Bank:

Date of Exam:

Charter #:

Prepared By:

#11– INSURANCE AND RISK MANAGEMENT

(Risk Focused)

ASSIGNMENT OVERVIEW

Banks may generally own: (1) property, casualty, and liability insurance policies in order to protect against certain risks or losses arising from business or events; and (2) life insurance policies to compensate the bank upon the death of a "key officer" or fund benefits for officers and employees. The objective of these procedures is to assess the adequacy of risk management systems and determine if insurance coverage adequately protects against significant or catastrophic loss. The evaluation will also determine whether there is excessive coverage or credit exposure to insurance companies and evaluate the propriety of accounting. For more detailed guidance, consult the FDIC Examination Manual, section 4.4, Fidelity and Other Indemnity Protection. Also refer to the related Reference file on DOBIE which identifies useful regulations, guidance, and other issuances by various regulatory authorities.

INSTRUCTIONS

Examiners must follow the requirements in the Examiner Bulletin addressing Guidelines for Procedures and Work Paper Documentation for Commercial Examinations.

All examiners performing these procedures must be listed above in the "Prepared By" section. All of the CORE ANALYSIS PHASE should be completed. Comments and findings for each step should be made in the comment box below each question. Reference to work paper documentation should also be included here. Documentation is to be sufficient to allow an audit trail of the examiner's thought process and all significant findings.

Based on any significant/critical findings in the CORE ANALYSIS PHASE or as directed by the EIC, the applicable Supplemental Assessment Phase (SAP) should also be performed. Responses should be entered in the SAP and conclusions summarized in the CORE ANALYSIS section comments. Examiners should indicate when SAP is performed.

Information on the Summary of Findings page must tie back to the findings noted within the procedure. The SEIC/EIC will determine which information in the Summary of Findings will be included in the Report of Examination.

The EIC/AEIC should review this procedure when complete. Acknowledgement that this procedure has been reviewed by the EIC/AEIC will be indicated on the SCOPE FORM.

EXAMINERS ARE RESPONSIBLE FOR EXERCISING SOUND JUDGMENT AND UTILIZING REASONABLE INVESTIGATIVE AND ANALYTICAL SKILLS TO ARRIVE AT AN ACCURATE ASSESSMENT OF THE RISK PROFILE OF THIS SEGMENT OF THE INSTITUTION'S OPERATIONS. PERFORMING ALTERNATE PROCEDURES NOT LISTED WITH THESE GUIDELINES MAY BE NECESSARY TO COMPLETE THIS RISK ANALYSIS.

CORE ANALYSIS PHASE

#11 Insurance and Risk Management

1. Prior Criticism

1. Determine whether deficiencies were noted in the **last examination** and most recent **internal/external audit.** If so, determine if deficiencies have been addressed and/or corrected by management. Detail how deficiencies were corrected. *Include copy of exam and/or audit exceptions and management response in work papers or summarize exceptions/criticisms below or indicate the page number in the last examination report where deficiencies are noted, if applicable.*

Comment:

2. Adequacy of Insurance Coverage

2a. Obtain the Schedule of Insurance and evaluate the reasonableness of fidelity bond coverage. Consider the average coverage amounts from the American Bankers Association survey on fidelity insurance coverage. See **Appendix**. *Include schedule in 11-A of the work papers.*

Comment:

2b. Determine if the bank has Comprehensive General Liability Insurance. (Insurance that provides coverage against specified hazards, such as personal injury, medical payments, or other specific risks that may create exposure to a suit for damages against the bank.) *If the bank does not, make a recommendation.*

Comment:

3. Management and Board Oversight

3a. As the bank's insurable risk changes, determine if the board reviews adequacy of insurance policies. If not, evaluate how management ensures adequacy of coverage. Comment on any deficiencies in the monitoring process.

Comment:

3b. If the bank uses the services of an agent that is an insider or is tied to an insider, ensure a conflict of interest does not exist and that the transaction is handled in an arms-length manner. *Comment on any apparent conflicts of interests.*

Conflict of interest? YES ☐ NO ☐

If Yes, Comment:

3c. If any defalcations have occurred since the last exam that require the bank to file a claim, comment on the event and actions taken by the bank and the current status.

#11 Insurance and Risk Management
Defalcations? YES ☐ NO ☐ **If yes, Comment:**
4. Bank Owned Life Insurance (BOLI)
4a. Determine if the bank owns any "BOLI" policies. If yes, then complete the **SAP, providing comments in the SAP and summarizing weaknesses** in the comment section below.
Completed SAP? YES ☐ NO ☐ **If Yes, Comment:**
4b. Determine if the bank owns any life insurance policies on borrowers and the circumstances under which it was obtained. Banks may have an insurable interest in the life of a borrower to the extent of the borrower's obligation to the lender. However, a bank may not structure a loan to be solely repaid upon the death of the insured. Similarly, a bank may not purchase a policy as a means for affecting a recovery on obligations that have been charged-off. Under these circumstances, the policy assumes the characteristics of an investment, which is not permitted by law. For additional guidance, refer to Supervisory Memorandum 1010 Bank-Owned Life Insurance; FDIC FIL 127-2004 *Interagency Statement on the Purchase and Risk Management of Life Insurance*; and FDIC FIL 16-2004 *Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance*.
Comment:
5. Final Analysis
5. Complete the **Summary of Findings**.

