



OCC BULLETIN

Comptroller of the Currency
Administrator of National Banks

Subject: Bank Purchases of Life Insurance Description: Guidelines for National Banks

TO: Chief Executive Officers of All National Banks, Department and Division Heads, and All Examining Personnel

PURPOSE

This bulletin provides general guidelines for national banks to help ensure that bank purchases of life insurance are consistent with safe and sound banking practices. It replaces Bulletin 96-51, dated September 20, 1996, which is hereby rescinded.

BACKGROUND

Corporate-owned life insurance (COLI) includes all life insurance that a corporation, such as a bank, purchases and owns or has a beneficial interest in. Life insurance is a financial instrument which serves many necessary and useful business purposes. However, as with most financial instruments, COLI can be complicated and is not without risk. Furthermore, COLI transactions are unique and represent activities which differ greatly from the main business activity of most corporations. Some national banks have purchased COLI without fully understanding the transactions and the associated risks.

This bulletin is designed to help national banks make informed decisions consistent with safe and sound banking practices. Bankers should complete a thorough analysis before purchasing COLI. This bulletin sets forth supervisory policy, including minimum standards for pre-purchase analyses, applicable to the purchase of COLI by national banks. The bulletin also includes discussions of the most common uses of COLI and the associated risks.

LEGAL AUTHORITY

The authority for national banks to purchase and hold life insurance is found in 12 USC 24(Seventh), which provides that national banks may exercise “all such incidental powers as shall be necessary to carry on the business of banking.” Purchases of life insurance that the OCC has found to be incidental to banking include key-person insurance, insurance on borrowers, insurance purchased in connection with employee compensation and benefit plans, and insurance



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taken as security for loans.¹ The OCC may approve other uses for bank-owned life insurance on a case-by-case basis. However, a purchase of life insurance must address a legitimate need of the bank for insurance. Life insurance may not be purchased to generate funds for the bank's normal operating expenses, for speculation, or for the primary purpose of providing estate planning benefits for bank insiders unless it is part of a reasonable compensation package. In addition, the purchase of life insurance is subject to supervisory considerations, and life insurance holdings must be consistent with safe and sound banking practices.

SUPERVISORY POLICY

The purchase of permanent life insurance (permanent insurance) policies subjects the policyholder to several risks. The cash surrender value (CSV) of most life insurance products is subject to credit risk.² Usually, the CSV is a long-term, unsecured, nonamortizing obligation of the insurance company. The CSV is also subject to several other risks, such as transaction risk, interest rate risk, liquidity risk, compliance risk, and price risk.

National banks holding life insurance in a manner inconsistent with safe and sound banking practices may be subject to supervisory action. This bulletin outlines supervisory considerations to be used in making this assessment. Supervisory action may include, but is not limited to, partial surrender or divestiture of affected policies.

Pre-purchase Analysis:

The safe and sound use of bank-owned life insurance depends on effective senior management and board oversight. Regardless of the bank's financial capacity and risk profile, the board must understand the role bank-owned life insurance plays in the overall business strategies of the bank.

The board's role in analyzing and overseeing bank-owned life insurance should be commensurate with the size, complexity, and risk inherent in the transaction. Although the board may delegate

¹ The appendix contains a discussion of each of these four uses of COLI.

² Permanent insurance and cash surrender value are described in the appendix on page 1.



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decision-making authority related to bank purchases of life insurance to management, the board remains responsible for ensuring that purchases of life insurance are consistent with safe and sound banking practices.

The objective of the pre-purchase analysis is to help ensure that the bank understands the risks, rewards, and unique characteristics of COLI. As such, each purchase or assumption of a beneficial interest in COLI should be preceded by a thorough pre-purchase analysis. At a minimum, the pre-purchase analysis should consider the following standards.

