SUPERVISORY MEMORANDUM – 1010

March 1, 2017

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

FROM: Charles G. Cooper, Banking Commissioner

SUBJECT: Bank Owned Life Insurance (BOLI)

PURPOSE

This Texas Department of Banking (the Department) supervisory memorandum establishes guidelines and best practices[1] for Texas state banks that purchase or hold life insurance products. It is designed to aid state banks in making informed decisions consistent with safe and sound banking practices as they relate to bank-owned life insurance (BOLI).

As set out in the guidelines of this memorandum, a bank's management and board should acquire a thorough understanding of the nature and characteristics of any BOLI product before committing bank resources. A central theme to these guidelines is that BOLI should only be regarded as a method to control risks and not as an investment substitute or a method to fund insider incentives.

This revision and replacement of former Policy Memorandum 1010 (February 24, 2004) is similar to the interagency statement issued jointly by the federal bank regulatory agencies on December 7, 2004, see, e.g., FDIC Financial Institution Letter (FIL) 127-2004, Interagency Statement on the Purchase and Risk Management of Life Insurance.

IMPLEMENTATION

This memorandum provides for a bank management's initial and ongoing assessment of its ownership of life insurance products. Appendixes A and B should be completed by a state bank before its initial purchase of life insurance on employees or directors, and annually thereafter.

[1] 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.

BACKGROUND

Most banks find their guidance regarding BOLI purchases from the federal *Interagency Statement on the Purchase and Risk Management of Life Insurance* (*e.g.*, FIL 127-2004 (FDIC) or SR 04-19 (FRB)). The Interagency Statement also addresses the risk weighting of BOLI assets. With the adoption of Basel III and the passage of Dodd Frank, banks may no longer rely solely on the major rating agencies to determine the risk weighting of their BOLI assets. The purpose of the next section of the document, Types of BOLI, is to explain the differences in the products and identify how to assign risk weighting to BOLI assets under the New Basel III Capital Rules.

TYPES OF BOLI

The different types of products available to banks interested in purchasing BOLI include General Account, Separate Account and Hybrid Separate Account products, and each is subject to differences is how risk weighting is assigned.

General Account

General Account BOLI assumes the general assets of the insurance company issuing the BOLI policy will support the policy's cash values. Accordingly, the credit risk of the portfolio is borne by the carrier and typically a minimum interest crediting rate is provided. General Account BOLI is recognized at a risk weighting at 100%.

General Account BOLI policies invest a significant portion in fixed income investments such as corporate bonds, government bonds, private placements, mortgages, asset backed securities, etc., with a smaller percentage invested in equities.

The advantage of a well-diversified traditional General Account product is that it incorporates a long-term investment strategy that is actively managed, well-diversified, and contains a long-term investment horizon. The key disadvantage is that the assets backing the BOLI policyholder are generally subject to claims from other creditors of the insurance company.

Separate Account

In a Separate Account, the policy cash values are backed by assets segregated from the general assets of the insurance company, and are not subject to claims from other creditors of the insurance company. Under this approach the insurance company segregates the holdings from their general account into bank eligible investments managed by fund managers. The bank selects the investment style but does not control the investments. Investments must be bank qualified. Assets are segregated by state law and protected from general creditors. Fund managers provide detailed reporting of the assets within the portfolio. The crediting rate is determined by the insurance company using a yield-to-worst ratio. However there is no guaranteed minimum crediting rate. A stable value insurance rider can be purchased in order to smooth out the mark to market performance and provide downside protection. Cash surrender value fluctuates depending upon the returns from the underlying investments supporting the policies. The cash value potentially could be zero.

Separate Account BOLI under the New Basel III Capital Rules is considered to be an equity exposure to the underlying investment fund(s). There are three approaches for determining the risk weighting of Separate Account assets under the new rule. In the past, some Separate Account products have enjoyed a minimum risk weighting of 20% following one of these three approaches. This may or may not be the case under the New Basel III Capital Rules. The risk weighting will depend largely on the approach selected as well as pertinent terms of the underlying investment funds.

