Texas Department of Banking

SUPERVISORY MEMORANDUM – 1010

February 24, 2004 (rev.)

TO: All State-Chartered Banks
All Bank and Trust Examining Personnel

FROM: Randall S. James, Banking Commissioner

SUBJECT Bank-Owned Life Insurance (BOLI)

I. INTENT OF ISSUANCE

This supervisory memorandum establishes guidelines and best practices for Texas state-chartered banks that purchase or hold life insurance products and is designed to ensure that such activities are consistent with safe and sound banking practices. A bank's board should be active in the prepurchase and postpurchase monitoring of all BOLI plans.

This issuance completely revises Policy Memorandum 1010 issued on September 1, 1997, and is similar to bulletins issued by federal regulatory agencies (OCC Bulletin 2000-23 issued by the Office of the Comptroller of the Currency, Regulatory Bulletin 32-26 issued by the Office of Thrift Supervision, and FDIC Financial Institutions Letter 16-2004).

II. IMPLEMENTATION

This memorandum provides for bank management's initial and ongoing assessment of its ownership of life insurance products. Appendixes A and B should be completed by all banks before their initial purchase of life insurance on employees or directors and annually thereafter. For banks that already hold life insurance products, an initial review for compliance with this memorandum should be performed before August 31, 2004.

III. BACKGROUND

BOLI includes all forms of life insurance that a state-chartered bank purchases, and owns, or has a beneficial interest in. With prudent planning and analysis, along with adequate monitoring and controls, BOLI can afford certain protections and enhance an institution's overall value. However, BOLI transactions can be complicated and often represent activities substantially different than traditional bank products or services. BOLI transactions introduce unique risk characteristics that some state-chartered banks have entered into without fully understanding and/or contrary to sound banking practices.

This supervisory memorandum is designed to aid state-chartered banks in making informed decisions consistent with safe and sound banking practices. Bankers should acquire a thorough understanding of the nature and characteristics of any BOLI product before committing bank resources and ensure that the transaction meets the minimum guidelines set out in this memorandum. BOLI should only be regarded as a method to control risks rather than an investment substitute or method to unjustly fund insider incentives.

IV. LEGAL AUTHORITY

The purchase of life insurance will be subject to supervisory review and must be consistent with safe and sound banking practices. Generally, Texas state-chartered banks may purchase BOLI as an exercise of incidental powers under Texas Finance Code §32.001(b)(6). The Department views the following purchases of life insurance to be incidental to banking:

- Key-person insurance;
- Life insurance on borrowers (this memorandum does not address disability insurance or debt waiver coverage);
- Life insurance purchased in direct connection with and to support the funding needs of employee[1] compensation and benefit plans; and
- Insurance taken as security for loans.

In addition, the Department may approve other uses of BOLI on a case-by-case basis subject to a finding that the purchases address a legitimate need of the bank.[2] Generally, life insurance should not be purchased to generate funds for a bank's normal operations, for speculation, or for primarily providing estate-planning benefits for bank insiders unless it is part of a reasonable compensation package.

Texas law requires that an employer have an insurable interest in the employee's life before purchasing life insurance on the employee that benefits the employer. Employment alone does not give an employer an insurable interest. Banks considering life insurance purchases are encouraged to review the Texas court cases relating to BOLI and consult the Texas Department of Insurance regarding unusual or difficult to understand terms and conditions of a contemplated insurance product.

V. SUPERVISORY POLICY

A comprehensive understanding of the nature, characteristics and risks should be achieved before bank resources are committed to any BOLI product. All BOLI transactions should meet the guidelines set out in this memorandum. BOLI should only be regarded as a method to control risks rather than an investment substitute or method to unjustly fund insider incentives.

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[1] The term "employee" as used in this memorandum includes all forms of employees that perform services for the institution, including but not limited to direct, contract, agent, and leased employees.

[2] Approval from the commissioner is subject to representations made in a bank's original Request for Approval and should any material condition or circumstance subsequently change, the approval would terminate without notice, and the institution would need to submit a new Request for Approval based upon the new conditions.

Cash value life insurance is a long-term, illiquid, nonamortizing asset that is an unsecured obligation of the insurance carrier. Bank transactions of this nature are subject to credit, liquidity, and interest rate risks. Additionally, the bank should be aware of several other risks including: transaction; compliance; and price risks. Banks holding life insurance in a manner inconsistent with safe and sound banking practices may be subject to supervisory actions that could include, but are not limited to, partial surrender or divestiture of affected policies.

Bank management and the board should complete a thorough analysis before purchasing material amounts of BOLI and acquire a comprehensive understanding of the contemplated transaction. This supervisory memorandum includes minimum standards for prepurchase analysis, purchase limits, appropriate approvals, and postpurchase monitoring.

Grandfather Provision: Banks with BOLI values in excess of the "Individual" and "Concentration" limits detailed in section V(A)(9) of this memorandum as of February 20, 2004, shall: (i) divest of their interest in an amount sufficient to comply with the applicable limits, or (ii) seek approval from the commissioner to exceed the applicable limits. Banks needing to exercise one of these two options have until August 31, 2004, to establish compliance with this memorandum.