SUMMARY OF FINDINGS

#11 - INSURANCE AND RISK MANAGEMENT
Describe all strengths evident from the evaluation.
Describe all weaknesses evident from evaluation, including violations of law/regulation/rules; noncompliance with Departmental policies/guidelines; internal policy deficiencies/ noncompliance; internal control weaknesses; MIS problems; and deficiencies in management supervision.
Determine why weaknesses exist and comment on management's response and plan of action. Identify bank personnel making the response.
SUMMARY RATING ASSIGNED: Choose an item.

Provide copy of this page to EIC/AEIC. Receipt and review of this form by the EIC/AEIC will be evidenced by his/her initials in the appropriate column for this procedure on the SCOPE FORM

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SUPPLEMENTAL ASSESSMENT PHASE

SAP

Document findings within the SAP and summarize conclusions in the corresponding CORE ANALYSIS section.

BANK OWNED LIFE INSURANCE (BOLI)(Q4A)

Refer to the Interagency Statement on the Purchase and Risk Management of Life Insurance, SR 04-19 (FRB) or FIL-127-2004 (FDIC) and the Department's Supervisory Memorandum 1010 for guidance.

1. Obtain and review a complete list of all life insurance policies owned by the bank, noting the following specifics:

- Type of coverage.
- Name of insurance company.
- Expiration date (term).
- Coverage amount.
- Selling agent.
- Amount of premium payment.
- Cash surrender value.
- Beneficiaries.

2. Determine if management and the Board continue to monitor BOLI products after purchases as required by Section E, Post-purchase Monitoring, and Appendix A in Supervisory Memorandum 1010.

3. Ensure that management periodically evaluates the financial or ratings information on the insurance companies to affirm the claims-paying ability of these companies. Comment on any deficiencies.

Comments:

KEY PERSON LIFE INSURANCE

4. A bank may only own life insurance to protect itself against the death of an individual ("key-person policies") or provide a reasonable employee benefit (including deferred compensation). Any ownership outside of these parameters may be considered a violation of 12 CFR 362, which

SAP
requires that state bank insurance activities conform to that which is authorized for national banks under Supervisory Memorandum 1010. If the bank owns any life insurance policies, determine whether: • The board approved and reviewed the appropriateness of the policy before it was purchased. The absence of any prior review should be criticized, particularly where a significant amount of bank funds are committed. **5.** If the bank owns any key-person polices where the bank receives the entire death benefit: • Determine if the employee, that the bank has an insurable interest on, is a key person whose death would be of such consequence to the bank to give an insurable interest. • Ensure that the bank obtained written approval from the employee before the policy was purchased. If the bank has a continuing interest in a deferred compensation or retirement plan, the employee's written consent should acknowledge and grant permission for the BOLI policy to continue even after employment with the bank is terminated. • If any event occurred to discontinue that person's significance to the bank, such as retirement, resignation, discharge, or change in responsibilities, refer to Supervisory Memorandum 1010 to determine if the bank can continue holding the policy. Supervisory Memorandum 1010 states that any of these could result in the transaction no longer being viewed as incidental to banking.
Comments:
DEFERRED COMPENSATION PLANS
6. Determine if the bank owns any deferred compensation/employee benefit policies. In most cases, this is where a bank owns life insurance on an employee, but has agreed to share all or a portion of the benefits with the employee or his/her estate, either through a "split-dollar" policy (with two beneficiaries) or through separate compensation arrangements. • If the policy is on individual who is a principal shareholder of the bank but holds no office at the institution, generally this individual is not entitled to compensation and, therefore, should not be a party to this type of arrangement. • Ensure that the policy is held to protect the bank against contractual liabilities under deferred compensation or retirement programs for bank employee(s). • Determine if the policy is part of a reasonable compensation agreement or benefit plan. If not, review 12 CFR 362 to ensure a violation has not occurred due to use of the policy as an apparent estate-management device. • If the bank has any deferred compensation plans which may be tied to the key-person policy, ensure that the bank established an accrued liability in accordance withFASB ASC 710-10

SAP

Compensation-Retirement Benefits and 715-60 Compensation - Retirement Benefits - Defined Benefit Plans - Other Postretirement. (See Accounting Comments which follow).

7. Determine that the value of the employee benefit policy does not exceed reasonable compensation when combined with other forms of compensation provided to covered employees.