Hybrid Separate Account

In a Hybrid Separate Account policy, like Separate Accounts, the policy cash values are backed by assets segregated from the general assets of the insurance company, and are not subject to claims from other creditors of the insurance company. Under the Hybrid Separate Account structure, policy owners have the choice between investing in the Separate Account options offered within the product. One of those options is usually an investment portfolio that is similar to or a clone of the insurance company's General Account. There may be a minimum interest rate that is credited to guarantee against investment losses. Typically, there are restrictions on how and when assets can be moved from the "General Account" portfolio to one or more of the other Separate Account portfolios.

Under the New Basel III Capital Rules, Hybrid Separate Account products may be treated as either General Account or Separate Account, if the Hybrid account meets the definition of a Separate Account for risk weighting purposes. It is the responsibility of the bank to determine the risk weighting of its Hybrid portfolio. In making this determination, the bank may wish to contact the insurance company offering the Hybrid Account to obtain its position as to whether the insurer's Hybrid Account meets the definition of a Separate Account. If the Hybrid Account meets the definition of a Separate Account, then the bank can elect to follow either a more conservative or more aggressive risk weighting approach. If the Hybrid Account does not meet the definition of a Separate Account, then the bank should risk weight its assets at 100% like a General Account.

To qualify for a Separate Account, the following conditions have to be met:

1. The account must be legally recognized under applicable law.
2. The assets in the account must be insulated from the general liabilities of the insurance company under applicable law and protected from the insurance company's general creditors in the event of the insurer's solvency
3. The insurance company must invest the fund within the account as directed by the contract holder in the investment alternatives designated or in accordance with specific investment objectives or policies.
4. All investment performance, net of fees and assessments, must be passed through to the contract holder, provided that contracts may specify conditions under which there may be a minimum guarantee but not a ceiling.

It is unlikely that Hybrid Separate Account policies will meet the definition of a Separate Account outlined in point number four above. As a result, it will be difficult for banks to take advantage of the lower risk weighting available with such a product due to the classification rules.

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 banks may purchase BOLI as an exercise of incidental powers under Texas Finance Code § 32.001(b). 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[2] 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.[3] Generally, life insurance may not be purchased as an investment alternative to generate funds for a bank's normal operations, for speculation, or for primarily providing estate-planning benefits for bank insiders such as an executive officer, director, or principal shareholder of the bank

Texas law requires an employer to have an insurable interest in an employee's life before purchasing life insurance beneficial to the employer on an employee. Employment alone does not give an employer an insurable interest. State banks considering life insurance purchases are encouraged to review Texas Insurance Code Chapter 1103 Subchapters A and B, as well as Texas court cases on insurable interests.

SUPERVISORY POLICY

A comprehensive understanding of the nature, characteristics and risks of a BOLI product should be achieved by the board and management before bank resources are committed. This can be partially accomplished by ensuring that all BOLI transactions meet the guidelines set out in this memorandum. The bank may also wish to consult with the Texas Department of Insurance regarding unusual or difficult to understand terms and conditions of a contemplated insurance product.

Cash value life insurance is a long-term, illiquid, non-amortizing asset that may be an unsecured obligation of the insurance carrier if funds are invested in a General Account. Bank transactions of this nature are subject to credit, liquidity, and interest rate risks. Additionally, banks should be aware of several other risks, including: transaction; tax; compliance; and price risks. Therefore, BOLI should only be regarded as a method to manage risks rather than an investment substitute or a method to fund insider incentives. Banks holding life insurance in a manner inconsistent with safe and sound banking practices may be subject to supervisory actions which could include, but are not limited to, partial surrender or divestiture of affected policies. Thus, bank

[2] 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.

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

management and the board should complete a thorough analysis and acquire a comprehensive understanding of the contemplated transaction before purchasing material amounts of BOLI.