A. Prepurchase Analysis

The safe and sound use of cash value life insurance depends on effective senior management knowledge and board oversight. Regardless of the institution's financial capacity and risk profile, the board must understand the role BOLI plays in the overall business strategies of the institution. The board's role in analyzing and overseeing cash value life insurance should be commensurate with the size, complexity, and risk inherent in the transaction. Although the board may delegate decision-making authority related to the purchase of life insurance to management, the board remains responsible for ensuring that such purchases: (i) are consistent with safe and sound banking practices; (ii) are in compliance with applicable laws and regulations; and (iii) are appropriate for the needs of the institution.

The objective of the prepurchase analysis is to help ensure that bank management and the board understand the risks, rewards, and unique characteristics of BOLI. In most instances, banks should consider both the best and worst case scenarios and the probability of such occurrences during prepurchase analysis. At a minimum, the prepurchase analysis should consider the following standards.

1. Determination of the Need for Insurance

The institution should determine the need for insurance by identifying the specific risk of loss or obligation against which it is insuring. The existence of a risk of loss or an obligation does not necessarily mean that a bank can purchase or hold an interest in life insurance. For example, a bank may not purchase life insurance on a borrower as a mechanism for recovering obligations that the bank has charged off, or expects to charge off, for reasons other than the borrower's death. Also, a bank should surrender or otherwise liquidate cash value insurance acquired through debts previously contracted within a short time, generally 90 days, of obtaining control of the policy.

The purchase of insurance to indemnify a bank against a specific risk does not relieve it from other responsibilities related to managing that risk. As an example, a bank may purchase life insurance to indemnify itself from the loss of a "key person". However, banks should not use "key-person" life insurance in place of, nor does it diminish the need for, "key-person" succession planning.

A bank's authority to hold life insurance on a key person lapses if the individual is no longer a key person for the institution. Specifically, the key person's retirement, resignation, discharge, or a change in the person's responsibilities could cause the nature of the transaction to no longer be viewed as incidental to banking.

Banks may purchase life insurance on employees that are not "key officers" if the purchase is in direct connection with and to support the funding needs of employee compensation and benefit plans. As a best practice[3], banks should not purchase BOLI on any employee that does not benefit from the purchase, either directly benefiting, or through a split-dollar arrangement or from their participation in a group benefit or compensation. Written permission should also be obtained from the employee. Banks should avoid the appearance of taking advantage of lesser paid employees - the so-called "janitor policies" - and limit purchases to employees in the top 35% of the organization's salary structure. Lesser paid employees can still benefit from policies purchased on employees in the top 35%, but this reduces the reputation risk to the organization and the perception that bank management is taking advantage of these employees.

The Department has reviewed the merits regarding the practice of an institution holding life insurance on directors, officers, or employees that are no longer employed or associated with the institution, either because of termination or retirement. Generally, the Department believes that this practice could subject the bank to unnecessary reputation and compliance risks. As a best practice, banks should consider insurance products that allow substitutions of the insured parties with subsequent recalculation of premiums and benefits. Additionally, the Department also recognizes that the bank may have an ongoing obligation or liability to directors, officers, or employees beyond termination of employment or service due to their eligibility for benefits in the deferred compensation or retirement plan. In these cases, the bank is considered to have a continuing interest and could maintain an insured interest on these individuals after their association with the bank. **Therefore, banks may continue to hold insurance on former employees or directors in order to offset a future obligation related to that former key employee or to offset a future obligation of an employee group in which the employee is a participant.**

As a best practice, banks should obtain the written approval from the employee <u>before</u> a BOLI policy is purchased covering that employee. This is especially important if the employee is not receiving a direct benefit from the BOLI policy, and the bank is purchasing the policy to meet a

[3] "Best practice(s)" as used throughout this memorandum means a recommended practice or control. Though not a requirement, implementation of best practices will be reviewed by examiners in assessing the bank's overall controls over BOLI programs. Best practices are subject to modification and refinement as needed.

future obligation under a broad employee benefit program. If the bank has a continuing interest in a deferred compensation or retirement plan as described above, the employee's written consent should acknowledge and grant permission for the BOLI policy to continue even after employment with the bank is terminated.

Texas law generally recognizes that a lender has an insurable interest in the life of a borrower to the extent of the borrower's obligation to the lender. Banks may protect themselves against risk of loss from the death of a borrower. That protection may take the form of debt cancellation contracts or by the purchase of life insurance policies on borrowers. A lender's insurable interest may equal the borrower's obligation plus the cost of insurance and time value of money.

Holding life insurance in an amount in excess of the bank's credit risk of loss may constitute an unsafe and unsound practice. Once a credit is repaid, otherwise satisfied in full, or charged off, the risk of loss is eliminated. Therefore, banks should surrender or otherwise dispose of life insurance on individual borrowers under these circumstances. For this reason, the economic consequence of terminating the insurance should be considered in selecting the type of insurance and the structure of the policy.

2. Quantifying the Amount of Insurance Needed

Banks contemplating BOLI should estimate the size of the obligation or the risk of loss and ensure that the institution is not purchasing an excessive amount of insurance. To calculate such estimates, banks may include the cost of insurance and the time value of money in determining the amount of insurance needed. The bank should base the estimate of the amount of insurance needed on reasonable financial and actuarial assumptions. In situations where a 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. The bank can then compare the aggregate obligation or risk of loss to the aggregate amount of insurance purchased.