I. *Determination of the Need for Insurance*

The bank should determine the need for insurance by identifying the specific risk of loss or obligation to be insured against. The existence of a risk of loss or an obligation does not necessarily mean that a national bank can purchase or hold an interest in life insurance. For example, a national bank may not purchase life insurance on a borrower as a mechanism for effecting a recovery on obligations that have been charged-off, or are expected to be charged-off for reasons other than the borrower's death.³ Also, a national bank should surrender or otherwise dispose of permanent life insurance acquired through debts previously contracted (DPC) within a short time frame, generally 90 days, of obtaining control of the policy.⁴

Additionally, the purchase of insurance to indemnify a national bank against a specific risk does not relieve a national bank from other responsibilities related to managing that risk. For example, a national bank may purchase life insurance to indemnify itself from the loss of a "key-person." However, "key-person" life insurance should not be used in place of, nor does it diminish the need for, adequate management or "key-person" succession planning.⁵

³ The purchase of life insurance on borrowers whose obligations have been charged-off, or are expected to be charged-off, is further discussed in the appendix on pages 6-7.

⁴ Life insurance acquired through DPC is further discussed in the appendix on page 7.

⁵ The relationship between "key-person" insurance and management succession planning is discussed in the appendix on pages 4-5.



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II. *Quantification of the Amount of Insurance Needed*

The bank should estimate the size of the obligation or the risk of loss and ensure that the amount of insurance purchased is not excessive in relation to the estimate. For such estimates, national banks may include the cost of insurance and the time value of money in determining the amount of insurance needed. The estimate of the amount of insurance needed should be based on reasonable financial and actuarial assumptions. In situations where a national bank purchases life insurance on a group of employees or a homogenous group of borrowers, it can estimate the size of the obligation or the risk of loss for the group on an aggregate basis and compare that to the aggregate amount of insurance purchased.

Purchasing or holding excessive permanent insurance may be an unsafe and unsound practice if it subjects the bank to unwarranted risks. Bank-owned life insurance subjects the bank to several risks which may be significant. The risks are explained in the “Risks Associated With COLI” section of this bulletin.

III. *Vendor Selection*

The vast majority of COLI purchases are made through vendors, either brokers/consultants or agents. Most corporations have used brokers/consultants. However, some corporations have purchased COLI through agents who work for specific insurance companies. It is also possible to purchase COLI directly from insurance carriers without using a vendor.

The role of the vendor, if any, depends on the type of vendor selected. For example, the vendor may be an agent of a specific insurance company who serves as the bank's primary contact with the insurance company, explains the company's various products, and helps the bank in making product selection. Or, the vendor may be an independent broker who has established working relationships with many insurance companies. In addition to being the bank's primary contact with the insurance company, the broker will work with the bank in selecting a carrier and in designing, negotiating, and administering/servicing the COLI.

The bank does not have to use a vendor. In deciding whether or not to use a vendor or what type of vendor to use, the bank should consider its knowledge of COLI, the amount of resources it can



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and is willing to spend servicing/administering the COLI, and the benefits a vendor may provide. Depending on the role of the vendor, the vendor's services can be extensive and critical to successful implementation and operation of a COLI plan. If the bank uses a vendor, it should make appropriate inquiries to satisfy itself regarding the vendor's ability to honor its commitments, which may be long term. In assessing the vendor's ability to honor its commitments, the bank should typically review the vendor's services, general reputation, experience, and financial capacity. The nature and thoroughness of the review should be determined by the size and complexity of the potential COLI purchase.

IV. *Carrier Selection*

COLI plans are typically of long duration and may represent significant risks for the bank. Therefore, carrier selection is one of the most critical steps in a COLI purchase. The bank should review the product design, pricing, and administrative services of the carrier(s) and compare them with the bank's needs. In addition, the bank should also review the carrier's ratings, general reputation, experience in the market place, and past performance. A broker/consultant, if used, may assist the bank in this regard.

Furthermore, before purchasing life insurance, the bank should perform a credit analysis on the selected carrier(s) in a manner consistent with safe and sound banking practices for commercial lending. A more complete discussion of the credit analysis is included in the "Credit Risk" section of this bulletin.