A. *Pre-Purchase Analysis*

The safe and sound use of cash value life insurance depends on effective senior management knowledge and board oversight. Regardless of the bank'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 bank.

The objective of the pre-purchase analysis is to help ensure that bank management and the board understands 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 the pre-purchase analysis. At a minimum, the pre-purchase analysis should consider the following guidelines.

1. Determination of the Need for Insurance

   A state bank 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. Notably, the purchase of insurance to indemnify a bank against a specific risk does not relieve it from other responsibilities related to managing that risk.

   A state bank may purchase life insurance to indemnify itself from the loss of a "key-person" whose contributions are indispensable to the institution. However, a bank should not use key- person life insurance in place of, or to diminish the need for, key-person succession planning. To qualify for the tax benefits of investing in BOLI (e.g., death benefits are non-taxable), insureds in the BOLI plan should all be in the top thirty-five percent of the organization's compensation structure and have provided written permission to purchase/hold the policy with respect to employees that are not key-persons, a bank should avoid the appearance of taking advantage of lesser paid employees. Regardless, lesser paid employees can benefit from policies purchased on employees in the top thirty-five percent if the gains on those policies are applied to pay for the bank's overall employee benefit costs such as those related to health or retirement plans. A bank may own life insurance to protect itself against the death of an individual ("key person policies"), or provide a reasonable employee benefit (including deferred compensation). It is also permissible for a state bank to retain a policy on an officer who leaves the bank. An individual who is a principal shareholder of the bank, but holds no office (i.e., not an officer or director) is not entitled to compensation and, therefore, should not be a party to this type of arrangement.

The Department has reviewed the merits regarding the practice of a state bank holding life insurance on directors, officers or employees that are no longer employed or associated with the institution, either because of termination or retirement. As a best practice, a state bank should not purchase BOLI on any employee that does not benefit from the purchase, either directly, through a supplemental life insurance plan such as split-dollar, survivor income or death benefit only plans or from their participation in a group benefit or compensation plan. To obtain favorable tax treatment for a BOLI plan, a state bank must obtain written approval from any employee covered by a BOLI policy before it is purchased. The employee’s written consent should acknowledge and grant permission for the BOLI policy to continue after their employment with the bank has ceased in accordance with Internal Revenue Code (IRC) Section 101(j).

A state bank may protect itself against risk of loss from the death of a borrower if the bank has an insurable interest. 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. This protection may take the form of debt cancellation contracts or 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, a state bank 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. Also, a bank should surrender or otherwise liquidate cash value insurance acquired through debts previously contracted within a short time of obtaining control of the policy, generally within 90 days.

2. Quantifying the Amount of Insurance Needed

   A state bank contemplating a BOLI purchase should estimate the size of the obligation or the risk of loss to ensure that the bank is not purchasing an excessive amount of insurance. To calculate such estimates, the bank may include the cost of insurance and the time value of money in determining the amount of insurance needed. These estimates should be based 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.

3. Vendor Selection

   While the vast majority of BOLI purchases are made through vendors, BOLI may sometimes be purchased directly from insurance carriers without using a vendor.

Regardless of whether a state bank decides to utilize or 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;
- The vendor's qualifications; 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; however, management should also demonstrate an understanding of the risks involved in a BOLI purchase and not delegate carrier selection, product choices or product design features to a vendor. If the bank uses a vendor, it should make appropriate inquiries into the vendor's ability to honor its commitments and the vendor's general reputation, experience, and financial capacity. The depth of these inquiries should be tailored to the size and complexity of the potential BOLI purchase. Furthermore, the bank should analyze and compare the qualifications and merits of several vendors to enhance the objectivity of the pre-purchase analysis.

Good corporate governance practices should be followed. If a state bank 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],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) – Other Considerations.

4. Carrier Selection

BOLI plans are typically of long duration and may represent significant risks for a state bank. Therefore, carrier selection is a critical step in a BOLI purchase. A state bank should review the product design, pricing, exit options, and administrative costs and services of the carrier(s) and compare them with the bank's needs. In addition, the bank 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 bank in carrier evaluation, 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 bank 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 in the BOLI market, and history of safe operations with its supervisory agencies. Not all carriers offer BOLI.