Purchasing or holding excessive permanent insurance may be an unsafe and unsound practice if it subjects the institution to unwarranted risk. BOLI subjects a bank to several risks which may be significant. These risks are further explained below in section V(C) - Risks Associated with BOLI.

3. Vendor Selection

While the majority of BOLI purchases are made through vendors, either brokers/consultants or agents, it is also possible to purchase BOLI directly from insurance carriers without using a vendor. Should an institution decide not to utilize the services of a vendor, the following items should be considered:

- The bank's knowledge of BOLI;
- The resources the bank can, and is willing to, spend on servicing and administering the BOLI; and
- The benefits a vendor may provide.

Depending on the vendor's role, the vendor's services can be extensive and critical to successful implementation and operation of a BOLI plan. If the institution uses a vendor, it should make appropriate inquiries to satisfy itself about the vendor's ability to honor its commitments and the vendor's general reputation, experience, and financial capacity. The institution should base its review on the size and complexity of the potential BOLI purchase. Furthermore, the institution should analyze and compare the qualifications and merits of several vendors to enhance the objectivity of the prepurchase analysis.

Good corporate governance practices should be implemented. If the institution uses a vendor that is associated with the bank in any capacity such as a director, officer, employee, principal shareholder or an affiliate, as defined under sections 23A and 23B of the Federal Reserve Act[4], the board should fully and formally disclose such information along with appropriate analysis and support. The board must ensure that transactions of this nature are in compliance with internal conflicts of interest policies and laws addressing insider and affiliate transactions. For additional information about compliance with applicable laws see section V(D) below – Other Considerations.

4. Carrier Selection

BOLI plans are typically of long duration and may represent significant risks for the institution. Therefore, carrier selection is a critical step in a BOLI purchase. The institution should review the product design, pricing, exit options, and administrative costs and services of the carrier(s) and compare them with the institution's needs. In addition, the institution should review the carrier's ratings (e.g., A.M. Best Company), general reputation, experience in the market place, and past performance. A broker or consultant, if used, may assist the institution in this area, and bank management should ascertain the reasonableness of costs charged by the broker or consultant for services rendered.

Before purchasing a life insurance product, the institution should perform a credit analysis on the selected carrier(s) in a manner consistent with safe and sound banking practices for commercial lending. The carrier should exhibit a sound financial position, high level of experience, and history of safe operations with its supervisory agencies.

5. Review the Characteristics of the Available Insurance Products

There are a few basic types of life insurance products in the market place. However, providers can combine and modify these products in many different ways. The resulting final product can be quite complex. The institution must 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 accomplish this, the institution should thoroughly analyze and understand the products under consideration.

When purchasing insurance on "key persons" and individual borrowers, the institution should consider that the institution's need for the insurance will likely disappear before the insured

[4] Regulation W (12 CFR 223) implements sections 23A and 23B of the Federal Reserve Act for state member banks. The Federal Deposit Insurance Act (12 USC 1828(j)) applies sections 23A and 23B to state nonmember banks.

individual dies. In such cases, term or declining term insurance is often the most appropriate form of life insurance.

6. Assess the Benefits

The bank should analyze the benefits of contemplated BOLI purchases against the risks enumerated in section V(C) - Risks Associated with BOLI. While the analysis should include an assessment of how the purchase will accomplish the objective specified in V(A)(1) - Determination of the Need for Insurance, the analysis should also consider the long-term financial ramifications and requirements to the bank. The analysis should include an assessment of the anticipated financial performance of the insurance product, including the interest crediting rate and the policy's net accumulation rate.[5] While the projected yield on some single-premium life insurance policies may seem attractive, the actual yield may be much lower. Also, insurance and administrative costs the issuer builds into the policy further reduce such yields, and life insurance becomes more expensive as the insured person ages. Often insurance costs will greatly reduce a high stated yield on a cash value product. The bank should ascertain yields before and after these costs.

One of the more common methods used to analyze future benefits and values of an insurance product is "pro forma" analysis. Often this involves assigning projected rates of return, along with expected holding costs and estimated tax benefits, for a proposed BOLI product as compared to more traditional bank investments. The rationale used in deriving the assumptions of a pro forma analysis should be well documented and supported. Banks should also consider assigning percentages of probability with each pro forma scenario along with forecasting best and worst case scenarios.

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

Split-dollar insurance arrangements typically provide additional compensation and/or other benefits to the employee. Before a 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 institution should combine the compensation provided by the split-dollar arrangement with all other compensation to ensure that total compensation is not excessive. The Department views excessive compensation as an unsafe and unsound practice. Nonmember state-chartered banks should refer to Appendix A, Part 364 of the FDIC Rules and Regulations and state-chartered member banks should refer to Appendix D-1, 12 CFR Part 208 for guidelines on determining excessive compensation.

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[5] The interest-crediting rate refers to the gross yield on the investment in the insurance policy. That is the rate at which the cash value increases before considering any deductions for mortality costs, load charges, or other costs the issuer periodically charges 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. The net accumulation rate is the rate at which the policy increases after all costs are deducted, which may be materially less than the interest-crediting rate.