V. *Review the Characteristics of the Available Insurance Products*

There are a few basic types of life insurance products in the marketplace. However, these products can be combined and modified in many different ways. The resulting final product can be quite complex. The bank should review the characteristics of the various insurance products available. It should select the product or products with characteristics that match the institution's objectives and needs. To do this, the bank should thoroughly analyze and understand the products being considered.

When purchasing insurance on "key-persons" and individual borrowers, the bank should consider whether the bank's need for the insurance will be eliminated before the insured



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individual dies. In such cases, term or declining term insurance may be the most appropriate form of life insurance.⁶

VI. *Analyze the Benefits of COLI*

The bank should analyze the benefits of COLI purchases being considered. The analysis should include an assessment of how the purchase will accomplish the objective specified in “I. Determination of the Need for Insurance.” It should also include an analysis of the anticipated performance of the insurance. A more complete discussion of this analysis is included in the “Transaction Risk” section of this bulletin.

VII. *Determine the Reasonableness of Compensation Provided to the Insured Employee if the Insurance Results in Additional Compensation*

Split-dollar insurance arrangements⁷ typically provide additional compensation and/or other benefits to the employee. Before a national bank enters into a split-dollar arrangement, it should identify and quantify the compensation objective, and ensure that the arrangement is consistent with the stated objective. Also, the bank should combine the compensation provided by the split-dollar arrangement with all other compensation to ensure that total compensation is not excessive. Excessive compensation is prohibited as an unsafe and unsound practice. Guidelines for determining excessive compensation can be found in Appendix A to 12 CFR Part 30–Interagency Guidelines Establishing Standards for Safety and Soundness.

VIII. *Analyze the Associated Risks and the Bank's Ability to Monitor and Respond to those Risks*

Ownership of or beneficial interests in COLI may subject a national bank to several risks. These risks include: transaction, credit, interest rate, liquidity, compliance, and price. A bank's pre-purchase analysis should include a thorough evaluation of these risks. An explanation of each risk is included in the “Risks Associated With COLI” section of this bulletin.

⁶ “Key-person” insurance and life insurance on borrowers are discussed further in the appendix on pages 4-7.

⁷ Split-dollar insurance arrangements are defined and discussed in the appendix on pages 3-4.



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Furthermore, the pre-purchase analysis should allow a national bank to determine whether the transaction is consistent with safe and sound banking practices. In making this determination, a national bank should consider, among other things:

- The complexity of the transaction.
- The size of the transaction relative to the bank's capital.
- The diversification of the credit risk.
- The financial capacity of the bank.
- The financial capacity of the insurance carrier(s).
- The bank's ability to identify, measure, monitor, and control the associated risks.

In assessing the size of the transaction, a national bank should consider the CSV relative to its capital levels at the time of purchase. The bank should also consider projected increases in the CSV and projected changes in capital levels for the duration of the contract.

Consistent with prudent risk management practices, a national bank should establish internal quantitative guidelines. These guidelines generally limit the aggregate CSV of policies from any one insurance company and the aggregate CSV of policies from all insurance companies. Among other things, a bank should consider the legal lending limits (12 CFR Part 32) and concentration of credit guidelines (OCC Bulletin 95-7, dated February 9, 1995) when establishing the respective limits.

IX. *Evaluate Alternatives*

Some COLI purchases involve indemnifying the bank against a specific risk. For example, COLI is sometimes purchased to indemnify the bank against the potential for loss arising from the untimely death of a "key-person." As an alternative to purchasing COLI, a bank may choose to self-insure against this risk. Other COLI purchases are used to recover costs or provide for employee benefits. In these cases, a bank may choose to generate the necessary funds through investments instead of by purchasing insurance. Regardless of the purpose of COLI, a complete pre-purchase analysis will include an analysis of the alternatives.



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X. *Document Decision*

The primary objective of this bulletin is to provide guidelines that will help national banks make informed decisions consistent with safe and sound banking practices. In doing so, national banks generally should consider the pre-purchase analysis just described. A national bank should maintain documentation adequate to show that the bank made an informed decision. The bank should continue to monitor that decision based on the standards set forth in this bulletin.

