In June 2026, this document was revised to remove references to reputational risk.

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision

INTERAGENCY STATEMENT ON THE PURCHASE AND RISK MANAGEMENT OF LIFE INSURANCE

PURPOSE

This interagency statement provides general guidance for banks and savings associations (institutions) regarding supervisory expectations for the purchase of and risk management for bank-owned life insurance (BOLI). It also provides guidance for split-dollar arrangements and the use of life insurance as security for loans. The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (agencies) are providing this guidance for institutions to help ensure that their risk management processes for BOLI are consistent with safe and sound banking practices. Among the safe and sound banking practices discussed in this interagency statement is the need for senior management and board oversight of BOLI, including both a thorough pre-purchase analysis of risks and rewards and post-purchase risk assessment. The guidance discusses the permissibility of BOLI purchases and holdings, as well as their risks and associated safety and soundness considerations. The appendix to this document contains a discussion of insurance types and the purposes for which institutions commonly purchase life insurance, as well as a glossary of BOLI-related terminology.

The guidance in this interagency statement for the pre-purchase analysis of life insurance applies to all BOLI contracts entered into after the date of this interagency statement. The guidance concerning the ongoing risk management of BOLI subsequent to its purchase applies to all holdings of life insurance regardless of when purchased. Institutions that purchase life insurance after the date of this interagency statement that are not in compliance with this guidance may be subject to supervisory action. Institutions that entered into BOLI contracts before this date will be evaluated according to each agency's pre-purchase guidance in effect at that time.

Compliance with the supervisory guidance in this interagency statement regarding permissible uses for insurance (*e.g.*, recovery of the costs of providing benefits) does not determine whether the policy satisfies state insurable interest requirements.

BACKGROUND

Life insurance holdings can serve a number of appropriate business purposes. Because the cash flows from a BOLI policy are generally income tax-free if the institution holds the policy for its full term, BOLI can provide attractive tax-equivalent yields to help offset the rapidly rising cost of providing employee benefits. Over the past several years, however, a growing number of institutions have aggressively increased their holdings of BOLI. A number of institutions own life insurance with an aggregate cash surrender value (CSV) in excess of 25 percent of capital even though the agencies have previously identified this capital concentration threshold as the level that institutions should consider when establishing internal limits for their BOLI holdings.

Some institutions have acquired BOLI as part of a "yield-chasing" asset/liability management strategy in an attempt to increase earnings during the recent period of low interest rates and reduced loan demand. The agencies are concerned that some institutions have committed a significant amount of capital to BOLI without having an adequate understanding of the full array of risks it poses – especially risks that are difficult to measure, such as liquidity, transaction/operational, and compliance/legal risks. The agencies expect institutions to implement appropriate risk management processes including meaningful risk limits before implementing or adding to a BOLI program.

The guidance is organized as follows:

- Legal Authority
- Accounting Considerations
- Supervisory Guidance
- Risk Management of BOLI
- Risk-Based Capital Treatment
- Summary
- Appendix

LEGAL AUTHORITY

National banks may purchase and hold certain types of life insurance under 12 USC 24 (Seventh), which provides that national banks may exercise "all such incidental powers as shall be necessary to carry on the business of banking." Federal savings associations also may purchase and hold certain types of life insurance incidental to the express powers granted under the Home Owners' Loan Act. The OCC and OTS have delineated the scope of these authorities through various interpretations addressing the permissible use of life insurance by national banks and federal savings associations.

Under these authorities, national banks and federal savings associations may purchase life insurance in connection with employee compensation and benefit plans, key person insurance, insurance to recover the cost of providing pre- and post-retirement employee benefits, insurance on borrowers, and insurance taken as security for loans. The OCC and OTS may approve other uses on a case-by-case basis.

National banks and federal savings associations may *not* purchase life insurance:

- For speculation;
- To provide funds to acquire shares of stock from the estate of a major shareholder upon the shareholder's death, for the further purpose of controlling the distribution of ownership in the institution;
- As a means of providing estate-planning benefits for insiders, unless the benefit is a part of a reasonable compensation package; or
- To generate funds for normal operating expenses other than employee compensation and benefits.

These restrictions apply even if a national bank or a federal savings association is a Subchapter S corporation for federal income tax purposes.

National banks and federal savings associations may not hold life insurance in excess of their risk of loss or cost to be recovered. For example, once an individual no longer qualifies as a key person because of retirement, resignation, discharge, change of responsibilities, or for any other reason, the risk of loss has been eliminated. Therefore, national banks and federal savings associations may be required to surrender or otherwise dispose of key person life insurance held on an individual who is no longer a key person. Typically, term or declining term insurance is the most appropriate form of life insurance for key person protection.

National banks and federal savings associations may hold equity-linked variable life insurance policies (that is, insurance policies with a return tied to the performance of a portfolio of equity securities held in a separate account[1] of the insurance company) only for the purpose of economically hedging their equity-linked obligations under employee benefit plans. As discussed more fully in the section on "Price Risk," for equity-linked variable life insurance holdings to be permissible, the national bank or federal savings association must demonstrate that:

- It has a specific, equity-linked obligation; and
- Both at the inception of the hedge and, on an ongoing basis, changes in the value of the equity-linked variable life insurance policy are highly correlated with changes in the value of the equity-linked obligation.

If a national bank or federal savings association does not meet these requirements, the equity-linked variable life insurance holdings are not permissible. The use of equity-linked variable life insurance holdings as a long-term hedge against general benefit costs is not permissible because the life insurance is not hedging a specific equity-linked liability and does not meet the "highly correlated" requirement.

As a general matter, the ability of state-chartered banks to purchase insurance (including equity-linked variable life insurance) is governed by state law. In some instances, state laws permit state-chartered banks to engage in activities (including making investments) that go beyond the authority of a national bank. The Federal Deposit Insurance Act (section 24) generally requires insured state-chartered banks to obtain the FDIC's consent before engaging as principal in activities (including making investments) that are not permissible for a national bank. Similarly, the Federal Deposit Insurance Act (section 28) generally requires a state-chartered savings association to obtain the FDIC's consent prior to engaging as principal in activities (including making investments) that are not permissible for a federal savings association. While insured state-chartered banks and state savings associations may seek the FDIC's consent to make purchases of life insurance that would not be within the authority of a national bank or federal savings association, such banks and savings associations should be aware that the FDIC will not grant permission to make life insurance purchases if the FDIC determines that doing so would present a significant risk to the deposit insurance fund or that engaging in such purchases is inconsistent with the purposes of federal deposit insurance.

[1] A separate account is a design feature that is generally available to purchasers of whole life or universal life whereby the policyholder's cash surrender value is supported by assets segregated from the general assets of the carrier. Under such an arrangement, the policyholder neither owns the underlying separate account nor controls investment decisions (*e.g.*, timing of investments or credit selection) in the underlying separate account that is created by the insurance carrier on its behalf. Nevertheless, the policyholder assumes all investment and price risk.

ACCOUNTING CONSIDERATIONS

Institutions should follow generally accepted accounting principles (GAAP) applicable to life insurance for financial and regulatory reporting purposes. Financial Accounting Standards Board (FASB) Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance* (TB 85-4), discusses how to account for holdings of life insurance. Under TB 85-4, only the amount that could be realized under an insurance contract as of the balance sheet date (that is, the CSV reported to the institution by the carrier, less any applicable surrender charges not reflected by the insurance carrier in the reported CSV) is reported as an asset. The guidance set forth in TB 85-4 concerning the carrying value of insurance on the balance sheet is generally appropriate for all forms of BOLI.

An institution may purchase multiple permanent insurance policies from the same insurance carrier with each policy having its own surrender charges. In some cases, the insurance carrier will issue a rider or other contractual provision stating that it will waive the surrender charges if all of the policies are surrendered at the same time. Because it is not known at any balance sheet date whether one or more of the policies will be surrendered before the deaths of the insureds, the possibility that the institution will surrender all of these policies simultaneously and avoid the surrender charges is a gain contingency. Under FASB Statement No. 5, *Accounting for Contingencies*, "[c]ontingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization." Accordingly, an institution should report each of the insurance policies on its balance sheet at the policy's CSV reported by the insurance carrier, less any applicable surrender charges not reflected in the reported CSV, without regard to the existence of the rider.