[4] 12 USC 371c and 371c-1. Regulation W (12 CFR part 223) implements sections 23A and 23B of the Federal Reserve Act with respect to member banks. Sections 23A and 23B also apply to nonmember banks, see 12 USC 1828(j).

5. Review the Characteristics of the Available Insurance Products

   While only a few basic types of life insurance products exist in the market place, insurance professionals can combine and modify these products in many different ways. The resulting final product can be quite complex. A state bank must review the characteristics of the various insurance products available. It should select the product or products with characteristics that match the bank's objectives and needs. To accomplish this, the bank should thoroughly analyze and understand the products under consideration. The products offered include General Account, Hybrid Separate Account and Separate Account.

   General Account: These products typically provide minimum interest rate guarantees. Current interest rates are typically credited on a quarterly or annual basis. The net rates credited reflect the overall earnings of an insurance company's general account, as well as any expenses associated with the policies. The policies are backed by the general assets of the insurance company. Therefore, the credit quality of a potential carrier is a critical issue to potential buyers.

   Hybrid Separate Account: These products combine features of both the General Account and Separate Account products. Often, two or three investment options are available. Like a General Account, a minimum interest and book value guarantee of assets are provided and the general assets of the insurance company stand behind the policies. Like a Separate Account, the BOLI assets are protected from the claims on the insurer.

   Separate Account: The returns of these policies reflect assets in a segregated account that are not subject to the general creditors of the insurance company. Multiple investment options are typically available. Plan returns are subject to market fluctuations. With a Separate Account product, the policy owner bears the risk of default of assets in the separate account.

   When purchasing insurance on "key persons" and individual borrowers, the bank should consider that the bank's need for the insurance will likely disappear before the insured individual dies. In such cases, term or declining term insurance is often the most appropriate form of life insurance. Purchasing or holding excessive permanent insurance may be an unsafe and unsound practice if it subjects the bank to unwarranted risk, and 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. Purchasing "key person" policies where the bank is not the beneficiary may be considered compensation to the employee.

6. Assess the Benefits

   A state bank should analyze the benefits of a contemplated BOLI purchase 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 objectives specified in V(A)(1), Determination of the Need for Insurance, the analysis should also consider the potential 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 yield[5]. While the projected yield on some single-premium life insurance policies may seem attractive, the actual yield may be much lower. Insurance and administrative costs the issuer builds into the policy reduce the yield. Further, life insurance becomes more expensive as the insured person ages. At older ages, insurance costs can greatly reduce the stated credited interest rate on a cash value product. The bank should ascertain yields before and after these costs (i.e., gross yields and net yields). However, the bank should keep in mind that if the policies are held until the death of the insured(s), the bank will receive the death benefit proceeds from the policies.

One of the more common methods used to analyze future benefits and values of an insurance product are "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 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 bank 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. State nonmember banks should refer to Appendix A of 12 CFR part 364 and state member banks should refer to Appendix D-1 of 12 CFR part 208 for guidelines on determining excessive compensation.

8. Analyze the Associated Risks and the Bank'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, including: transaction; credit; interest rate; liquidity; compliance; and price risk. A state bank's pre-purchase analysis should include a thorough evaluation of these risks. Furthermore, the pre- purchase 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:

[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 yield is the rate at which the policy increases after all costs are deducted, which may be materially less than the interest-crediting rate.

- Complexity of the transaction;
- Size of the transaction relative to the bank's capital;
- Diversification of the credit risk;
- Financial capacity of the bank, including the ability to hold BOLI for the anticipated period of time;
- Financial capacity of the insurance carrier(s); and
- The bank'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]6 relative to its capital levels at the time of purchase. The state 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 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.