8. Analyze the Associated Risks and the Institution's Ability to Monitor and Respond to those Risks

Ownership of or beneficial interests in BOLI may subject a bank to several types of risk that may include: transaction; credit; interest rate; liquidity; compliance; and price issues. A bank's prepurchase analysis should include a thorough evaluation of these risks. Furthermore, the prepurchase analysis should allow a bank to determine whether the transaction is consistent with safe and sound banking practices. In making this determination, a bank should consider, among other things, the:

- Complexity of the transaction;
- Size of the transaction relative to the institution's capital;
- Diversification of the credit risk;
- Financial capacity of the institution, including the ability to hold BOLI for the anticipated period of time;
- Financial capacity of the insurance carrier(s); and
- Institution's ability to identify, measure, monitor, and control the associated risks.

9. Volume Limitations

In assessing the size of the transaction, bank management should consider the cash surrender value (CSV)[6] relative to its capital levels at the time of purchase. The institution 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 bank should establish internal quantitative guidelines. These guidelines should generally limit the aggregate CSV of policies from any one insurance company and the aggregate CSV of policies from all insurance companies. Note: The actual amount received may be substantially affected by the tax considerations. Banks should know these implications prior to a policy's acquisition.

[6] The liquidation value of the insurance policy if terminated by the policyholder. In the first few years of the policy's life there may be a significant difference between the stated policy value and the cash surrender value due to early cancellation penalties or surrender charges.

The Finance Commission of Texas has adopted a maximum investment limit for BOLI carried on the books of state-chartered banks from a single insurance issuer.

- ***Individual Limit to a Single Insurance Issuer*** - As prescribed in 7 TAC §12.3(a)(9) a bank must limit its investment in the CSV of life insurance from any one issuer to 25% of capital and certified surplus.

In conjunction, this memorandum establishes an aggregate concentration limit for all BOLI policies carried on the books of a state-chartered bank.

- ***Concentration Limit to All Insurance Issuers*** – A bank should limit its aggregate investment in the CSV of life insurance to all issuers to 25% of Tier 1 Capital. An institution however, should not automatically assume that a concentration level as high as 25% is acceptable, as any investment level must be justified and supported as discussed in this policy statement.

  State-chartered banks desiring to exceed the concentration limit must receive the prior written approval of the commissioner to do so. Such requests should enumerate what steps the bank has taken to mitigate the risks involved.

Application of Limits to Separate Account BOLI – *The above maximum investment and concentration limits apply to all BOLI, including separate account BOLI, even when the insurance carrier identifies such investments as separate accounts made up solely of high quality investments. This is because control over the investment and lack of liquidity associated with BOLI apply to both separate account and general account products.*

Exception: For certain separate account BOLI, however, a bank may look through to the underlying asset for determining applicability of the "Individual" limit in 7 TAC §12.3. To qualify for separate treatment of the "Individual" limit, a bank must evaluate the issuer's controls over its separate account assets such as internal and external audits of the assets and activities of the separate accounts, segregation of duties of staff managing the accounts, and a review of fund reporting requirements. The bank must determine that such controls are sufficient to prevent any accidental or illicit misuse of assets in the underlying investments, and the institution's evaluation of the sufficiency of the insurance company's internal and external controls over the separate accounts. In the absence of a thorough review by the bank demonstrating a reliable and bankruptcy remote separation of such accounts by a financially sound and well-managed issuer, the limitation of 7 TAC §12.3 will apply.

The bank should also obtain a legal opinion stating that such separate account assets are insulated by statute or otherwise from other unrelated liabilities (such as in bankruptcy) of the insurance company.

9. Evaluate Alternatives

Some BOLI purchases involve indemnifying the institution against a specific risk. For example, banks sometimes purchase BOLI to indemnify the institution against the potential for loss arising from the untimely death of a "key person." As an alternative to purchasing BOLI, an institution may choose to self-insure against this risk. Other uses of BOLI purchases are to recover costs or provide for employee benefit plans. In these cases, instead of purchasing BOLI, an institution may choose to invest the money in other assets. Regardless of the purpose of BOLI, a complete prepurchase analysis will include an assessment of the alternatives.

10. Exit Strategy

An important part of a bank's preplanning and decision process is the development of a well thought-out exit strategy in the event that the bank needs to prematurely divest of its ownership interest in the BOLI product. The board should fully analyze the financial ramifications to the bank should divesture become a necessity or a choice. Furthermore, the exit strategy should describe the methods and means with which divestiture would occur in order to minimize asset value loss or liability recognition - including income tax consequences. The exit strategy should be updated annually with each performance review of the BOLI program.

Banks should be cautious about the practice of replacing one BOLI product with another, especially in the absence of a legitimate need to address material risk concerns. As previously discussed, premature divesture of a BOLI product can involve significant asset value loss or income tax liability recognition. In some cases insurance vendors or company providers promote such practices as a means to increase their premium income, usually to the detriment of the bank. Regardless, the bank should consider the practice of replacing one or more BOLI product as a material event requiring comprehensive prepurchase analysis and study as discussed in this policy.

11. Approval and Documentation

The board of directors should approve the initial BOLI program and any subsequent changes. A bank should maintain adequate documentation to show that the institution made an informed decision. For additional information about the ongoing review of a BOLI program, see section V(E) – Postpurchase Monitoring.

B. FINANCIAL CONSIDERATIONS

Bank management should understand and analyze how BOLI will affect the institution's financial condition. Management should analyze the effect the anticipated performance of the insurance will have on the institution's earnings, capital, cash flows, and liquidity. Management should also consider the impact that surrender of the insurance (before maturity at the death of the insured) would have on the institution's earnings and capital. This might occur if the institution had a credit quality concern relating to the issuer, if the tax treatment changed, or if the institution had other needs or uses for the invested funds.