In accordance with the instructions for Consolidated Reports of Condition and Income and Thrift Financial Reports, an institution should report the carrying value of its BOLI holdings as an "other asset" and the earnings on these holdings should be reported as "other noninterest income."

The agencies have seen a number of cases in which institutions have failed to account properly for a type of deferred compensation agreement, commonly referred to as a revenue-neutral plan or an indexed retirement plan. The accounting for such plans is separate and distinct from the accounting for BOLI. However, because many institutions buy BOLI to help offset the cost of providing such deferred compensation, the agencies have issued guidance addressing the accounting requirements for both deferred compensation agreements and BOLI. See the "Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance," dated February 11, 2004, for a complete description, including examples, of the appropriate accounting treatment.

SUPERVISORY GUIDANCE

Before entering into a BOLI contract, institutions should have a comprehensive risk management process for purchasing and holding BOLI. A prudent risk management process includes:

- Effective senior management and board oversight;
- Comprehensive policies and procedures, including appropriate limits;
- A thorough pre-purchase analysis of BOLI products; and
- An effective ongoing system of risk assessment, management, monitoring, and internal control processes, including appropriate internal audit and compliance frameworks.

The risks associated with temporary (term) insurance are significantly less than those arising from holdings of permanent insurance. Accordingly, the risk management process for temporary insurance may take this difference into account and need not be as extensive as the risk management process for permanent insurance.

Senior Management and Board Oversight

The safe and sound use of BOLI depends on effective senior management and board oversight. Regardless of an institution's financial capacity and risk profile, the board must understand the complex risk characteristics of the institution's insurance holdings and the role this asset is intended to play in the institution's overall business strategy. Although the board may delegate decision-making authority related to purchases of BOLI to senior management, the board remains ultimately responsible for ensuring that the purchase and holding of BOLI is consistent with safe and sound banking practices.

An institution holding life insurance in a manner inconsistent with safe and sound banking practices is subject to supervisory action. Where ineffective controls over BOLI risks exist, or the exposure poses a safety and soundness concern, the appropriate agency may take supervisory action against the institution, including requiring the institution to divest affected policies, irrespective of potential tax consequences.

Policies and Procedures

Consistent with prudent risk management practices, each institution should establish internal policies and procedures governing its BOLI holdings, including guidelines that limit the aggregate CSV of policies from any one insurance company as well as the aggregate CSV of policies from all insurance companies. When establishing these internal CSV limits, an institution should consider its legal lending limit, the capital concentration threshold, and any applicable state restrictions on BOLI holdings.[2] In this regard, given the liquidity, transaction/operational, and compliance/legal risks associated with BOLI, it is generally not prudent for an institution to hold BOLI with an aggregate CSV that exceeds 25 percent of the institution's capital as measured in accordance with the relevant agency's concentration guidelines.[3] Therefore, the agencies expect an institution that plans to acquire BOLI in an amount that results in an aggregate CSV in excess of 25 percent of capital, or any lower internal limit, to gain prior approval from its board of directors or the appropriate board committee. The agencies particularly expect management to justify that any increase in BOLI resulting in an aggregate CSV above 25 percent of capital does not constitute an imprudent capital concentration. An institution holding BOLI in an amount that approaches or exceeds the 25 percent of capital concentration threshold can expect examiners to more closely scrutinize the

[2] In July 1999, the OTS adopted a policy that savings associations may not invest more than 25 percent of their total capital in BOLI without first notifying and obtaining authorization from their OTS Regional Office. In order to maintain strong and effective communications with institutions under its supervision, the OTS retains this policy. The other agencies may also institute approval or notification requirements.

[3] Each agency's definition of a concentration differs slightly. Institutions should refer to the definition provided by their supervisory agency when measuring the CSV of BOLI as a percentage of capital: OCC Bulletin 95-7 for national banks; FRB Commercial Bank Examination Manual Section 2050.1 for state member banks; FDIC Manual of Examination Policies, Section 11.1 for insured state nonmember banks; and OTS Thrift Activities Handbook, Section 211 for savings associations.

risk management policies and controls associated with the BOLI assets and, where deficient, to require corrective action.

When seeking the board's approval to purchase or increase BOLI, management should inform the board members of the existence of this interagency statement, remind them of the illiquid nature of the insurance asset, advise them of the potential adverse financial impact of early surrender, and identify any other significant risks associated with BOLI. Such risks might include, but are not limited to, the costs associated with changing carriers in the event of a decline in the carrier's creditworthiness and the potential for noncompliance with state insurable interest requirements and federal tax law.

Pre-purchase Analysis

The objective of the pre-purchase analysis is to help ensure that the institution understands the risks, rewards, and unique characteristics of BOLI. The nature and extent of this analysis should be commensurate with the size and complexity of the potential BOLI purchases and should also take into account existing BOLI holdings. A mark of a well-managed institution is the maintenance of adequate records concerning its pre-purchase analyses, usually including documentation of the purpose and amount of insurance needed.

An effective pre-purchase analysis involves the following management actions:

I. Identify the Need for Insurance and Determine the Economic Benefits and Appropriate Insurance Type

An institution should determine the need for insurance by identifying the specific risk of loss to which it is exposed or the specific costs to be recovered. It is not appropriate to purchase life insurance to recover a loss that the institution has already incurred. An institution's purchase of insurance to indemnify it against a specific risk of loss does not relieve it from other responsibilities related to managing that risk. The type of BOLI product, *e.g.,* general[4] or separate account, and its features should be appropriate to meet the identified needs of the institution. The appendix contains a description of insurance types and design features.

An institution should analyze the cost and benefits of planned BOLI purchases. The analysis should include the anticipated performance of the BOLI policy and an assessment of how the purchase will accomplish the institution's objectives. Before purchasing BOLI, an institution should analyze projected policy values (CSV and death benefits) using multiple illustrations of these projections provided by the carrier, some of which incorporate the institution's own assumptions. An institution should consider using a range of interest-crediting rates and mortality-cost assumptions. In some cases, the net yield (after mortality costs) could be negative, particularly for separate account products. The potential for unfavorable net yields underscores the importance of carefully evaluating BOLI costs and benefits across multiple scenarios, both currently and into the future.

[4] A general account is a design feature that is generally available to purchasers of whole or universal life insurance whereby the general assets of the insurance company support the policyholder's CSV.

II. Quantify the Amount of Insurance Appropriate for the Institution's Objectives

An institution should estimate the size of the employee benefit obligation or the risk of loss to be covered and ensure that the amount of BOLI purchased is not excessive in relation to this estimate and the associated product risks. When using BOLI to recover the cost of providing employee benefits, the estimated present value of the expected future cash flows from BOLI, less the costs of insurance, should not exceed the estimated present value of the expected after-tax employee benefit costs. In situations where an institution purchases BOLI on a group of eligible employees, it may estimate the size of the obligation or the risk of loss for the group on an aggregate basis and compare that to the aggregate amount of insurance to be purchased. This estimate should be based on reasonable financial and actuarial assumptions. State insurable interest laws may further restrict or limit the amount of insurance that may be purchased on a group of employees. Management must be able to support, with objective evidence, the reasonableness of all of the assumptions used in determining the appropriate amount of insurance coverage needed by the institution, including the rationale for its discount rates and cost projections.

III. Assess Vendor Qualifications

When making a decision about vendors, an institution should consider its own knowledge of insurance risks, the vendor's qualifications, and the amount of resources the institution is willing to spend to administer and service the BOLI. Depending on the role of the vendor, the vendor's services can be extensive and may be critical to successful implementation and operation of a BOLI plan, particularly for the more complex separate account products.

While it is possible to purchase insurance directly from insurance carriers, the vast majority of insurance purchases are made through vendors – either brokers, consultants, or agents. A vendor may design, negotiate, and administer the BOLI policy. An institution should ensure that it understands the product it is purchasing and that it selects a product that best meets its needs. Management, not just the vendor, must demonstrate a familiarity with the technical details of the institution's insurance assets, and be able to explain the reasons for and the risks associated with the product design features they have selected.

