

Comment: Regulators Issue Guide on Risks in Coverage for Executives' Lives

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A statement jointly issued this month by the four bank regulatory agencies alerts bank managements to significant issues raised by purchase of separate-account, bank-owned life insurance.

The agencies recognized that, though bank-owned life insurance, or BOLI, can be used effectively to recover costs linked to providing employee benefits, some institutions have invested significant capital in BOLI without a thorough analysis of the risks and implications. The Office of the Comptroller of the Currency bulletin was issued as an interagency statement on the purchase and risk management of life insurance in which the Fed, Federal Deposit Insurance Corp., and Office of Thrift Supervision joined.

Separate account BOLI has cash surrender value that is supported by assets in an account segregated from the insurance carrier's general assets. With separate account BOLI, the bank does not own the underlying separate account and does not control the selection or timing of investments in the account created by the carrier on the bank's behalf. However, the bank assumes all investment and price risk.

For an institution that plans to acquire BOLI in excess of regulatory concentration levels - 25% of the bank's Tier 1 capital plus the allowance for loan and lease losses - the agencies expect two actions of bank managers: Do an analysis to support the judgment that such acquisitions do not create an imprudent capital concentration, and obtain approval from the board of directors or a designated board committee before the acquisition. The OCC may require that any national bank exceeding the capital concentration guidelines explain why it believes its capital concentration in BOLI is prudent.

National bank examiners who investigate BOLI programs will consider the extent to which risks are identified, measured, monitored, and controlled by bank management. The OCC is particularly interested in the effectiveness of the pre-purchase analysis and the appropriateness of internal limits for individual and aggregate BOLI policy cash surrender value. Besides credit and interest rate risks, the appropriateness of the response to liquidity, reputation, compliance, and transaction risks will be considered by investigators.

Liquidity risk: The preferred strategy of buying BOLI and holding it until benefit payment means that banks should ensure they have the long-term financial flexibility to hold the policies in accordance with their expected use. Many separate account products limit the amounts a policyholder can withdraw from the product without penalty, increasing liquidity risk.

Reputation risk: Arguably, the purchase of BOLI may bear more reputation risk than other banking practices because of the potential negative reaction to a bank's benefiting from life insurance on some employees. Obtaining explicit informed consent in writing from each covered employee can reduce this risk.

Compliance risk: Both general account and separate account BOLI products require a thorough understanding of tax laws and banking regulations by bank management to mitigate compliance risk. Separate account BOLI policy owners must be careful to ensure that they are not perceived by regulators as taking control of the separate account assets, especially when they are the only policyholders associated with the account.

Transaction risk: Separate account BOLI products may increase transaction risk because of their negotiable features such as investment options, terms, conditions, cost of stable-value protection clauses, and mortality options. These more complicated transactions raise tax, accounting, and contractual issues attached to the third parties that

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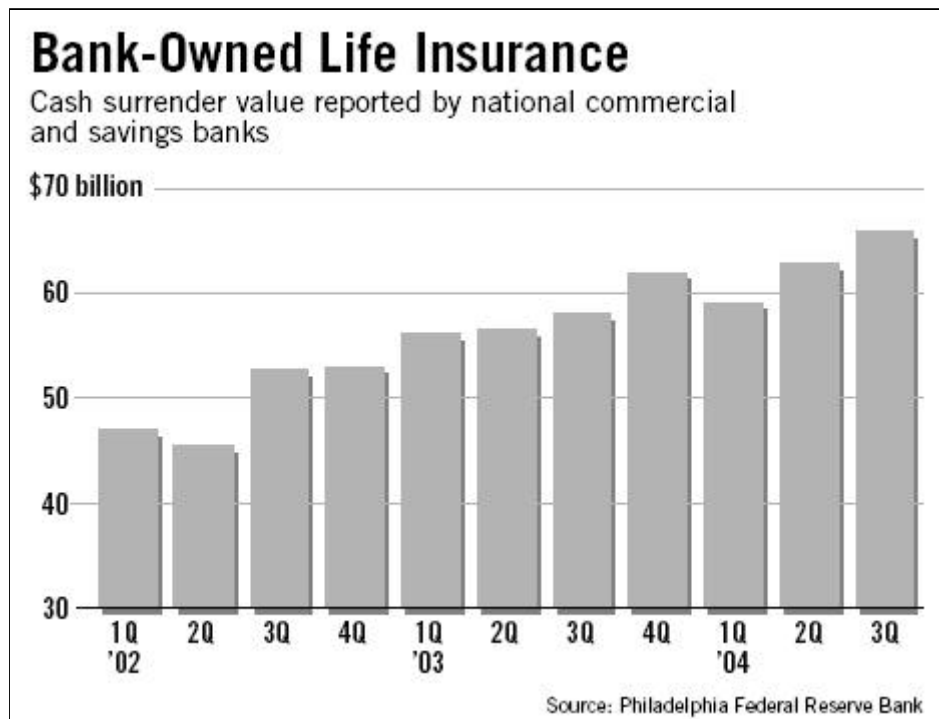


provide the more complex aspects of separate account BOLI.

Under most state laws two regulatory regimes exist for permanent life insurance contracts: universal life and traditional.

With universal life, no required relationship exists between the premium and the amount of insurance, though for most BOLI the death benefit is set equal to the minimum requirement to qualify as life insurance under the Internal Revenue Code. By contrast, traditional life participating single-premium contracts have specific relationships between the amount of the premium and the policy's initial death benefit.

FDIC data indicate that 3,384 of the 9,037 U.S. commercial and savings banks held BOLI policies, totaling \$65.8 billion of cash surrender value, at Sept. 30. The total has been rising steadily in recent years. This trend, along with increased legislative and regulatory scrutiny, shows BOLI's efficacy in financing employee benefits.



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