C. RISKS ASSOCIATED WITH BOLI

Examiners will assess risk relative to its effect on capital and earnings. The applicable risks associated with BOLI are: Transaction; Credit; Interest Rate; Liquidity; Compliance; and Price. An analysis of each of these risks is set forth in the following paragraphs.

1. Transaction Risk

The degree of transaction risk associated with BOLI is a function of a bank not fully understanding or properly implementing a transaction. In addition to following the other guidelines included in this memorandum, banks should take two additional steps to help reduce transaction risk. Management should have a thorough understanding of how the insurance product works and the variables that dictate the product's performance. The variables most likely to affect product performance are the policy's interest crediting rate, mortality cost,[7] and other expense charges. Typically, the most significant variable is the interest-crediting rate, followed by the mortality cost. Therefore, before purchasing BOLI, a 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. Management should also understand and analyze how BOLI will affect the bank's financial condition. Given the anticipated performance of the insurance, management should analyze the effect on the institution's earnings, capital, and liquidity. Management should consider the impact on the institution's earnings and capital should the bank, for any reason, surrender the insurance before maturity. Other administrative costs related to legal, accounting, and tax issues, as discussed in V(D) Other Considerations, should also be considered.

2. Credit Risk

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.

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 BOLI plans, the expected time for collection of death proceeds is extremely long. Additionally, the CSV is an unsecured, long-term, and nonamortizing obligation of the insurance carrier.

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[7] 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.

Before purchasing life insurance, 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.

3. Interest Rate Risk

General account[8] 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. The insurance carrier establishes interest-crediting rates. Over the long term, interest-crediting rates are primarily a function of the carrier's investment portfolio performance. The policy's CSV grows at a slower rate with 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, management should:

- Review the policy's past performance over various business cycles;
- Analyze projected policy values (CSV and death benefits); and
- Consider having the carrier use a different interest crediting rate for each set of policy projections.

Variable or separate account[9] 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, 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.

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[8] General account life insurance products include whole life insurance or annuities where the policyholder's cash value and any income is supported by the general assets and credit of the issuing insurance company.

[9] Variable or separate account life insurance products may take the form of universal life insurance or annuities where the policyholder's cash value and income is supported by assets held by the insurance company in assets that are segregated from the general assets of the carrier. The policyholder assumes all investment and price risk, and the insurer serves to manage the assets for the policyholder and administer the policy. Generally, assets in separate accounts can only be used for payment of insurance and administration costs related to the policy and policyholder benefits.

4. Liquidity Risk

Usually, life insurance policies are illiquid and unmarketable. 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 BOLI plan. The bank's prepurchase analysis should include an exit strategy to minimize asset value loss and liability recognition if premature disposal of BOLI become necessary.

5. Compliance Risk

Failure to comply with applicable laws, rules, regulations, and prescribed practices (including this memorandum) could compromise the success of a BOLI program and result in significant losses for the bank as a result of fines, penalties, or loss of tax benefits. For this reason, a thorough compliance review is needed before BOLI products are purchased. Consideration should be given to any formal or informal contracts with the executives for deferred compensation or other benefit payments linked to the insurance arrangements. Any other bank contracts that may be related to BOLI products should also be reviewed. Additional legal and regulatory considerations are more fully discussed in section V(D) - Other Considerations in this memorandum.

6. Price Risk

Typically, price risk is associated with separate account BOLI. The policyholder selects an asset or group of assets to invest in and assumes all of the price risk associated with the investments within the separate account. In general, 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 asset(s) held within the separate account. The owner of separate account BOLI may elect to invest in very high quality assets or low quality assets. However, a bank may only invest in separate account BOLI investments that the institution may invest in directly.

Because the bank does not have direct control of the separate account assets, it is more difficult for the bank to control price or other risks. Therefore, before purchasing a separate account life insurance product, 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.

Banks may purchase separate account insurance products that hold equity securities only for the purpose of hedging their obligations under employee compensation and benefit plans.[10] 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, banks should:

- 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.
- 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.
- 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.

D. OTHER CONSIDERATIONS

Before BOLI is purchased, bank management must fully analyze and understand the legal, accounting, call report, and tax implications of these significant purchases. Due to the complexity of these issues, outside advice and counsel may be needed. This guidance addresses many of the issues that are involved in BOLI purchases, but it is certainly not all-inclusive. Unusual circumstances and variations of standard BOLI products will require additional research and specialized assistance.

1. Accounting and Call Report

Banks should follow generally accepted accounting principles (GAAP) for financial reporting purposes. Financial Accounting Standards Board (FASB) Technical Bulletin 85-4, *Accounting for Purchases of Life Insurance*, discusses how to account for investments in life insurance. The guidance set forth in Technical Bulletin 85-4 is generally appropriate for most forms of BOLI.

[10] An economic hedge exists when an institution offsets changes in the value of the liability or other risk exposure being hedged by counterbalancing changes in the value of the hedging investment.

Under Technical Bulletin 85-4, a state-chartered bank should record its interest in the policy's cash surrender value as an "other asset." The increase in the cash value over time should be recorded as "other noninterest income." In accordance with Call Report requirements, the bank should update its interest in cash value at least quarterly.