An institution that uses a vendor should make appropriate inquiries to satisfy itself about the vendor's ability to honor its long-term commitments, particularly when the vendor is expected to be associated with the institution's insurance program over an extended period of time. The institution should evaluate the adequacy of the vendor's services and its experience, financial soundness, and commitment to the BOLI product. Vendors typically earn a large portion of their commissions upon the sale of the product, yet they often retain long-term servicing responsibilities for their clients. The vendor's commitment to investing in the operational infrastructure necessary to support BOLI is a key consideration in vendor selection.

An institution should be aware that the vendor's financial benefit from the sale of insurance may provide the vendor with an incentive to emphasize the benefits of a BOLI purchase to the institution without a commensurate explanation of the associated risks. Therefore, reliance solely upon pre-packaged, vendor-supplied compliance information does *not* demonstrate prudence with respect to the purchase of insurance. An institution should not delegate its selection of product design features to its vendors. An institution that is unable to demonstrate a thorough understanding of BOLI products it has purchased and the associated risks may be subject to supervisory action.

IV. Review the Characteristics of the Available Insurance Products

There are a few basic types of life insurance products in the marketplace. These products, however, can be combined and modified in many different ways. The resulting final product can be quite complex. Furthermore, certain permanent insurance products have been designed specifically for banks. These products differ from other forms of corporate-owned life insurance (COLI) policies in that the policies designed for banks are generally structured without surrender or front-end sales charges in order to avoid having to report these charges as expenses when initially recording the carrying value. However, BOLI products may have lower net yields than COLI products due to the absence of these charges. An institution should review the characteristics of the various insurance products available, understand the products it is considering purchasing, and select those with the characteristics that best match the institution's objectives, needs, and risk tolerance.

Design features of permanent insurance policies determine: 1) whether the policy is a general account, separate account, or hybrid product;[5] 2) whether the insurance contract is a modified endowment contract (MEC) that carries certain tax penalties if surrendered; and 3) the method used to credit earnings to the policy. Some implications of these design features are discussed in more detail in the "Risk Management of BOLI" section of this interagency statement.

When purchasing insurance on a key person or a borrower, management should consider whether the institution's need for the insurance might end before the insured person dies. An institution generally may not hold BOLI on a key person or a borrower once the key person leaves the institution or the borrower has either repaid the loan, or the loan has been charged off. Therefore, the maturity of the term or declining term insurance should be structured to match the expected tenure of the key person or the maturity of the loan, respectively. Permanent insurance generally is not an appropriate form of life insurance under these circumstances.

V. Select Carrier

To achieve the tax benefits of insurance, institutions must hold BOLI policies until the death of the insured. Therefore, carrier selection is one of the most critical decisions in a BOLI purchase and one that can have long-term consequences. While a broker or consultant may assist the institution in evaluating carrier options, the institution alone retains the responsibility for carrier selection. Before purchasing life insurance, an institution should perform a credit analysis on the selected carrier(s) in a manner consistent with safe and sound banking practices for commercial lending. A more complete discussion of the credit analysis standards is included in the "Credit Risk" section of this interagency statement.

Management should review the product design, pricing, and administrative services of proposed carriers and compare them with the institution's needs. Management should also review the carrier's commitment to the BOLI product, as well as its credit ratings, experience in the marketplace, and past performance. Carriers not committed to general account BOLI products may have an incentive to lower the interest-crediting rate on BOLI over time, reducing the favorable economics of the product. 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 cost, load charges, or other costs that are periodically

[5] A hybrid product combines features of both general and separate account products.

charged against the policy's cash value. Insurance companies frequently disclose both a current interest-crediting rate and a guaranteed minimum interest-crediting rate. Institutions should be aware that the guaranteed minimum interest-crediting rate may be periodically reset in accordance with the terms of the insurance contract. As a result, the potential exists for a decline in the interest-crediting rate.

While institutions can exercise what is known as a 1035 Exchange[6] option to change carriers, there are some practical constraints to using this option. First, the institution must have an insurable interest in each individual to be insured under the new carrier's policy. In a 1035 Exchange, former employees of the institution may not be eligible for coverage under the new policy because state insurable interest laws may prohibit their eligibility. Second, the original carrier may impose an exchange fee specifically applicable to such 1035 Exchanges.

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

Insurance arrangements that are funded by the institution and that permit the insured officer, director, or employee to designate a beneficiary are a common way to provide additional compensation or other benefits to the insured. Split-dollar life insurance arrangements are often used for this purpose. Before an institution enters into a split-dollar arrangement or otherwise purchases insurance for the benefit of an officer, director, or employee, the institution should identify and quantify its compensation objective and ensure that the arrangement is consistent with that objective. The compensation provided by the split-dollar or other insurance arrangement should be combined with all other compensation provided to the insured to ensure that the insured's total compensation is not excessive. Excessive compensation is considered an unsafe and unsound banking practice. Guidelines for determining excessive compensation can be found in the Interagency Guidelines Establishing Standards for Safety and Soundness.[7]

Because shareholders and their family members who are not officers, directors, or employees of an institution do not provide goods or services to the institution, they should not receive compensation from the institution. This includes compensation in the form of split-dollar life insurance arrangements.

Prior to an institution's purchase of a life insurance policy to be used in a split-dollar life insurance arrangement, the institution and the insured should enter into a written agreement. Written agreements usually describe the rights of the institution, the insured individual, and any other parties (such as trusts or beneficiaries) to the policy's CSV and death benefits. It is important for an institution to be aware that ownership of the policy by the employee, a third party, or a trust (non-institution owner) may not adequately protect the institution's interest in the policy because the institution ordinarily will not have the sole right to borrow against the CSV or to liquidate the policy in the event that funds are needed to provide liquidity to the institution. Moreover, if a non-institution owner borrows heavily against the CSV, an institution's ability to recover its premium payments upon the death of the insured may be impaired.

[6] A 1035 Exchange is a tax-free replacement of an insurance policy for another insurance contract covering the same person in accordance with section 1035 of the Internal Revenue Code.

[7] For national banks, Appendix A to 12 CFR 30; for state member banks, Appendix D-1 to 12 CFR 208; for insured state nonmember banks, Appendix A to 12 CFR 364; for savings associations, Appendix A to 12 CFR 570.

At a minimum, an institution's economic interest in the policy should be equal to the premiums paid plus a reasonable rate of return, defined as a rate of return that is comparable to returns on investments of similar maturity and credit risk.

Split-dollar life insurance has complex tax and legal consequences. An institution considering entering into a split-dollar life insurance arrangement should consult qualified tax, legal, and insurance advisors.

VII. Analyze the Associated Risks and the Ability to Monitor and Respond to those Risks

An institution's pre-purchase analysis should include a thorough evaluation of all significant risks, as well as management's ability to identify, measure, monitor, and control those risks. An explanation of key risks (liquidity, transaction/operational, credit, interest rate, compliance/legal, and price) is included in the "Risk Management of BOLI" section of this interagency statement.

VIII. Evaluate Alternatives

Regardless of the purpose of BOLI, a comprehensive pre-purchase analysis will include an analysis of available alternatives. Prior to acquiring BOLI, an institution should thoroughly analyze the risks and benefits, compared to alternative methods for recovering costs associated with the loss of key persons, providing pre- and post-retirement employee benefits, or providing additional employee compensation, as appropriate.

IX. Document Decision

A well-managed institution maintains adequate documentation supporting its comprehensive pre-purchase analysis, including an analysis of both the types and design of products purchased and the overall level of BOLI holdings.

RISK MANAGEMENT OF BOLI

Risk assessment and risk management are vital components of an effective BOLI program. In addition to conducting a risk assessment as part of a thorough pre-purchase analysis, monitoring BOLI risks on an ongoing basis is important, especially for an institution whose aggregate BOLI holdings represent a capital concentration. Management of an institution should review the performance of the institution's insurance assets with its board of directors at least annually. More frequent reviews are appropriate if there are significant anticipated changes to the BOLI program such as additional purchases, a decline in the financial condition of the insurance carrier(s), anticipated policy surrenders, or changes in tax laws or interpretations that could have an impact on the performance of BOLI. This risk management review should include, but not necessarily be limited to:

- *Comprehensive assessment of the specific risks discussed in this section*.[8]
- *Identification of which employees are, or will be, insured (e.g., vice presidents and above, employees of a certain grade level).* For example, an institution that acquires another

[8] All of the risks discussed in this section are applicable to permanent insurance. In contrast, because temporary insurance does not have a savings component or a CSV, it does not expose an institution to liquidity, interest rate, or price risk. These risks need not be evaluated in the comprehensive assessment of the risks of temporary insurance.

institution that owns BOLI may acquire insurance on individuals that it would not insure under its own standards. While the acquiring institution need not correct such exceptions, it is important to know that such exceptions exist.