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

- ***Individual Limit to a Single Insurance Issuer***: Pursuant to Title 7 of the Texas Administrative Code (7 TAC) § 12.3(a)(9) a state bank must limit its investment in the CSV of life insurance from any one issuer to 25% of Tier 1 Capital.

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

A state bank that desires to exceed the concentration limit should receive the prior written approval of the Commissioner to do so. The request 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

[6] CSV is 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.

associated with BOLI apply to Separate Account, Hybrid Separate Account and General Account products.

10. Evaluate Alternatives

    Some BOLI purchases involve indemnifying the bank against a specific risk. For example, a state bank may purchase BOLI to indemnify the bank against the potential for loss arising from the untimely death of a "key person." As an alternative to purchasing BOLI, a state bank could choose to self-insure against this risk. Another potential use of BOLI is to recover costs of or provide for an employee benefit plan. Instead of purchasing BOLI, a bank could choose to invest the money in other assets. Regardless of the purpose for a BOLI purchase, a complete pre- purchase analysis should include an assessment of the alternatives.

11. Exit Strategy

    An important part of a state bank's pre-planning and decision making process is the development of a well-evaluated exit strategy in the event that the bank needs to prematurely divest its ownership interest in the BOLI product. The board should fully analyze the financial ramifications to the bank were divesture to become a requirement or an option. Further, the exit strategy should describe the methods and means with which divestiture would occur in order to minimize possible 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.

    Generally, BOLI policies can be surrendered at any time, and the full amount of the cash surrender value withdrawn. There are no financial penalties imposed by the insurance company.

    However, before surrendering a BOLI policy, a state bank should obtain competent legal and accounting advice regarding any adverse tax consequences.

    A state bank 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. Transferring assets from one BOLI product to another BOLI product at a different insurance company is called a 1035 exchange (IRC Section 1035). The insurance company is likely to impose surrender charges or other restrictions if the replacement is done before the expiration of the surrender charge or restriction period provided in the policy contract. In some cases, insurance vendors may promote such practices as a means to increase their commission 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 pre-purchase analysis and evaluation as discussed in this policy.

12. Approval and Documentation

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

B. Financial Considerations

Bank management should understand and analyze how BOLI will affect the bank's financial condition. Management should analyze the effect the anticipated performance of the insurance will have on the bank'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 bank's earnings and capital. This might occur if the bank had a credit quality concern relating to the issuer, if the tax treatment changed, or if the bank 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 key 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 (including tax)

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, a state bank should take two additional steps to help reduce transaction risk.

First, management should develop 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 illustration scenarios provided by the carrier which utilize varying interest-crediting rates and mortality costs assumptions for each illustration.

Second, bank management should 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 bank's earnings, capital, and liquidity. Management should consider the impact on the bank'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.

[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

2. Credit Risk

All life insurance policyholders are exposed to credit risk, which is primarily a function of the insurance carrier's financial ability and willingness to pay death benefits as contractually obligated. The credit quality of the insurance company and duration of the investment portfolio(s) are key variables in evaluating the level of credit risk. Additionally, policy design features are able to affect how credit risk exposure arises in BOLI. For example, with any life insurance policy, including BOLI, the expected time for collection of death benefits may be extremely long; additionally, the CSV is an unsecured, long-term, and non-amortizing obligation of the insurance carrier, if the funds are invested in a General Account.

To adequately minimize risk, before purchasing BOLI, 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.

3. Interest Rate Risk

General Account[8] and most Hybrid Separate Account 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. Because a bank's investment in permanent life insurance is recorded as 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 these products, it is particularly important that management fully understand this risk before purchasing the policy. Before purchasing permanent life 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

[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.

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.