Sometimes the institution receives all the benefits, but separately agrees to provide those benefits to an employee as deferred compensation. In this case, the bank should account for any cash surrender value in accordance with Technical Bulletin 85-4. Also, the bank should record a deferred liability for any deferred compensation arrangements in accordance with Accounting Principles Board (APB) Opinion No. 12, *Omnibus Opinion-1967*, as amended by Statement of Financial Accounting Standards (SFAS) No. 106, *Employers' Accounting for Postretirement Benefits Other than Pensions*.

Split-Dollar Arrangements - Under employee benefit split-dollar policies, the bank and the employee agree to share in the policy's cash surrender value and/or death benefits. In some circumstances, the bank may not be accruing a separate liability for the employee benefit. In such instances, the institution should record an asset for its investment in the policy equal to the lower of one of the following values:

- The policy's cash surrender value, determined in accordance with FASB Technical Bulletin 85-4; and
- The present value of the future cash flow(s) the bank expects to receive discounted at an appropriate interest rate in accordance with Accounting Principles Board Opinion No. 21.

The bank should immediately record the amount exceeding the investment as an employee benefit expense. The institution may also, where appropriate, record it in other assets as a deferred charge. The bank must amortize the asset as an employee benefit expense in a systematic and rational manner over the time remaining until the employee's full eligibility date. The institution should update its interest in the CSV at least quarterly.

Accounting for Indexed Retirement Plans - Indexed Retirement Plans (IRPs) are one type of deferred compensation agreement that institutions enter into with selected employees. IRPs are typically designed so that the spread each year, if any, between the tax-equivalent earnings on the BOLI covering an individual employee and a hypothetical earnings calculation is deferred and paid to the employee as a postretirement benefit. This spread is commonly referred to as "excess earnings." The hypothetical earnings are computed based upon a predefined variable index rate (e.g., cost of funds or federal funds rate) times a notional amount. The notional amount is typically the amount the institution initially invested to purchase the BOLI plus subsequent after-tax benefit payments actually made to the employee. By including the after-tax benefit payments and the amount initially invested to purchase the BOLI in the notional amount, the hypothetical earnings reflect an estimate of what the institution could have earned if it had not invested in the BOLI or entered into the IRP with the employee. Each employee's IRP may have a different notional amount upon which the index is based. The individual IRP agreements also specify the retirement age and vesting provisions, which can vary from employee to employee.

An IRP agreement typically requires the excess earnings that accrue before an employee's retirement to be recorded in a separate liability account. Once the employee retires, the balance in the liability account is generally paid to the employee in equal, annual installments over a set number of years (e.g., 10 or 15 years). These payments are commonly referred to as the "primary benefit" or "preretirement benefit."

The employee may also receive the excess earnings that are earned after retirement. This benefit may continue until his or her death and is commonly referred to as the "secondary benefit" or "postretirement benefit." The secondary benefit is paid annually, once the employee has retired, in addition to the primary benefit.

Deferred compensation agreements with select employees under individual contracts generally do not constitute postretirement income plans (i.e., pension plans) or postretirement health and welfare benefit plans. The accounting for individual contracts that, when taken together, do not represent a postretirement plan should follow APB Opinion No. 12. If the individual contracts, taken together, are equivalent to a plan, the plan should be accounted for under Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions*, or SFAS 106.

APB Opinion No. 12 requires that an employer's obligation under a deferred compensation agreement be accrued according to the terms of the individual contract over the required service period to the date the employee is fully eligible to receive the benefits, i.e., the "full eligibility date." Depending on the individual contract, the full eligibility date may be the employee's expected retirement date, the date the employee entered into the contract, or a date between these two dates. APB Opinion No.12 does not prescribe a specific accrual method for the benefits under deferred compensation contracts, stating only that the "cost of those benefits shall be accrued over that period of the employee's service in a systematic and rational manner." The amounts to be accrued each period should result in a deferred compensation liability at the full eligibility date that equals the then present value of the estimated benefit payments to be made under the individual contract.

For each IRP, an institution should calculate the present value of the expected future benefit payments under the IRP at the employee's full eligibility date. The expected future benefit payments can be reasonably estimated, should be based on reasonable and supportable assumptions, and should include both the primary benefit and, if the employee is entitled to excess earnings that are earned after retirement, the secondary benefit. The estimated amount of these benefit payments should be discounted because the benefits will be paid in periodic installments after the employee retires. The number of periods the primary and any secondary benefit payments should be discounted may differ because the discount period for each type of benefit payment should be based upon the length of time during which each type of benefit will be paid as specified in the IRP.

After the present value of the expected future benefit payments has been determined, the institution should accrue an amount of compensation expense and a liability each year from the date the employee enters into the IRP until the full eligibility date. The amount of these annual accruals should be sufficient to ensure that a deferred compensation liability equal to the present value of the expected benefit payments is recorded by the full eligibility date. *Any method of* *deferred compensation accounting that does not recognize some expense for the primary benefit and any secondary benefit in each year from the date the employee enters into the IRP until the full eligibility date, is not systematic and rational.*

TB 85-4 addresses the accounting for BOLI. Only the amount that could be realized under the insurance contract as of the balance sheet date (i.e., the cash surrender value reported to the institution by the insurance carrier less any applicable surrender charges not reflected by the insurance carrier in the reported cash surrender value) is reported as an asset. *Because there is no right of offset, an investment in BOLI should be reported as an asset separately from the deferred compensation liability.*

Institutions should follow Accounting Principles Board Opinion No. 20, *Accounting Changes* (APB 20), if a change in their accounting for deferred compensation agreements, including IRPs, is necessary. APB 20 defines various types of accounting changes and addresses the reporting of corrections of errors in previously issued financial statements. APB 20 states that "[e]rrors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared."