- *Assessment of death benefit amounts relative to employee salaries.* Such information helps management to assess the insurable interest risk associated with disproportionately large death benefits.
- *Calculation of the percentage of insured persons still employed by the institution.* Larger institutions often find that their policies insure more former employees than current employees.
- *Evaluation of the material changes to BOLI risk management policies.*
- *Assessment of the effects of policy exchanges.* Exchanges typically are costly and it is a sound practice to review the costs and benefits of such actions.
- *Analysis of mortality performance and impact on income.*
- *Evaluation of material findings from internal and external audits and independent risk management reviews.*
- *Identification of the reason for, and tax implications of, any policy surrenders.* In some cases, institutions have surrendered BOLI policies and incurred tax liabilities and penalties. Formal assessment of the costs and benefits of a surrender is a useful component of sound corporate governance.
- *Peer analysis of BOLI holdings.* An institution should compare its BOLI holdings relative to capital to the holdings of its peers to assess whether it is an outlier.

Liquidity Risk

Liquidity risk is the risk to earnings and capital arising from an institution's inability to meet its obligations when they come due without incurring unacceptable losses. Before purchasing permanent insurance, management should recognize the illiquid nature of the product and ensure that the institution has the long-term financial flexibility to hold the asset in accordance with its expected use. The inability to hold the life insurance until the death(s) of the insured(s) when the death benefits will be collected may compromise the success of the BOLI plan. An institution generally does not receive any cash flow from the insurance until the death benefit is paid. Depending upon the age of the insured population, it is possible that an institution that insures a small number of employees may not recognize any cash flow from the insurance for many years. The illiquid nature of insurance assets, combined with the difficulty of projecting liquidity needs far into the future, is a major reason an institution should keep its BOLI holdings below the agencies' concentration guidelines. Examiners will consider an institution's BOLI holdings when assessing liquidity and assigning the liquidity component rating.

The purchase of BOLI may negatively affect an institution's liquidity position, both because BOLI is one of the least liquid assets on an institution's balance sheet, and because institutions normally fund BOLI purchases through the sale of liquid assets (*e.g.*, marketable securities). To access the CSV of BOLI, the institution must either surrender or borrow against the policy. In accordance with the policy contract and federal tax laws, the surrender of a policy may subject an institution to surrender charges, tax liabilities for previously untaxed increases in the CSV, and tax penalties. Borrowing against the CSV is disadvantageous in most cases due to limitations on the ability to deduct interest on the borrowing and other possible adverse tax consequences.

A BOLI product qualifying as a modified endowment contract (MEC) for tax purposes has particular liquidity disadvantages. If an institution surrenders a MEC, it will incur a tax liability on the increase in the policy's CSV from earnings on the policy since its inception and may incur an additional tax penalty for early surrender.

In order to avoid such additional tax penalties, an institution may opt to purchase a non-MEC contract. A non-MEC contract permits the policy owner to surrender the policy without incurring the additional tax penalty that, under certain circumstances, applies to MECs. Moreover, depending on the terms of the insurance contract, an institution generally may withdraw up to the basis (that is, the original amount invested) without creating a taxable event. However, a non-MEC policy increases in complexity if it is in the form of a separate account covered by a stable value protection (SVP) contract. An SVP contract protects the policy owner from declines in the value of the assets in the separate account arising from changes in interest rates, thereby mitigating price risk and earnings volatility. An SVP contract is most often used in connection with fixed-income investments. Institutions should recognize that SVP providers often place restrictions on the amount that may be withdrawn from the separate account, thereby reducing the liquidity of the BOLI asset. An institution considering the purchase of a non-MEC for its potential liquidity advantages compared to a MEC also should be aware of contractual provisions, such as 1035 Exchange fees and "crawl-out" restrictions,[9] which may limit such advantages.

Transaction/Operational Risk

As it applies to BOLI, transaction/operational risk is the risk to earnings and capital arising from problems caused by the institution's failure to fully understand or to properly implement a transaction. Transaction/operational risk arises due to the variety and complexity of life insurance products, as well as tax and accounting treatments. To help mitigate this 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, and other expense charges.

Transaction/operational risk is also a function of the type and design features of a life insurance contract. With a general account product, there are only two parties to the contract: the policy owner and the insurance carrier. With a separate account product, the insurance carrier has a separate contract with an investment manager. There could also be an SVP provider with whom the carrier has a separate contract.

Transaction/operational risk may also arise as a result of the variety of negotiable features associated with a separate account product. These include the investment options; the terms, conditions, and cost of SVP; and mortality options. Deferred acquisition costs (DAC) represent the insurance carrier's up-front costs associated with issuing an insurance policy, including taxes and commissions and fees paid to agents for selling the policy. The carrier charges the policyholder for these costs and capitalizes the DAC, including the prepayment of taxes in accordance with federal tax law. As the carrier recovers the DAC in accordance with applicable tax law, it credits the amount to the separate account policyholder. Once it has been credited to the institution, the DAC is essentially a receivable from the carrier and, therefore, represents a general account credit exposure.

[9] A crawl-out restriction limits the amount of CSV eligible for a 1035 Exchange or surrender over a period of time.

Separate account policies have additional transaction risks that can result from accounting requirements. Several institutions have had to restate their earnings because of contractual provisions in their policies that were ambiguous with respect to the amount of the CSV available upon surrender of the policy. Because BOLI must be carried at the amount that could be realized under the insurance contract as of the balance sheet date, if any contractual provision related to costs, charges, or reserves creates uncertainty regarding the realization of a policy's full CSV, the agencies will require an institution to record the BOLI net of those amounts. As part of an effective pre-purchase analysis, an institution should thoroughly review and understand how the accounting rules will apply to the BOLI policy it is considering purchasing.

Tax and Insurable Interest Implications

Before the purchase of BOLI and periodically thereafter, management should also explicitly consider the financial impact (*e.g.*, tax provisions and penalties) of surrendering a policy. Recent adverse press coverage of COLI should serve as a reminder to institutions that the current tax law framework, as it applies to BOLI, is always subject to legislative changes. A tax change that makes future BOLI cash flows subject to income tax, while perhaps deemed unlikely by many institutions, would have a negative impact on the economics of the BOLI holdings. An institution should recognize that earnings from BOLI could make it subject to the alternative minimum tax.

Institutions should also recognize that their actions, subsequent to purchase, could jeopardize the tax-advantaged status of their insurance holdings. The risk that a life insurance policy could be characterized by the Internal Revenue Service (IRS) as an actively managed investment is particularly relevant to separate account policies. Many larger institutions prefer separate account products because of perceived lower credit risk and greater transparency (that is, explicit disclosure of costs). Assets held by the insurance company on behalf of the policy owners in the separate account are intended to be beyond the reach of the insurance company's general creditors in the event of insolvency; however, the protected status of separate account assets is generally untested in the courts. While the separate account structure helps to mitigate an institution's credit exposure to the insurance carrier, the institution can have no "control" over investment decisions (*e.g.*, timing of investments or credit selection) in the underlying account. Generally, allocating separate account holdings across various divisions of an insurance company's portfolio does not raise concerns about "control," but other actions that a policy owner takes may be construed as investment control and could jeopardize the tax-advantaged status.

To benefit from the favorable tax treatment of insurance, a BOLI policy must be a valid insurance contract under applicable state law and must qualify under applicable federal law. Institutions must have an insurable interest in the covered employee, as set forth in applicable state laws. Furthermore, the favorable tax-equivalent yields of BOLI result only when an institution generates taxable income. Institutions that have no federal income tax liability receive only the nominal interest-crediting rate as a yield. In such an environment, BOLI loses much of its yield advantage relative to other investment alternatives.