RISKS ASSOCIATED WITH COLI

For purposes of the OCC's discussion of risk, examiners assess banking risk relative to its impact on capital and earnings. From a supervisory perspective, risk is the potential that events, expected or unanticipated, may have an adverse impact on the bank's capital or earnings. The OCC has defined nine categories of risk for bank supervision purposes. These risks are: *Credit, Interest Rate, Liquidity, Price, Foreign Exchange, Transaction, Compliance, Strategic, and Reputation*. These categories are not mutually exclusive; any product or service may expose the bank to multiple risks. For analysis and discussion purposes, however, the OCC identifies and assesses the risks separately.

The applicable risks associated with COLI are: *Transaction, Credit, Interest Rate, Liquidity, Compliance, and Price*. The definitions of these six risks are summarized below. For complete definitions, see the “Bank Supervision Process” booklet of the *Comptroller's Handbook*. An analysis of how each of these risks impact the decision to purchase and hold COLI is set forth in the following paragraphs.

Transaction Risk

Transaction risk is the risk to earnings or capital arising from problems with service or product delivery. The degree of transaction risk associated with COLI is a function of a bank not fully understanding or properly implementing a transaction. In addition to following the other guidelines included in this bulletin, national banks should take two additional steps to help reduce transaction risk. Bank management should have a thorough understanding of how the insurance product works and the variables that dictate the product's performance. The variables



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most likely to affect product performance are the policy's interest crediting rate,⁸ mortality cost,⁹ and other expense charges. Typically, the most significant variable is the interest crediting rate, followed by the mortality cost. Therefore, before purchasing COLI, a national bank should analyze projected policy values (CSV and death benefits) from multiple illustrations provided by the carrier. Banks should consider using different interest crediting rates and mortality costs assumptions for each illustration.

Bank management should also understand and analyze how COLI will affect the bank's financial condition. Given the anticipated performance of the insurance, management should analyze the effect on the bank's earnings, capital, and liquidity. Management should also consider the impact on the bank's earnings and capital should the bank, for any reason, surrender the insurance before maturity at the death of the insured.

Credit Risk

Credit risk is the risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or otherwise fail to perform as agreed. All life insurance policyholders are exposed to credit risk. The credit quality of the insurance company and duration of the contract are key variables. With term insurance, credit risk arises from the insurance carrier's contractual obligation to pay death benefits upon the death of the insured. Credit risk is primarily a function of the insurance carrier's ability (financial condition) and willingness to pay death benefits as promised. Credit risk may be reduced by the support provided by state insurance guaranty associations or funds. A bank's credit exposure through the ownership of term life insurance is not reflected on the bank's balance sheet.

⁸ The interest crediting rate refers to the gross yield on the investment in the insurance policy, *i.e.*, the rate at which the cash value increases before considering any deductions for mortality cost, load charges, or other costs that are periodically charged against the policy's cash value. Insurance companies frequently disclose a current interest crediting rate and a guaranteed minimum interest crediting rate. The guaranteed rate may be less than the current rate. As a result, the potential exists for future declines in the interest crediting rate.

⁹ Mortality cost represents the cost imposed on the policyholder by the insurance company to cover the amount of pure insurance protection for which the insurance company is at risk.



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With permanent insurance, credit risk arises from the insurance carrier's obligation to pay death benefits upon death of the insured and from its obligation to return the CSV to the policyholder upon request. The risk is similar to that with term insurance, but there are a few differences. With most permanent insurance COLI plans, the expected time frame for collection of death proceeds is extremely long term. Additionally, the CSV is an unsecured, long-term, and nonamortizing obligation of the insurance carrier. The risk inherent in the insurance company's failure to return the CSV value is, reflected on the bank's balance sheet.