For Call Report purposes, an institution must determine whether the reason for a change in its accounting for deferred compensation agreements meets the APB 20 definition of an accounting error. If the reason for the change meets this definition, the error should be reported as a prior period adjustment in the Call Report if the amount is material. Otherwise, the effect of the correction of the error should be reported in current earnings. For more detailed information about IRPs, refer to FDIC Financial Institutions Letter 16-2004 entitled Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-owned Life Insurance.

2. Legal and Regulatory

Banks must ensure that BOLI programs comply with all laws, rules, regulations, and prescribed practices (including those discussed in this memorandum). A compliance review should be performed before purchase and annually thereafter to ensure continued conformity. The Department will evaluate all significant holdings and future purchases of life insurance by banks in light of these guidelines.

The bank should ensure execution of the appropriate policy endorsements, assignments, and related agreements. The institution should also determine if the policy provides adequate safeguards and controls to protect its interest in the policy. Lastly, management should ensure that the bank's share of any cash surrender value and death benefits are appropriately endorsed or assigned to the institution.

Due to the complexity of this review, advice of qualified counsel may be necessary. In particular, the following areas should be reviewed:

- Affiliate transactions - sections 23A and 23B of the Federal Reserve Act;

- Insider transactions -12 CFR Part 215 (Regulation O) and Section 402 of the Sarbanes-Oxley Act of 2002;
- Insider compensation - Part 364 of the FDIC Rules and Regulations – Standards for Safety and Soundness and 12 CFR Part 208.
- Employee retirement plans – Employee Retirement Income Security Act of 1974 (ERISA);

Affiliate Transactions - Banks should determine the applicability of, and ensure compliance with sections 23A and 23B of the Federal Reserve Act. For example, split-dollar life insurance arrangements may be subject to Section 23A of the Federal Reserve Act when a bank purchases an insurance policy, and the beneficiary is its holding company or a management official of the holding company. This will be considered an unsecured extension of credit because the bank pays the holding company's portion of the premium and the holding company will not fully reimburse the institution for its payment until some time in the future. State-chartered banks may not make unsecured loans to affiliates.

In other cases, the parent holding company may actually own the insurance policy and pay the entire premium. A subsidiary bank may make annual loans to the holding company in an amount equal to the premiums paid or, equal to the annual increase in the cash surrender value of the policy, with the insurance policy serving as collateral for the loan. The holding company repays the loans upon either the termination of employment or death of the insured employee. These loans are subject to the quantitative restrictions of section 23A, including the collateral requirements -130 percent of the amount of the loan in this case. The transactions must also comply with the provisions of section 23B of the Federal Reserve Act.

Insider Transactions - Certain insurance arrangements may be subject to Regulation O. In cases where the bank purchases the insurance to provide a fringe benefit to an executive officer of the bank and the institution pays the cost of the policy, the officer should either:

- Reimburse the bank for the amount of the premiums; or
- Report the economic value of the insurance benefit to the Internal Revenue Service as additional taxable or deferred income.

If the officer is responsible to reimburse all or a portion of the value of the insurance benefit, the obligation represents a loan by the bank to the executive officer and may be subject to Regulation O. In addition, certain insider loans may be restricted by the Sarbanes-Oxley Act of 2002 which amended Section 13 of the Securities and Exchange Act of 1934.

Tax Treatment - Since the tax benefits are critical to the success of most BOLI programs, management should ensure that BOLI plans comply with all applicable tax law. Changes in tax law may influence management's determination to continue or expand the bank's BOLI program. Consequently, an initial and ongoing assessment of the tax implications is a necessary part of effective administration of a BOLI program.

The tax treatment relating to split-dollar life insurance arrangements is addressed in 26 CFR Parts 1, 31, and 602 of the Internal Revenue Code and is effective September 17, 2003. The

Internal Revenue Service regulations provide for two mutually exclusive regimes—an economic benefit regime and a loan regime--for determining the tax treatment of split-dollar life insurance arrangements. Ownership of the life insurance contract determines which regime applies. Generally, in a split-dollar life insurance, when the employer provides an employee with economic benefits, the employee would take those economic benefits into account by reporting them as compensation on the employee's Federal income tax return for the year in which the benefits are provided, and the employer would take the economic benefits into account by reporting them on the appropriate employment tax and information returns. Due to the complexity of these tax laws, it is recommended that the bank consult with a specialist to determine the appropriate tax reporting method.

E. POSTPURCHASE MONITORING

The institution's board of directors should continue to monitor ownership and purchases of BOLI based upon the standards set forth in this memorandum.

With respect to individual BOLI policies purchased, the board should receive an annual report detailing the:

- Face and cash surrender values of policies purchased for each officer;
- Aggregate amount of all compensation, including purchases of BOLI policies, for each officer; and
- Continued designation of the insured person as a key officer, if applicable.