Some institutions seem to have drawn comfort from assurances from insurance carriers that the carrier would waive lack of insurable interest as a defense against paying a claim. While the carrier may indeed make a payment, such payment may not necessarily go to the institution. Such assurances may not be sufficient to satisfy the IRS requirements for a valid insurance

contract, nor do they eliminate potential claims from the estate of the insured that might seek to claim insurance proceeds on the basis that the institution lacked an insurable interest.

For example, some institutions have established out-of-state trusts to hold their BOLI assets. While such trusts may have legitimate uses, such as to gain access to an insurance carrier's product, in some cases the purpose is to avoid unfavorable insurable interest laws in the institution's home state and to domicile the policy in a state with more lenient requirements. In some cases, institutions have not made employees aware that they have taken out insurance on their lives.

A recent Fifth Circuit Court of Appeals ruling demonstrates the potential danger of this approach. A Texas employer used a Georgia trust to hold life insurance policies on its employees in Texas, and the trust agreement provided that the insurable interest law of Georgia should apply. In a lawsuit brought by the estate of a deceased employee, the court ignored this provision because the insured employee was not a party to the trust agreement. It then found that the insurable interest law of Texas applied and under that state's law, the employer did not have an insurable interest in the employee. The result was that the employer was not entitled to the insurance death benefits.[10] The outcome in this case suggests that institutions that have used, or are considering using, an out-of-state trust to take advantage of more favorable insurable interest laws in another state should assess whether they could be vulnerable to a similar legal challenge.

Institutions should have appropriate legal review to help ensure compliance with applicable tax laws and state insurable interest requirements. Institutions that insure employees for excessive amounts may be engaging in impermissible speculation or unsafe and unsound banking practices. The agencies may require institutions to surrender such policies.

Credit Risk

Credit risk is the potential impact on earnings and capital arising from an obligor's failure to meet the terms of any contract with the institution or otherwise perform as agreed. All life insurance policyholders are exposed to credit risk. The credit quality of the insurance company and duration of the contract are key variables. With insurance, credit risk arises from the insurance carrier's contractual obligation to pay death benefits upon the death of the insured, and if applicable, from the carrier's obligation to pay the CSV (less any applicable surrender charges) upon the surrender of the policy.

Most BOLI products have very long-term (30- to 40-year) expected time frames for full collection of cash proceeds, *i.e.*, the death benefit. For general account policies, the CSV is an unsecured, long-term, and nonamortizing obligation of the insurance carrier. Institutions record and carry this claim against the insurance company as an asset.

Before purchasing BOLI, an institution should conduct an independent financial analysis of the insurance company and continue to monitor its condition on an ongoing basis. The institution's credit risk management function should participate in the review and approval of insurance carriers. As with lending, the depth and frequency of credit analysis (both initially and on an ongoing basis) should be a function of the relative size and complexity of the transaction and the size of outstanding exposures. Among other things, an institution should consider its legal

[10] *Mayo v. Hartford Life Insurance Company*, 354 F.3d 400 (5th Cir. 2004).

lending limit, concentration guidelines (generally defined as the aggregate of direct, indirect, and contingent obligations and exposures that exceed 25 percent of the institution's capital), and any applicable state restrictions on BOLI holdings when assessing its broader credit risk exposure to insurance carriers. To measure credit exposures comprehensively, an institution should aggregate its exposures to individual insurance carriers, and the insurance industry as a whole, attributable to both BOLI policies and other credit relationships (*e.g.*, loans and derivatives exposures).

There are product design features of a BOLI policy that can reduce credit risk. As noted earlier, an institution can purchase separate account products, where the institution assumes the credit risk of the assets held in the separate account, rather than the direct credit risk of the carrier as would be the case in a general account policy. With separate account policies, the insurance carrier owns the assets, but maintains the assets beyond the reach of general creditors in the event of the insurer's insolvency. However, even with a separate account policy, the policy owner incurs some general account credit risk exposure to the insurance carrier associated with the carrier's mortality and DAC reserves. Amounts equal to the mortality and DAC reserves are owed to the policyholder and represent general account obligations of the insurance carrier. In addition, the difference, if any, between the CSV and the minimum guaranteed death benefit would be paid out of the insurance carrier's general account.

A separate account policy may have an SVP contract issued by the insurance carrier or by a third party that is intended to protect the policyholder from most declines in fair value of separate account assets. In general, the provider of an SVP contract agrees to pay any shortfall between the fair value of the separate account assets when the policy owner surrenders the policy and the cost basis of the separate account to the policy owner. Under most arrangements, the insurance carrier is not responsible for making a payment under the SVP contract if a third-party protection provider fails to make a required payment to it. The SVP contract thus represents an additional source of credit risk for a separate account product. The policyholder's exposure under an SVP contract is to both the protection provider, which must make any required payment to the insurance carrier, and the carrier, which must remit the payment received from the protection provider to the institution. Because of this exposure, an institution should also evaluate the repayment capacity of the SVP provider.

State insurance regulation governing reserve requirements for insurance carriers, state guaranty funds, and reinsurance arrangements help to reduce direct credit risks from general account exposures. Further, an institution can use a 1035 Exchange to exit a deteriorating credit exposure, although most policies impose fees for the exchange. While credit risk for existing general and separate account policies may be low currently, the extremely long-term nature of a BOLI policy underscores the fact that credit risk remains an important risk associated with life insurance products. Strong current credit ratings offer no guarantee of strong credit ratings 20, 30, or 40 years into the future.

Interest Rate Risk

Interest rate risk is the risk to earnings and capital arising from movements in interest rates. Due to the interest rate risk inherent in general account products, it is particularly important that management fully understand how these products expose the policyholder to interest rate risk before purchasing the policy. The interest rate risk associated with these products is primarily a function of the maturities of the assets in the carrier's investment portfolio, which often range from 4 to 8 years. When purchasing a general account policy, an institution chooses one of a

number of interest-crediting options (that is, the method by which the carrier will increase the policy's CSV). Using the "portfolio" crediting rate, the institution will earn a return based upon the existing yield of the carrier's portfolio each year. Using the "new money" crediting rate, the institution earns a return based upon yields available in the market at the time it purchases the policy.

Separate account products may also expose the institution 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 U.S. Treasury securities, the institution is exposed to interest rate risk in the same way as holding U.S. Treasury securities directly in its investment portfolio. However, because the institution cannot control the separate account assets, it is more difficult for the institution to control this risk. Accordingly, before purchasing a separate account product, an institution's 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 institution. The institution also should establish monitoring and reporting systems that will enable management to monitor and respond to interest rate fluctuations and their effect on separate account assets.

Compliance/Legal Risk

Compliance/legal risk is the risk to earnings and capital arising from violations of, or nonconformance with, laws, rulings, regulations, prescribed practices, or ethical standards. Failure to comply with applicable laws, rulings, regulations, and prescribed practices could compromise the success of a BOLI program and result in fines or penalties imposed by regulatory authorities or loss of tax benefits. Among the legal and regulatory considerations that an institution should evaluate are compliance with state insurable interest laws; the Employee Retirement Income Security Act of 1974 (ERISA); Federal Reserve Regulations O and W (12 CFR 215 and 223, respectively); the Interagency Guidelines Establishing Standards for Safety and Soundness; the requirements set forth under the Legal Authority section of this document; and federal tax regulations applicable to BOLI.

Tax benefits are critical to the success of most BOLI plans. Accordingly, an institution owning separate account BOLI must implement internal policies and procedures to ensure that it does not take any action that might be interpreted as exercising "control" over separate account assets. This is especially important for privately placed policies in which the institution is the only policyholder associated with the separate account assets.

When purchasing BOLI, institutions should be aware that the splitting of commissions between a vendor and the institution's own subsidiary or affiliate insurance agency presents compliance risk. The laws of most states prohibit the payment of inducements or rebates to a person as an incentive for that person to purchase insurance. These laws may also apply to the person receiving the payment. When an insurance vendor splits its commission with an institution's insurance agency that was not otherwise involved in the transaction, such a payment may constitute a prohibited inducement or rebate. Accordingly, an institution should assure itself that this practice is permissible under applicable state law and in compliance with Federal Reserve Regulation W before participating in any such arrangement. Moreover, payments to an affiliate that did not perform services for the institution could also raise other regulatory and supervisory issues.

