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Subject: OCC Issues Bulletin Addressing Bank-Owned Life Insurance

Major References: ***OCC Bulletin 2004-56***

Prior AALU Washington Reports: *04-165*

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Late last year, the Comptroller of the Currency, in conjunction with other federal agencies, issued OCC Bulletin 2004-56, addressing the procedures banks must follow in purchasing and maintaining bank-owned life insurance (BOLI). By issuing the Bulletin, the OCC reaffirmed that the "purchase of BOLI can be an effective way for institutions to manage exposures arising from commitments to provide employee compensation and pre- and post-retirement benefits" and sought to "remind financial institutions that the purchase and risk management of BOLI must be consistent with safe and sound banking practices." The Comptroller expressed concern that "some institutions have invested a significant amount of capital in BOLI without an adequate understanding of the full array of risks it poses."

The Bulletin makes clear that banks may purchase life insurance (i) in connection with employee compensation and benefit plans, (ii) as key person insurance, (iii) to recover the cost of providing pre- and post-retirement employee benefits, (iv) on borrowers, (v) as security for loans, and (vi) for such other uses as the OCC may approve on a case-by-case basis.

The Bulletin sets forth the following requirements for bank purchases of life insurance:

- A bank may not hold life insurance in excess of the risk of loss or cost to be covered, and may not continue to hold life insurance after the risk of loss has been eliminated. For instance, if a bank purchases insurance on a key person for key person purposes, it must surrender the policy when the key person leaves the bank's employ. (For that reason, the Bulletin suggests that permanent insurance typically is not appropriate for key person life insurance; rather, the risk should be covered by term or declining term insurance structured to match the expected tenure of the key person.)

- A bank may hold equity-linked variable life insurance only for the purpose of economically hedging its equity linked obligations under an employee benefit plan. Changes in the value of the insurance must be "highly correlated" with changes in the value of the equity-linked obligation. (An example is a hedge of a deferred compensation obligation that fluctuates in accordance with a stock market index with a separate account that contains a stock index mutual fund.)

- A bank must limit the aggregate cash surrender value (CSV) of policies purchased from any one insurance carrier, as well as the aggregate CSV of policies from all insurance carriers. Generally, a bank may not hold BOLI with an aggregate CSV in excess of 25 percent of its capital.

The Bulletin further requires banks considering the purchase of BOLI to undertake the following:

- Determine the need for insurance by identifying the specific costs to be recovered or the risk of loss to which the bank is exposed.

- Determine the size of the risk of loss or obligation to be covered and ensure that the amount of BOLI purchased is not excessive in relation to that amount. When BOLI is used to recover the cost of providing employee benefits, the estimated present value of the expected future cash flows from the BOLI, less the costs of insurance, may not exceed the estimated present value of the expected after-tax employee benefit costs.

- Review the characteristics of the various insurance products available and select those that best match the institution's objectives, needs, and risk tolerance.

- Carefully assess the qualifications of the insurance agent or vendor who is placing the BOLI policies. The bank should evaluate the adequacy of the vendor's services; the vendor's reputation, experience, and financial soundness; and the vendor's ability to honor its long-term commitments. The vendor's commitment to investing in the operations infrastructure necessary to support BOLI is a "key consideration" in vendor selection.

- Undertake a credit analysis of the selected insurance carrier, and consider the carrier's general reputation, experience in the marketplace, past performance, and commitment to the BOLI product. Carrier selection is "one of the most critical decisions in a BOLI purchase."

- Thoroughly understand the risks attendant to the program, including liquidity risk arising from the illiquid nature of the product; "transaction/operational" risk arising from a failure to fully understand and properly implement this complex transaction; tax rules and risks, including the financial impact of surrendering a policy, the inability under the tax laws to control the investments underlying the contract, and the need for an insurable interest in the covered employees; risks to the bank's reputation; and risks arising from fluctuating interest rates or account values.

- Obtain the informed consent of any employee whose life will be covered by the BOLI program.

- Obtain the advance approval of the bank's board of directors (or a designated board committee) for the BOLI purchase.

Any AALU member who wishes to obtain a copy of OCC Bulletin 2004-56 may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your social security number and select *Current Washington Report* for linkage to source material or (3) email Leigh Foley at foley@aalu.org and include a reference to this *Washington Report*.

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