Appendix A provides an example to assist banks in compliance with this section.

With respect to the aggregate of all BOLI policies purchased, the board should approve no less than annually a report detailing the:

- Continued ability of BOLI to meet the bank's goals and objectives;
- Material changes in policies or coverage;
- Adequacy of documentation, including written authorization from employees consenting to the BOLI purchase;
- Aggregate face and cash surrender values of policies purchased;
- Relationship of the face and surrender values to bank capital;
- Before and after tax rate of return of the policies;
- Liquidity and surrender value aspects of the policies;
- Changes in law and regulatory guidelines, including tax law;
- Financial condition of each insurance company and its continued ability to honor claims;
- Rating of each insurance company; and
- If separate account products are held, the price risk of the underlying investments.

Appendix B provides an example to assist banks in compliance with this section.

V. CONTACT INFORMATION

For further information about this memorandum, contact the Regional Director assigned to your institution or a member of the Bank and Trust's review staff in Austin (512-475-1300).

APPENDIX - A

Banks may purchase BOLI to protect the bank from the loss of a key officer or to compensate employees, officers, or directors as part of a reasonable compensation package. It is important that board members know how much BOLI is purchased on each employee and how purchases relate to the employee's overall compensation. The following table is provided to assist banks in the Postpurchase Monitoring of BOLI programs. This table provides a reminder of some of the issues that banks should consider on an annual basis.

Review of BOLI Policies Purchased for Individual Employees (Example)

Employee Information		
Name / Title	*Smith, John / Vice President*	
Designated as "Key Officer?"	*No*	
Still employed by bank?	*No – Retired 3 Months Ago*	
Compensation Information		
Standard Compensation: Salary / Bonus / Other / Total	*$28,000 / $2,000 / $500 / $30,500*	
BOLI Compensation: Direct economic benefit provided to employee from BOLI policies (last calendar year)	*None*	
If the plan is a direct economic benefit to the employee, what is the estimated present value of the bank's future liability to the employee? (Exclude Group Benefits)	**Next Year**	*None*
	Total	*None*
Is compensation excessive? (Standard plus BOLI)	*No*	
Split-Dollar program?	*No*	
Is compensation in the top one-third of employees?	*Yes*	
Insurance Policy Information		
Reason(s) for Purchase: **See (1) Below**	*EC - Purchased to offset the bank's future liability for retirement benefits offered to all employees.*	
Insurance company name	*ABC Insurance Company, Austin, Texas*	
Type of Policy / Cash Value / Face Value / Loss Payee	*Whole Life / $50,000 / $200,000 / First Bank, Anywhere*	
Written authorization from employee before purchase?	*Yes*	
Loans from insurance company secured by CV:	*None*	
Estimated rate of return on policy / tax equivalent yield* / annual cost?**	*3% / 5% / $1,750*	

(1) Key Person (KP) ; Employee Compensation or Benefit Plan (EC)

*** = Tax Equivalent Yield is the estimated yield that a taxable investment would need to return to equal the return of this tax-exempt investment after consideration of the bank's income tax status.

Appendix B

Banks must monitor BOLI products after purchase. It is important that board members know how much BOLI is purchased from each insurance company and whether the investments are within the allowed limits. It is also important to assess the continued ability of BOLI to meet the bank's needs and whether there have been any significant changes in laws and regulatory guidance. The following table is provided to assist banks in the Postpurchase Monitoring of BOLI programs.

Review of Company Limits

Insurance Company Information			**Performance Information**			**Policy Information**			
Company Name	**Reason for Purchase:** **See (1) Below**	**Publicly Traded?**	**Financial Condition Reviewed as of:**	**Rating**	**Other**	**Cash Value / Face Value / Loss Payee**	**Cash Value as Percent of:** **Capital and Certified Surplus / Tier 1 Capital ****	**Rate of Return / Tax Equivalent Yield*****	**Separate Account BOLI? (Y/N)**
ABC Insurance Company <u>(Example)</u>	*EC*	*Yes*	*12-31-02*	*A++* *A.M. Best*	*Good Reputation*	*$420,000 / $4,000,000 FS Bank*	*5% / 4%*	*2% / 5%*	*No*
XYZ Insurance Company <u>(Example)</u>	*KP*	*Yes*	*12-31-02*	*A+* *A.M. Best*	*Established Company (1905)*	*$500,000 / $5,000,000 FS Bank*	*6% / 5%*	*2.3% / 5.4%*	*No*
DEF Insurance Company <u>(Example)</u>	*EC Split-Dollar*	*Yes*	*12-31-02*	*A+* *A.M. Best*	*Good Reputation*	*$300,000 / $3,000,000 FS Bank and Officers*	*3.5% / 3%*	*2.3% / 5.4%*	*No*
					Totals for All Policies	*$1,220,000 $12,000,000*	*14.5% / 12%*	*2.1% / 5.2%*	

** = Investment in individual policies must not exceed 25% of capital stock and certified surplus. Investment in all BOLI policies should not exceed 25% of Tier 1 Capital.

*** = Tax Equivalent Yield is the estimated yield that a taxable investment would need to return to equal the return of this tax-exempt investment after consideration of the bank's income tax status.

(1) Key Person (KP) ; Employee Compensation or Benefit Plan (EC)