Due to the significance of the compliance risk, institutions should seek the advice of counsel on these legal and regulatory issues.

Price Risk

Price risk is the risk to earnings and capital arising from changes in the value of portfolios of financial instruments. Accounting rules permit owners of insurance contracts to account for general account products using an approach that is essentially based on cost plus accrued earnings. However, for separate account products without SVP, the accounting would largely be based on the fair value of the assets held in the account because this value is the amount that could be realized from the separate account if the policy is surrendered. (See Accounting Considerations above.) Typically, the policyholder of separate account products assumes all price risk associated with the investments within the separate account. Usually, the insurance carrier will provide neither a minimum CSV nor a guaranteed interest-crediting rate for separate account products. Absent an SVP contract, the amount of price risk generally depends upon the type of assets held in the separate account.

Because the institution does not control the separate account assets, it is more difficult for it to control the price risk of these assets than if they were directly owned. To address income statement volatility, an institution may purchase an SVP contract for its separate account policy. The SVP contract is designed to ensure that the amount that an institution could realize from its separate account policy, in most circumstances, remains at or above the cost basis of the separate account to the policyholder. Institutions should understand, however, that SVP contracts protect against declines in value attributable to changes in interest rates; they do not cover default risk. Moreover, one purpose of the SVP contract is to reduce volatility in an institution's reported earnings. To realize any economic benefit of the SVP contract, an institution would have to surrender the policy. Since policy surrender is nearly always an uneconomic decision, the SVP contract provides, in a practical sense, accounting benefits only.

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. If the institution does not purchase SVP, management should establish monitoring and reporting systems that will enable it to recognize and respond to price fluctuations in the fair value of separate account assets.

Under limited circumstances it is legally permissible for an institution to purchase an equity-linked variable life insurance policy if the policy is an effective economic hedge against the institution's equity-linked obligations under employee benefit plans.[11] An effective economic hedge exists when changes in the economic value of the liability or other risk exposure being hedged are matched by counterbalancing changes in the value of the hedging instrument. Such a relationship would exist where the obligation under an institution's deferred compensation plan is based upon the value of a stock market index and the separate account contains a stock mutual fund that mirrors the performance of that index. Institutions need to be aware that this economic hedge may not qualify as a hedge for accounting purposes. Thus, the use of equity-linked variable life insurance policies to economically hedge equity-linked obligations may not have a neutral effect on an institution's reported earnings.

[11] Insured state banks and state savings associations may make such purchases only if permitted to do so under applicable state law.

Unlike separate account holdings of debt securities, SVP contracts on separate account equity holdings are not common. The economic hedging criteria for equity-linked insurance products lessens the effect of price risk because changes in the amount of the institution's equity-linked liability are required to offset changes in the value of the separate account assets. If the insurance cannot be characterized as an effective economic hedge, the presence of equity securities in a separate account is impermissible, and the agencies will require institutions to reallocate the assets unless retention of the policy is permitted under federal law.[12]

In addition to the general considerations discussed previously, which are applicable to any separate account product, an institution should perform further analysis when purchasing a separate account product involving equity securities. At a minimum, the institution should:

1. Compare the equity-linked liability being hedged (*e.g.*, deferred compensation) and the equity securities in the separate account. Such an analysis considers the correlation between the liability and the equity securities, expected returns for the securities (including standard deviation of returns), and current and projected asset and liability balances.

2. Determine a target range for the hedge effectiveness ratio (*e.g.*, 95 to 105 percent) and establish a method for measuring hedge effectiveness on an ongoing basis. The institution should establish a process for altering the program if hedge effectiveness drops below acceptable levels. Consideration should be given to the potential costs of program changes.

3. Establish a process for analyzing and reporting to management and the board the effect of the hedge on the institution's earnings and capital ratios. The analysis usually considers results both with and without the hedging transaction.

RISK-BASED CAPITAL TREATMENT

If an institution owns a general account insurance product, it should apply a 100 percent risk weight to its claim on the insurance company for risk-based capital purposes. A BOLI investment in a separate account insurance product, however, may expose the institution to the market and credit risks associated with the pools of assets in the separate account. The assets in a pool may have different risk weights, similar to the assets held in a mutual fund in which an institution has invested. For risk-based capital purposes, if an institution can demonstrate that the BOLI separate account policy meets the requirements below, it may choose to "look-through" to the underlying assets to determine the risk weight.

Criteria for a Look-Through Approach

To qualify for the "look-through" approach, separate account BOLI assets must be protected from the insurance company's general creditors in the event of the insurer's insolvency. An institution should document its assessment, based upon applicable state insurance laws and other relevant factors, that the separate account assets would be protected from the carrier's general

[12] Insured state banks and state savings associations may request the FDIC's consent to retain the policies, but consent will not be granted if it is determined that retaining the policies presents a significant risk to the appropriate insurance fund.

creditors. If the institution does not have sufficient information to determine that a BOLI separate account policy qualifies for the look-through approach, the institution must apply the standard risk weight of 100 percent to this asset.

In addition, when an institution has a separate account policy, the portion of the carrying value of the institution's insurance asset that represents general account claims on the insurer, such as DAC and mortality reserves that are realizable as of the balance sheet date, and any portion of the carrying value attributable to an SVP contract, are not eligible for the look-through approach. These amounts should be risk weighted at the 100 percent risk weight applicable to claims on the insurer or the SVP provider, as appropriate.

Look-Through Approaches

When risk weighting a qualifying separate account policy, an institution may apply the highest risk weight for an asset permitted in the separate account, as stated in the investment agreement, to the entire carrying value of the separate account policy, except for any portions of the carrying value that are general account claims or are attributable to SVP. In no case, however, may the risk weight for the carrying value of the policy (excluding any general account and SVP portions) be less than 20 percent.

Alternatively, an institution may use a pro-rata approach to risk weighting the carrying value of a qualifying separate account policy (excluding any general account and SVP portions). The pro-rata approach is based on the investment limits stated in the investment agreement for each class of assets that can be held in the separate account, with the constraint that the weighted average risk weight may not be less than 20 percent. If the sum of the permitted investments across market sectors in the investment agreement is greater than 100 percent, the institution must use the highest risk weight for the maximum amount permitted in that asset class, and then proceed to the next highest risk weight until the permitted amounts equal 100 percent.

For example, if a separate account investment agreement permits a maximum allocation of 60 percent for corporate bonds, 40 percent for U.S. government-sponsored enterprise debt securities, and 60 percent for U.S. Treasury securities, then the institution must risk weight 60 percent of the carrying value of the separate account investment (excluding any portion attributable to SVP) at the 100 percent risk weight applicable to corporate bonds and the remaining 40 percent at the 20 percent risk weight for U.S. government-sponsored enterprise debt securities. Because the sum of the permitted allocation for corporate bonds and government-sponsored enterprise debt securities totals 100 percent, the institution cannot use the zero percent risk weight for U.S. Treasury securities. However, if the permitted allocation for U.S. government-sponsored enterprise debt securities was 30 percent rather than 40 percent, the institution could risk weight the remaining 10 percent of the carrying value of its investment at the zero percent risk weight for U.S. Treasuries.

Regardless of the look-through approach an institution employs, the weighted average risk weight for the separate account policy (excluding any general account and SVP portions) may not be less than 20 percent, even if all the assets in the separate account would otherwise qualify for a zero percent risk weight. Furthermore, the portion of the carrying value of the separate account policy that represents general account claims on the insurer, such as realizable DAC and mortality reserves, and any portion of the carrying value attributable to an SVP contract, should be risk weighted at the risk weight applicable to the insurer or the SVP provider, as appropriate.

The following example demonstrates the appropriate risk-weight calculations for the pro-rata approach, incorporating the components of a BOLI separate account policy that includes general account claims on the insurer as well as the investment allocations permitted for different asset classes in the separate account investment agreement.

EXAMPLE: The separate account investment agreement requires the account to hold a minimum of 10 percent in U.S. Treasury obligations. It also imposes a maximum allocation of 50 percent in mortgage-backed securities issued by U.S. government-sponsored enterprises, and a maximum allocation of 50 percent in corporate bonds. Assume that the portion of the carrying value of the separate account policy attributable to realizable DAC and mortality reserves equals $10 and that the portion attributable to the SVP totals $10.

