI vendors. In reality, the only aspect of post-purchase compliance that is new is the express requirement that all this information be aggregated on an annual basis and be reported to and reviewed by the board of directors.

Conclusion

Although the interagency BOLI guidance may necessitate changes to an institution's existing or contemplated BOLI program, BOLI remains a very useful cost-recovery tool to finance benefit costs. Banks must now document that the purchase of BOLI, as well as the retention of BOLI, matches the

objectives of management, director-approved risk guidelines, and the institution's risk profile. To maintain current BOLI investment in compliance with these new supervisory expectations, a bank should retain qualified advisors skilled in BOLI regulatory compliance, IRS compliance, state insurable interest compliance, and well-conceived executive compensation planning if BOLI is linked with welfare benefit plans or nonqualified deferred compensation.

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