Before purchasing life insurance, bank management should evaluate the financial condition of the insurance company and continue to monitor its condition on an ongoing basis. In addition to reviewing the insurance carrier's ratings, the bank should conduct an independent financial analysis consistent with safe and sound banking practices for commercial lending. As with lending, the depth and frequency of the analysis should be a function of the relative size and complexity of the transaction.

Interest Rate Risk

Interest rate risk is the risk to earnings or capital arising from movements in interest rates. General account¹⁰ products expose the policyholder to interest rate risk. The interest rate risk of these products is primarily a function of the policy's interest crediting rate. Interest crediting rates are established by the insurance carrier. Over the long term, interest crediting rates are primarily a function of the carrier's investment portfolio performance. The policy's CSV is negatively affected (grows at a slower rate) by a declining interest crediting rate. Since a bank's investment in permanent insurance is recorded at the policy's CSV, the bank's earnings decline as the policy's interest crediting rate declines.

Due to the interest rate risk inherent in this product, it is particularly important that management fully understand the risk before purchasing the policy. Before purchasing permanent insurance, bank management should:

- Review the policy's past performance over various business cycles.
- Analyze projected policy values (CSV and death benefits).

¹⁰ General account products are defined in the appendix on page 2.



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- Consider having the carrier use a different interest crediting rate for each set of policy projections.

Variable or separate account¹¹ products may also expose the bank to interest rate risk depending on the types of assets held in the separate account. For example, if the separate account assets consist solely of Treasury securities, the bank is exposed to interest rate risk in the same way as holding Treasury securities directly in its investment portfolio. However, because the bank does not control the separate account assets, it is more difficult for the bank to control this risk. Therefore, before purchasing a separate account product, bank management should thoroughly review and understand the instruments governing the investment policy and management of the separate account. Management should understand the risk inherent within the separate account and ensure that the risk is appropriate for the bank. Also, the bank should establish monitoring and reporting systems that will enable the bank to monitor and respond to price fluctuations.

Liquidity Risk

Liquidity risk is the risk to earnings or capital arising from a bank's inability to meet its obligations when they come due, without incurring unacceptable losses. Usually, life insurance policies are not marketable and are illiquid. A secondary market for life insurance does not exist. Although the CSV of policies can be accessed quickly, it typically involves substantial loss. To access the CSV, the bank must withdraw from or borrow against the policy. This may subject the bank to surrender charges, taxes on the gain, and a tax penalty. In addition, the policyholder generally does not receive any cash flow until the death benefit is paid. The lack of liquidity in the product is more significant given that banks normally purchase life insurance policies through a conversion of a liquid asset (cash or marketable securities).

Before purchasing permanent insurance, management should recognize the illiquid nature of the product and ensure the bank has the long-term financial flexibility to hold this asset in accordance with its expected use. The inability of a bank to hold the life insurance until maturity (collection of death benefits) may compromise the success of the COLI plan.

¹¹ Variable or separate account products are defined in the appendix on page 2.



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Compliance Risk

Compliance risk is the risk to earnings or capital arising from violations of, or non-conformance with, laws, rules, regulations, prescribed practices, or ethical standards. Failure to comply with applicable laws, rules, regulations, and prescribed practices (including this bulletin) could compromise the success of a COLI program and result in significant losses for the bank as a result of fines, penalties, or loss of tax benefits. Because tax benefits are critical to the success of most COLI plans, management of a national bank should exercise caution to ensure that its plans comply with all applicable tax laws. In addition, bank management should ensure compliance with other applicable legal and regulatory standards. Other common legal and regulatory considerations include compliance with state insurable interest laws, the Employee Retirement Income Security Act of 1974 (ERISA), sections 23A and 23B of the Federal Reserve Act, 12 CFR Part 215 (Regulation O), and Appendix A to 12 CFR Part 30 - Interagency Guidelines Establishing Standards for Safety and Soundness. Due to the significance of the compliance risk, a national bank may want to seek the advice of qualified counsel.