Carrying Value of Separate Account Policy	$100.00
Less: Portion Attributable to DAC and Mortality Reserves	10.00
Portion Attributable to SVP	10.00
Net Carrying Value of separate account policy available for pro-rata	$80.00
Risk weight calculation:	
U.S. Treasury @ 10% x $80 = $8 x 0% RW	0.00
Corporate Bonds @ 50% x $80 = $40 x 100% RW	$40.00
GSE MBS @ 40% x $80 = $32 x 20% RW	6.40
Separate account risk-weighted assets subject to pro-rata	$46.40
Add Back: DAC and Mortality Reserves = $10 x 100% RW	$10.00
Add Back: SVP = $10 x 100% RW	10.00
General account and SVP risk-weighted assets	$20.00
Total BOLI-related risk-weighted assets	$66.40

SUMMARY

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. Consistent with safe and sound banking practices, institutions must understand the risks associated with this product and implement a risk management process that provides for the identification and control of such risks. A sound pre-purchase analysis, meaningful ongoing monitoring program, reliable accounting process and accurate assessment of risk-based capital requirements are all components of the type of risk management process the agencies expect institutions to employ.

Where an institution has acquired BOLI in an amount that approaches or exceeds agency concentration levels, examiners will more closely scrutinize the components of the risk management process and the institution's associated documentation. Where BOLI has been purchased in an impermissible manner, ineffective controls over BOLI risks exist, or a BOLI exposure poses a safety and soundness concern, the appropriate agency may take supervisory action, including requiring the institution to divest affected policies, irrespective of tax consequences.

APPENDIX

COMMON TYPES OF LIFE INSURANCE

Life insurance can be categorized into two broad types: temporary (also called "term") insurance and permanent insurance. There are numerous variations of these products. However, most life insurance policies fall within one (or a combination) of the following categories.

Temporary (Term) Insurance

Temporary (term) insurance provides life insurance protection for a specified time period. Death benefits are payable only if the insured dies during the specified period. If a loss does not occur during the specified term, the policy lapses and provides no further protection. Term insurance premiums do not have a savings component; thus, term insurance does not create CSV.

Permanent Insurance

In contrast to term insurance, permanent insurance is intended to provide life insurance protection for the entire life of the insured, and its premium structure includes a savings component. Permanent insurance policy premiums typically have two components: the insurance component (*e.g.*, mortality cost, administrative fees, and sales loads) and the savings component. 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.

The savings component typically is referred to as CSV. The policyholder may use the CSV to make the minimum premium payments necessary to maintain the death benefit protection and may access the CSV by taking out loans or making partial surrenders. If permanent insurance is surrendered before death, surrender charges may be assessed against the CSV. Generally, surrender charges are assessed if the policy is surrendered within the first 10 to 15 years.

Two broad categories of permanent insurance are:

- Whole Life – A traditional form of permanent insurance designed so that fixed premiums are paid for the entire life of the insured. Death benefit protection is provided for the entire life of the insured, assuming all premiums are paid.

- Universal Life – A form of permanent insurance designed to provide flexibility in premium payments and death benefit protection. The policyholder can pay maximum premiums and maintain a very high CSV. Alternatively, the policyholder can make minimal payments in an amount just large enough to cover mortality and other insurance charges.

PURPOSES FOR WHICH INSTITUTIONS COMMONLY PURCHASE LIFE INSURANCE

Key Person

Institutions often purchase life insurance to protect against the loss of "key persons" whose services are essential to the continuing success of the institution and whose untimely death would be disruptive. For example, an institution may purchase insurance on the life of an employee or director whose death would be of such consequence to the institution as to give it an insurable interest in his or her life. The determination of whether an individual is a key person does not turn on that individual's status as an officer or director, but on the nature of the individual's economic contribution to the institution.

The first step in indemnifying an institution against the loss of a key person is to identify the key person. The next and possibly most difficult step is estimating the insurable value of the key person or the potential loss of income or other value that the institution may incur from the untimely death of that person.

Because the most appropriate method for determining the value of a key person is dependent upon individual circumstances, the agencies have not established a formula or a specific process for estimating the value of a key person. Instead, the agencies expect institutions to consider and analyze all relevant factors and use their judgment to make a decision about the value of key persons.

Key person life insurance should not be used in place of, and does not diminish the need for, adequate management succession planning. Indeed, if an institution has an adequate management succession plan, its reliance on a key person should decline as the person gets closer to retirement.

Financing or Cost Recovery for Benefit Plans

Like other businesses, institutions often use life insurance as a financing or cost recovery vehicle for pre- and post-retirement employee benefits, such as individual or group life insurance, health insurance, dental insurance, vision insurance, tuition reimbursement, deferred compensation, and pension benefits.

Permanent insurance is used for this purpose. In these arrangements, an institution insures the lives of directors or employees in whom it has an insurable interest to reimburse the institution for the cost of employee benefits. The group of insured individuals may be different from the group that receives benefits. The institution's obligation to provide employee benefits is separate and distinct from the purchase of the life insurance. The life insurance purchased by the institution remains an asset even after the employer's relationship with an insured employee is terminated. The employees who receive benefits, whether insured or not, have no ownership interest in the insurance (other than their general claim against the institution's assets arising from the institution's obligation to provide the stated employee benefits).

There are two common methods of financing employee benefits through the purchase of life insurance. The first is the cost recovery method, which usually involves present value analysis. Typically, the institution projects the amount of the expected benefits owed to employees and then discounts this amount to determine the present value of the benefits. Then, the institution

purchases a sufficient amount of life insurance on the lives of certain employees so that the gain (present value of the life insurance proceeds less the premium payments) from the insurance proceeds reimburses the institution for the benefit payments. Under this method, the institution absorbs the cost of providing the employee benefits and the cost of purchasing the life insurance. The institution holds the life insurance and collects the death benefit to reimburse the institution for the cost of the employee benefits and the insurance.

The second method of financing employee benefits is known as cost offset. With this method, the institution projects the annual employee benefit expense associated with the benefit plan. Then, the institution purchases life insurance on the lives of certain employees. The amount earned on the CSV each year should not exceed the annual benefit expense.

Split-Dollar Life Insurance Arrangements

Institutions sometimes use split-dollar life insurance arrangements to provide retirement benefits and death benefits to certain employees as part of their compensation. Under split-dollar arrangements, the employer and the employee share the rights to the policy's CSV and death benefits. The employer and the employee may also share premium payments. If the employer pays the entire premium, the employee may need to recognize taxable income each year in accordance with federal income tax regulations.

Split-dollar arrangements may be structured in a number of ways. The two most common types of split-dollar arrangements are:

- Endorsement Split-Dollar – The employer owns the policy and controls all rights of ownership. The employer provides the employee an endorsement of the portion of the death benefit specified in the plan agreement with the employee. The employee may designate a beneficiary for the designated portion of the death benefit. Under this arrangement, the employer typically holds the policy until the employee's death. At that time, the employee's beneficiary receives the designated portion of the death benefits, and the employer receives the remainder of the death benefits.

- Collateral Assignment Split-Dollar – The employee owns the policy and controls all rights of ownership. Under these arrangements, the employer usually pays the entire premium or a substantial part of the premium. The employee assigns a collateral interest in the policy to the employer that is equal to the employer's interest in the policy. The employer's interest in the policy is set forth in the split-dollar agreement between the employer and the employee. Upon retirement, the employee may have an option to buy the employer's interest in the insurance policy. This transfer of the employer's interest to the employee is typically referred to as a "roll-out." If a "roll-out" is not provided or exercised, the employer does not receive its interest in the policy until the employee's death.

Split-dollar life insurance is a very complex subject that can have unforeseen tax and legal consequences. Internal Revenue Service regulations issued in 2003[13] govern the taxation of split-dollar life insurance arrangements entered into or materially modified after September 17,

[13] 68 Fed. Reg. 54336 (Sept. 17, 2003), chiefly codified at 26 CFR 1.61-22 and 1.7872-15.

2003.[14] These rules provide less favorable tax treatment to split-dollar arrangements than existed previously. Institutions considering entering into a split-dollar life insurance arrangement should consult qualified tax, insurance, and legal advisors.

