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DIVISION OF BANKING

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Memorandum

To: Wyoming Financial Institutions
From: Wyoming Division of Banking
Date: September 13, 2002
Re: Bank-Owned Life Insurance

Wyoming banks have been purchasing Bank-Owned Life Insurance (BOLI) and Key-Man Life Insurance for many years. Although there is no specific statutory citation in Wyoming Banking Law, it has been a permissible practice. This office believes this practice is incidental to the business of banking according to Wyoming Statutes 13-2-101 (a)(xii). Since this is a permissible practice, prior written approval of the commissioner is not required.

There are no specific statutory limitations on BOLI in the Wyoming Banking Statutes. Therefore, the Division follows the guidance established by the Federal Deposit Insurance Corporation. The FDIC references the OCC Bulletin 96-51 in their last memorandum on this subject. This memoranda states, "State banks wishing to own life insurance policies not permissible for a national bank must obtain specific Corporation approval. Furthermore, the activity must not pose a significant risk to the deposit insurance fund, and the applicant must comply with applicable capital standards." Since OCC Bulletin 96-51 was replaced with the revised bulletin, it appears the purchase standards set forth in the OCC Bulletin 2000-23, Bank Purchases of Life Insurance, (Bulletin) would apply to Wyoming state-chartered banks.

The Bulletin states that the safe and sound use of BOLI depends on effective senior management and board oversight. The board's role in analyzing and overseeing BOLI should be commensurate with the size, complexity and risk inherent in the transaction. Although the board may delegate decision-making authority to management, the board remains responsible for ensuring that purchases of BOLI are consistent with safe and sound practices.

Consistent with prudent risk management practices, management should establish internal quantitative guidelines. These guidelines generally limit the aggregate CSV of policies from any one insurance company and the aggregate CSV of policies from all insurance companies. Among other things, **a bank should consider the legal lending limits and concentration of credit guidelines.** Regulatory agencies have determined that a purchase of BOLI can not exceed twenty-five percent (25%) of Tier One Capital plus the Allowance For Loan And Lease Losses. Any amount greater than this would be considered an unsafe and unsound banking practice.



The Bulletin recognizes that life insurance can be categorized into two broad types of insurance, temporary or permanent insurance. The following are a list of common types of life insurance policies:

Temporary Insurance – consists of various forms of term insurance that provide insurance protection for a specific period of time.

Permanent Insurance – intended to provide life insurance protection for the entire life of the insured. Types of permanent insurance include: whole life, universal life, general account, variable or separate account

- Whole Life – a traditional form of permanent insurance designed so that fixed premiums are paid for the entire life of the insured.
- Universal Life – a form of permanent insurance designed to provide flexibility in premium payments and death benefit protection.
- General Account – form of whole or universal life insurance where the policyholder’s cash value is supported by the general assets of the insurance company.
- Separate Account Product – a form of whole or universal life where the policyholder’s cash value is supported by assets segregated from the general asset structure of the carrier. The policyholder assumes all investment and price risk.

Key-Person Insurance – insurance on the life of an employee whose death would be of such consequence to the bank as to give it an insurable interest in his or her life. Certain directors of the bank may also be “key-persons.”

Split Dollar Insurance Arrangements – the employer and the employee share the rights to the policy’s CSV and death benefit. The employee and employer may share premium payments. If the employer pays the entire premium, the employee must recognize the economic value of the insurance as taxable income each year.

The following is a summary of the Bulletin to assist banks that are considering BOLI.

The Bulletin requires that pre-purchase analysis should consider the following ten standards:

1. Determination of the Need for Insurance

The bank should determine the need for insurance by identifying the specific risk of loss or obligation to be insured against. The existence of a risk of loss or an obligation does not necessarily mean that a bank can purchase or hold an interest in life insurance. Additionally, the purchase of insurance to indemnify a bank against a specific risk does not relieve a bank from other responsibilities related to managing that risk. For example, a bank may purchase life insurance to indemnify itself from the loss of a “key-person.” However, “key-person” life insurance should not be used in place of, nor does it diminish the need for, adequate management or “key-person” succession planning.

2. Quantification of the Amount of Insurance Needed

The bank should estimate the size of the obligation or the risk of loss and ensure that the amount of insurance purchased is not excessive in relation to the estimate. For such estimates, banks may include the cost of insurance and the time value of money in determining the amount of insurance needed. The estimate of the amount of insurance needed should be based on reasonable financial and actuarial assumptions.

3. Vendor Selection

The vast majority of BOLI purchases are made through vendors, either brokers/consultants or agents. The role of the vendor, if any, depends on the type of vendor selected. For example, the vendor may be an agent of a specific insurance company who serves as the bank's primary contact with the insurance company. Or, the vendor may be an independent broker who establishes working relationships with many insurance companies.

If the bank uses a vendor, it should make appropriate inquiries to satisfy itself regarding the vendor's ability to honor its commitments, which may be long term. In assessing the vendor's ability to honor its commitments, the bank should typically review the vendor's services, general reputation, experience, and financial capacity. The nature and thoroughness of the review should be determined by the size and complexity of the potential BOLI purchase.

4. Carrier Selection

Carrier selection is one of the most critical steps in a BOLI purchase because BOLI plans are typically of long duration and may represent significant risks for the bank. The bank should review the product design, pricing, and administrative services of the carrier(s) and compare them with the bank's needs. Furthermore, before purchasing life insurance, the bank should perform a credit analysis on the selected carrier(s) in a manner consistent with safe and sound banking practices for commercial lending.