4. Liquidity Risk

   Liquidity risk stems from a bank's inability to meet its obligations as they become due. In general, surrender proceeds are paid within thirty (30) days of policy surrender and by law must be paid within 6 months. It's the tax ramifications that generally "limit" the liquidity since an excise tax of 10% must be paid on top of the usual tax on the gains. Although a secondary market for life insurance exists, typical BOLI policies are not attractive to buyers because of their high cash values relative to death benefits. Therefore, a bank should ensure that there is sufficient long-term financial flexibility to allow holding the asset in accordance with its expected use before purchasing. The inability of a bank to hold the life insurance until maturity may compromise the success of the BOLI plan. Part of this risk can be mitigated through the pre-purchase analysis of an exit strategy that minimizes the tax risk should premature disposal of BOLI becomes necessary. However, it should be recognized that the risk due to the lack of liquidity in BOLI is magnified given that a bank typically purchases life insurance policies through a conversion of a liquid asset (e.g. cash or marketable securities).

   While the CSV of policies can be accessed quickly, via loan, withdrawal and surrender, loan charges and/or tax penalties may be imposed. To access the CSV, the bank must withdraw from or borrow against the policy. This borrowing may subject the bank to loan interest charges. In addition, distributions from most BOLI policies, whether via loan, withdrawal or surrender, will subject the bank to taxes on the gain, and a 10% excise tax penalty. The extent of potential expenses, including interest, taxes, and penalties in the liquidation of BOLI should be examined and understood by management pre-purchase, as various features of a policy could increase the cost and further increase liquidity risk.

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 state 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. Care should be taken if a subsidiary or associated entity of the bank receives any commissions from the purchase of BOLI by the bank to avoid violation of rebating statutes. 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 level 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 state bank may only invest in Separate Account BOLI investments that the bank 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.

A state bank may purchase Separate Account insurance products that hold equity securities only for the purpose of hedging its obligations under an employee compensation or benefit plan.[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, a state bank 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.

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

- 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. Accounting Standards Codification ASC 325-30 Investments in Life Insurance (ASC 325-30) discusses how to account for investments in life insurance.

Under ASC 325-30 and via Call Reports, a state 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 bank receives all the benefits, but separately agrees to provide those benefits to an employee as deferred compensation or split dollar life insurance. In this case, the bank should account for any cash surrender value in accordance with ASC 325-30. Also, the bank should record a deferred liability for any deferred compensation or split dollar arrangements in accordance with either Accounting Standards Codification 710 (ASC 710) or 715 (ASC 715), as appropriate.

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 .If such arrangements provide for post-retirement benefits, then the liability should be accounted for in accordance with ASC 715-60 Post-Retirement Benefits Other Than Pensions – Split Dollar Life Insurance Arrangements.

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, a bank 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 bank 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.

Technical Bulletin 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 bank 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.

State banks 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, a state bank 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 FIL-16-2004, 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 bank 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 bank.

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 (12 USC 371c and 371c-1), also see 12 USC 1828(j) and 12 CFR part 223 (Regulation W);
- Insider transactions: 12 CFR part 215 (Regulation O) and Section 402 of the Sarbanes-Oxley Act of 2002 (15 USC 78m(k));
- Insider compensation: Appendix A of 12 CFR part 364 for nonmember banks, and Appendix D-1 of 12 CFR part 208 (Regulation H) for member banks.
- Employee retirement plans: Employee Retirement Income Security Act of 1974 (ERISA) (29 USC 1001 et seq.);

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 bank for its payment until sometime in the future. State 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 bank 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 IRS as additional taxable 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 (15 USC 78m).

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.

E. Post-Purchase Monitoring

The state bank's board of directors, with the assistance of management, should continue to monitor ownership and purchases of BOLI, at least annually, based upon the standards set forth in this memorandum.

1. Monitoring of Each Policy

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 insured;
- Aggregate amount of all compensation, including purchases of BOLI policies, for each insured; and
- Continued designation of the insured person as a key employee, if applicable.

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

2. Monitoring of Aggregate BOLI

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 a state bank in complying with this section.

CONTACT INFORMATION

For further information about this memorandum, contact the Regional Director assigned to your bank or a member of the Bank and Trust Supervision'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 provide compensation to 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 Post-Purchase 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	Universal 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 Post-Purchase 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
Total 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 Tier 1 capital. 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)