Life Insurance on Borrowers

State 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. In some states, the lender's insurable interest may equal the borrower's obligation plus the cost of insurance and the time value of money. Institutions are permitted to protect themselves against the risk of loss from the death of a borrower. This protection may be provided through self-insurance, the purchase of debt cancellation contracts, or by the purchase of life insurance policies on borrowers.

Institutions can take two approaches in purchasing life insurance on borrowers. First, an institution can purchase life insurance on an individual borrower for the purpose of protecting the institution specifically against loss arising from that borrower's death. Second, an institution may purchase life insurance on borrowers in a homogenous group of loans employing a cost recovery technique similar to that used in conjunction with employee benefit plans. Under this method, the institution insures the group of borrowers for the purpose of protecting the institution from loss arising from the death of any borrower in the homogenous pool. Examples of homogenous pools of loans include consumer loans that have distinctly similar characteristics, such as automobile loans, credit card loans, and residential real estate mortgages.

When purchasing insurance on an individual borrower, an institution should, given the facts and circumstances known at the time of the insurance purchase, make a reasonable effort to structure the insurance policy in a manner consistent with the expected repayment of the borrower's loan. To accomplish this, management should estimate the risk of loss over the life of the loan and match the anticipated insurance proceeds to the risk of loss. Generally, the risk of loss will be closely related to the outstanding principal of the debt. The insurance policy should be structured so that the expected insurance proceeds never substantially exceed the risk of loss.

When purchasing life insurance on borrowers in a homogenous pool of loans, an institution's management should, given the facts and circumstances known at the time of the insurance purchase, make a reasonable effort to match the insurance proceeds on an aggregate basis to the total outstanding loan balances. If allowed by state law, institutions may match the insurance proceeds to the outstanding loan balances plus the cost of insurance on either a present value or future value basis. This relationship should be maintained throughout the duration of the program.

The purchase of life insurance on a borrower is not an appropriate mechanism for effecting a recovery on an obligation that has been charged off, or is expected to be charged off, for reasons other than the borrower's death. In the case of a charged-off loan, the purchase of life insurance on the borrower does not protect the institution from a risk of loss since the loss has already occurred. Therefore, the institution does not need to purchase insurance. Acquiring insurance that an institution does not need may subject the institution to unwarranted risks, which would be an unsafe and unsound banking practice. In the case of a loan that the institution expects to charge off for reasons other than the borrower's death, the risk of loss is so pronounced that the

[14] Split-dollar arrangements entered into prior to September 17, 2003, and not materially modified thereafter may be treated differently.

purchase of life insurance by the institution at that time would be purely speculative and an unsafe and unsound banking practice.

Internal Revenue Code Section 264(f) disallows a portion of an institution's interest deduction for debt incurred to purchase life insurance on borrowers. Institutions considering the purchase of insurance on borrowers should consult their tax advisors to determine the economic viability of this strategy.

Life Insurance as Security for Loans

Institutions sometimes take an interest in an existing life insurance policy as security for a loan. Institutions also make loans to individuals to purchase life insurance, taking a security interest in the policy, a practice known as "insurance premium financing." As with any other type of lending, extensions of credit secured by life insurance should be made on terms that are consistent with safe and sound banking practices. For instance, the borrower should be obligated to repay the loan according to an appropriate amortization schedule.

Generally, an institution may not rely on its security interest in a life insurance policy to extend credit on terms that excuse the borrower from making interest and principal payments during the life of the borrower with the result that the institution is repaid only when the policy matures upon the death of the insured. Lending on such terms is generally speculative and an unsafe and unsound banking practice.

Institutions may acquire ownership of life insurance policies for debts previously contracted (DPC) by invoking their security interest in a policy after a borrower defaults. Consistent with safety and soundness, institutions should use their best efforts to surrender or otherwise dispose of permanent life insurance acquired for DPC at the earliest reasonable opportunity.[15] In the case of temporary insurance acquired for DPC, retention until the next renewal date or the next premium date, whichever comes first, will be considered reasonable.

[15] The OCC has generally directed national banks to surrender or divest permanent life insurance acquired for DPC within 90 days of obtaining control of the policy.

GLOSSARY

Cash Surrender Value (CSV) – The value available to the policyholder if the policy is surrendered. If no loans are outstanding, this amount is generally available in cash. If loans have been made, the amount available upon surrender is equal to the cash surrender value less the outstanding loan (including accrued interest).

Deferred Acquisition Costs (DAC) – DAC represents the insurance carrier's up-front costs associated with issuing an insurance policy, including taxes and commissions and fees paid to agents for selling the policy. The carrier charges the policyholder for these costs. Carriers capitalize DAC and recover them in accordance with applicable tax law. As the carrier recovers DAC, it credits the amount to the policyholder.

Experience-Rated Pricing – A pricing method that bases prices for insurance products on the actual expenses and claims experience for the pool of individuals being insured.

General Account – A design feature that is generally available to purchasers of whole or universal life insurance whereby the general assets of the insurance company support the policy's CSV.

Interest-Crediting Rate – 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 cost, load charges, or other costs that are periodically charged against the policy's cash value.

There are a number of crediting rates, including "new money" and "portfolio." Using the "portfolio" crediting rate, the institution will earn a return based upon the existing yield of the insurance carrier's portfolio each year. Using the "new money" crediting rate, the institution will earn a return based upon yields available in the market at the time it purchases the policy.

Modified Endowment Contract (MEC) – Type of policy that is defined in Internal Revenue Code Section 7702A. A MEC generally involves the payment of a single premium at the inception of the contract; thus, it fails the so-called seven-pay test set forth in the statute. MECs are denied some of the favorable tax treatment usually accorded to life insurance. For example, most distributions, including loans, are treated as taxable income. An additional 10 percent penalty tax also is imposed on distributions in some circumstances. However, death benefits remain tax-free.

Mortality Charge – The pure cost of the life insurance death benefit within a policy. It represents a cost to the purchaser and an income item to the carrier. Mortality charges retained by the insurance carrier are used to pay claims.

Mortality Reserve – In separate account products, the mortality reserve represents funds held by an insurance carrier outside of the separate account to provide for the payment of death benefits.

Non-MEC – An insurance contract that is not categorized as a MEC under Internal Revenue Code Section 7702A.

Separate Account – A separate account is a design feature that is generally available to purchasers of whole life or universal life whereby the policyholder's CSV is supported by assets segregated from the general assets of the carrier. Under such an arrangement, the policyholder neither owns the

underlying separate account nor controls investment decisions (*e.g.*, timing of investments or credit selection) in the underlying separate account that is created by the insurance carrier on its behalf. Nevertheless, the policyholder assumes all investment and price risk.

Seven-Pay Test – The seven-pay test is a test set forth in Internal Revenue Code Section 7702A that determines whether or not a life insurance product is a MEC for federal tax purposes.

Split-Dollar Life Insurance – A split-dollar life insurance arrangement splits the policy's premium and policy benefits between two parties, usually an employer and employee. The two parties may share the premium costs while the policy is in effect, pursuant to a prearranged contractual agreement. At the death of the insured or the termination of the agreement, the parties split the policy benefits or proceeds in accordance with their agreement.

Stable Value Protection (SVP) Contracts – In general, an SVP contract pays the policy owner of a separate account any shortfall between the fair value of the separate account assets when the policy owner surrenders the policy and the cost basis of the separate account to the policy owner. The cost basis of the separate account typically would take into account the fair value of the assets in the account when the policy was initially purchased, the initial fair value of assets added to the account thereafter, interest credited to the account, the amount of certain redemptions and withdrawals from the account, and credit losses incurred on separate account assets. Thus, SVP contracts mitigate price risk. SVP contracts are most often used in connection with fixed-income investments.

1035 Exchange – A tax-free replacement of an insurance policy for another contract covering the same person(s) in accordance with Section 1035 of the Internal Revenue Code.

Variable Life Insurance –Variable life insurance policies are investment-oriented life insurance policies that provide a return linked to an underlying portfolio of securities. The portfolio typically is a group of mutual funds chosen by the insurer and housed in a separate account, with the policyholder given some discretion in choosing among the available investment options.