Consider:

- The combined value of all cash and noncash benefits to be provided to the individual.
- The compensation history of the individual and others with comparable expertise at the bank.
- The financial condition of the bank.
- Any connection between the individual and any insider abuse with regard to the bank.

Comments:

OTHER BANK OWNED LIFE INSURANCE

8. If the bank owns any life insurance policies on employees not considered "key", determine:

- If the policy was obtained in to support the funding needs of employee compensation and benefit plans.
- If the bank obtained written permission to purchase/hold the policy.

9. Review Supervisory Memorandum 1010 for best practices regarding life insurance on employees that are not "key persons" and ensure compliance.

Comments:

EVALUATE RISK

10. Consider the potential for interest rate risk, liquidity risk, compliance risk, and price risk as detailed in SM 1010.

11. Calculate the bank's credit exposure to insurers under the life insurance policies. Credit exposure is calculated as the cash surrender value of policy/policies.

13. If the bank owns any single premium universal life insurance policies, determine compliance with the bank's legal lending limit under Sec. 34.201(a) of the Texas Finance Code, as per Supervisory Memorandum 1010.

14. Determine if the aggregate amount of the bank's credit exposure in all its life insurance policies exceed 25% of Tier 1 capital. If so, a concentration of credit should be cited. Prior written approval

SAP

from the Commissioner is also required.

15. Ensure that the bank's share of any cash surrender value and death benefits has been appropriately endorsed or assigned to the bank. Also access the adequacy of controls to protect the bank's interest in the policy (i.e. physical possession).

16. Determine that the value of life insurance policies is properly reflected in the Other Assets account, and that any offsetting liability under an employee benefit obligation is accurately recognized.

- The book value of the asset should equal the cash value of the policy minus any surrender charges. (*Many banks mistakenly book the premium amount of the policy as the cash surrender value*). If a bank records amounts in excess of the net CSV of the policy, then the excess should be classified Loss.
- Ensure that the amount is updated on at least a quarterly basis or upon receipt of revised cash value data from the insurer. The increase in the net cash surrender value of such a policy over time should be periodically credited to "other non-interest income" as per Financial Accounting Standards Board Technical Bulletin No. 85-4 "Accounting for Purchases of Life Insurance" now codified as ASC Topic 325-30 *Investments-Other - Investments in Insurance Contracts.*

  (FASB ASC 325-30, Investments-Other – Investments in Insurance Contracts (formerly FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*, and Emerging Issues Task Force Issue No. 06-5, *Accounting for Purchases of Life Insurance – Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4*) addresses the accounting for BOLI.)

17. For policies where the bank will receive all the benefits from the policy, but has separately agreed, either formally or informally, to provide the employee with deferred compensation or similar benefits, ensure that the bank is recording a separate liability for the deferred compensation arrangement in accordance with Accounting Principles Opinion No. 12 as amended by FAS 106 now codified as ASC Topic 715 –*Compensation- Retirement Benefits* on FASB website.

- Where a separate liability for the employees' benefit is not being accrued, ensure that the bank is recording an asset for its investment in the policy equal to the lower of: (1) the policy Cash Surrender Value, determined in accordance with ASC Topic 325-30 (formerly FASB TB 85-4); or (2) the present value of the future cash flows expected to be received by the bank, discounted in accordance with Accounting Principles Board Opinion No. 21. (codified as ASC 835-30- *Interest- Imputation of Interest* on the FASB website)

18. If any arrangement exists whereby the bank's holding company is scheduled to receive the bulk of any life insurance proceeds after the bank is reimbursed for **premiums** paid, ensure compliance with Section 12 CFR 371c, or Section 23A and 23B of the Federal Reserve Act. Such payment of the premiums by the bank may represent an impermissible unsecured extension of credit to its holding company.

Comments:

SAP

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APPENDIX

ADEQUACY OF INSURANCE COVERAGE

One of the most difficult insurance problems confronting bank management is determining the amount of blanket bond coverage that should be maintained. While an estimate of money and securities which might be lost through burglary or robbery can be fairly accurately calculated, there are no ready measures for estimating potential losses that may arise from employee dishonesty.

Determining an adequate amount of fidelity insurance on the bank's own personnel cannot be based solely on one precise factor. It requires the use of management and examiner judgment. Banking associations or the insurance industry may periodically develop schedules indicating the range of blanket bond coverage carried by banks grouped by deposit size. However, a bank's level of risk exposure is influenced by many variables, only one of which is deposit size. Therefore, an overall assessment of the effectiveness of the bank's internal operations must be considered. Other factors which may increase fidelity exposure and should be given consideration are:

- the amount of cash and securities normally held by the bank;
- the number of employees and their experience level;
- delegations of authority to employees;
- personnel turnover rates;
- the extent of trust, information technology, or off-balance sheet activities; and
- whether an institution is experiencing rapidly expanding operations.

Refer to FDIC Risk Management Manual, Section 4.4 for further guidance.

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