5. Review the Characteristics of the Available Insurance Products

There are a few basic types of life insurance in the marketplace. However, these products can be combined and modified in many different ways with the resulting final product quite complex. The bank should review the characteristics of the various insurance products available and thoroughly analyze and understand the product(s) being considered.

6. Analyze the Benefits of BOLI

The bank should analyze the benefits of BOLI purchases being considered. The analysis should include an assessment of how the purchase will accomplish the objects specified in step 1. It should also include an analysis of the anticipated performance of the insurance.

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

Split-dollar insurance arrangements typically provide additional compensation and/or other benefits to the employee. Before a bank enters into a split-dollar arrangement, it should identify and quantify

the compensation objective, and ensure that the arrangement is consistent with the stated objective. Also the bank should combine the compensation provided by the split-dollar arrangement with all other compensation to ensure that total compensation is not excessive. Excessive compensation is prohibited as an unsafe and unsound practice.

8. Analyze the Associated Risk and the Bank's Ability to Monitor and Respond to Those Risks

Ownership of or beneficial interests in BOLI may subject a bank to several risks, which include: transaction, credit, interest rate, liquidity, compliance, and price. A bank's pre-purchase analysis should include a thorough evaluation of these risks. Furthermore, the pre-purchase analysis should allow a bank to determine whether the transaction is consistent with safe and sound banking practices. In assessing the size of the transaction, a bank should consider the CSV relative to its capital levels at the time of purchase.

9. Evaluate Alternatives

Some BOLI purchases involve indemnifying the bank against a specific risk. Other BOLI purchases are used to recover costs or provide for employee benefits. Regardless of the purpose of BOLI, a complete pre-purchase analysis will include an analysis of alternatives.

10. Document Decision

The primary objective of the Bulletin is to provide guidelines that will help banks make informed decisions consistent with safe and sound banking practices. A bank should maintain documentation adequate to show that the bank made an informed decision. Furthermore, the bank should continue to monitor that decision.

As previously mentioned, there are a number of risks associated with BOLI. The following risks discussed are not mutually exclusive since any product may expose the bank to more than one risk.

Transaction Risk

Transaction risk is the risk to earnings or capital arising from problems with service or product delivery. The degree of transaction risk associated with BOLI is a function of a bank not fully understanding or properly implementing a transaction. Bank management should have a thorough understanding of how the insurance product works and the variables that dictate the product's performance. Additionally, management should also consider the impact on the bank's earnings and capital should the bank, for any reason, surrender the insurance before maturity at the death of the insured.

Credit Risk

Credit risk is the risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or otherwise perform as agreed. Credit risk is primarily a function of the insurance carrier's ability (financial obligation) and willingness to pay death benefits as promised. With permanent insurance, credit risk arises from the insurance carrier's obligation to pay death benefits upon death of the insured and from its obligation to return the CSV to the policyholder upon request. Before purchasing life insurance, bank management should evaluate the financial condition of the insurance company and continue to monitor its condition on an ongoing basis. In addition to reviewing the

insurance carrier's ratings, the bank should conduct an independent financial analysis consistent with safe and sound banking practices for commercial lending.

Interest Rate Risk

Interest rate risk is the risk to earnings or capital arising from movements in interest rates. Since a bank's investment in permanent insurance is recorded at the policy's CSV, the bank's earnings decline as the policy's interest crediting rate declines. Before purchasing permanent insurance, bank management should review the policies past performance over various business cycles, analyze projected policy values (CSV and death benefits), and consider having the carrier use a different interest credit rate for each set of policy projections. Before purchasing a separate account product, bank management should thoroughly review and understand the instruments governing the management and investment policy of the separate account. The bank should establish monitoring and reporting systems that will enable the bank to monitor and respond to price fluctuations.

Liquidity Risk

Liquidity risk is the risk to earnings or capital arising from a bank'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 the bank has the long-term financial flexibility to hold this asset in accordance with its expected use.

Compliance Risk

Compliance risk is the risk to earnings or capital arising from violations of, or non-conformance with, laws, rules, regulations, prescribed procedures, or ethical standards. Because tax benefits are critical to the success of most BOLI plans, bank management should exercise caution to ensure that its plans comply with all applicable tax laws. Additionally, management should ensure that its plan complies with applicable state insurance laws.

Price Risk

Price risk is the risk to earnings or capital arising from changes in the value of portfolios of financial instruments. The amount of price risk is dependent upon the type of assets held within the separate account. Before purchasing a separate account life insurance product, bank management should thoroughly review and understand the instruments governing the investment policy and management of the separate account.

Reputation Risk

Reputation risk is the risk to earnings or capital arising from negative public opinion. This effects the institution's ability to establish new relationships or services, or continue servicing existing relationships. This risk can expose the institution to litigation, financial loss, or damage to its reputation. Bank management should take necessary steps to ensure that individuals covered under a BOLI product are aware of the policy.

In summary, the purchase of BOLI is a permissible practice for Wyoming State chartered banks. However, the steps outlined by the Bulletin and summarized in this memorandum should be adhered to and fully documented prior to completing the transaction. For additional information or questions or a

copy of the OCC Bulletin 2000-23, please contact Albert Forkner, Bank Examiner with the Wyoming Division of Banking. This memorandum is for informational purposes only and is not intended as legal, accounting or tax advice. Bank management should consult with the bank's own professional advisors as to how this material may apply to their own specific circumstances.