Price Risk

Price risk is the risk to earnings or capital arising from changes in the value of portfolios of financial instruments. Typically, the policyholder of separate account products assumes all price risk associated with the investments within the separate account. Usually, neither the CSV nor the interest crediting rate on separate account products is guaranteed by the carrier. The amount of price risk is dependent upon the type of assets held within the separate account.

Because the bank does not control the separate account assets, it is more difficult for the bank to control the price risk. Therefore, before purchasing a separate account life insurance product, bank management should thoroughly review and understand the instruments governing the investment policy and management of the separate account. Management should understand the risk inherent in the separate account and ensure that the risk is appropriate for the bank. Also, bank management should establish monitoring and reporting systems that will enable them to monitor and respond to price fluctuations.



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Banks may purchase separate account insurance products that hold equity securities for the purpose of hedging their obligations under employee compensation and benefit plans.¹² This lessens the effect of price risk on the bank's financial statements because changes in the amount of the bank's liability will be hedged by changes in the value of the separate account assets. An example of such a relationship would be where the amount of the bank's deferred compensation obligation is measured by the value of a stock market index, and the separate account contains a stock mutual fund that mirrors the performance of that index. If the insurance cannot be characterized as an effective hedging transaction, the presence of equity securities in a separate account is impermissible.

In addition to the general considerations discussed above, which are applicable to any separate account product, further analysis should be performed when purchasing a separate account product involving equity securities. At a minimum, national banks should:

1. Analyze the bank liability being hedged (*e.g.*, deferred compensation) and the equity securities to be held as a hedge in the separate account. Such an analysis usually documents the correlation between the liability and the equity securities, expected returns for the securities (including standard deviation of returns), and current and projected asset and liability balances.
2. Determine a target hedge effectiveness ratio and establish a method for measuring hedge effectiveness. Establish a process for altering the program if hedge effectiveness drops below acceptable levels. Consideration should be given to the potential costs of program changes.
3. Establish a process for analyzing and reporting the effect of the hedge on the bank's income statement and capital ratios. Such an analysis usually shows results both with and without the hedging transaction.

¹² An economic hedge exists when changes in the value of the liability or other risk exposure being hedged are offset by counterbalancing changes in the value of the hedging instrument.



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ACCOUNTING CONSIDERATIONS

National banks should follow generally accepted accounting principles (GAAP) for financial reporting and Call Report purposes. Financial Accounting Standards Board (FASB) Technical Bulletin 85-4, "Accounting for Financial Purchases of Life Insurance" (TB 85-4) discusses how to account for investments in life insurance. The guidance set forth in TB 85-4 is generally appropriate for all forms of COLI.

Under TB 85-4, a national bank should record its interest in the policy's CSV as an "other asset." The increase in the CSV over time would be recorded as "other noninterest income." In accordance with Call Report requirements, the bank should update its interest in the CSV at least quarterly.

APPLICATION OF THE GUIDELINES

The guidelines in this bulletin are applicable to all purchases of life insurance entered into after the date of this bulletin. Purchases of life insurance policies entered into before the date of this bulletin will be evaluated in the following manner.

Policies purchased after issuance of former Banking Circular (BC)-249, Bank Purchases of Life Insurance

Policies purchased after February 4, 1991, should comply with either the guidelines contained in former BC-249 or with the guidelines in this bulletin.

Policies Purchased before the issuance of former BC-249, Bank Purchases of Life Insurance

Policies purchased before February 4, 1991, are provided a "safe harbor" if the following three conditions are met:

- The policies are convenient or useful in connection with the conduct of the bank's business.
- The policies do not threaten the safety and soundness of the, institution.
- The policies do not represent insider abuse or violate other laws, rules, or regulations.

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If these conditions are met, no further action by the bank is needed. However, the OCC may require corrective action at any time during the bank's ownership or while it has a beneficial interest in a policy, if any of the three conditions are not met. Such determinations will be made on a case by case basis.

ORIGINATING OFFICE

For further information about this bulletin, contact the Office of the Deputy Comptroller for Credit Risk at (202) 874-5170.

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