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Handbook: **Thrift Activities**

Subject: **Other Assets and Liabilities** **Section: 250**

RESCINDED

Thrift Activities Regulatory Handbook Update

Summary: This bulletin provides a revision to Appendix A of the Other Assets and Liabilities Handbook Section in the Thrift Activities Regulatory Handbook. Please remove existing Appendix A to Section 250 and insert the revised Appendix A, Corporate-Owned Life Insurance.

For Further Information Contact: Your Office of Thrift Supervision (OTS) Regional Office or the Supervision Policy Division of the OTS, Washington, DC. You may access this bulletin at our web site: www.ots.treas.gov. If you wish to purchase a handbook and a subscription to the updates, please contact the OTS Order Department at (301) 645-6264.

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OTS is reissuing Appendix A, Corporate-Owned Life Insurance, to Thrift Activities Handbook Section 250. Change bars in the margins indicate the following revisions:

Page 250A.1, Pre-Purchase Analysis – new second paragraph:

"Institution management and the board of directors cannot rely solely on a third-party analysis of the benefits of COLI such as one that a vendor or carrier of the product may prepare. OTS considers this to be an inappropriate transfer of the fiduciary responsibilities of the board and management to an outsider with a vested interest in selling the insurance product. Institution management must thoroughly review any such third-party analysis and make its own determination as to whether the purchase of COLI is appropriate for the savings association. Such review should include a comparison of various products and investment alternatives, be well documented, and, prior to any purchase, approved by the board of directors."

Page 250A.4, Roman numeral VIII – OTS revises the guidance regarding an association's investment in life insurance:

"OTS generally considers a concentration to exist when a savings association invests more than 25 percent of its core capital in one industry or related group of companies or investments. A savings association should carefully evaluate its overall investment in life insurance to determine its own appropriate aggregate level. Institutions should not automatically assume that a concentration level as high as 25 percent is always appropriate."

—Scott M. Albinson

Managing Director, Supervision

CORPORATE - OWNED LIFE INSURANCE

The following guidance is from Office of the Comptroller of the Currency Bulletin 96-51, Bank Purchases of Life Insurance. The OCC developed this guidance in coordination with the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision. Each agency agreed, in principle, to adopt guidance substantially similar to the guidance contained in Bulletin 96-51.

Corporate-owned life insurance (COLI) includes all life insurance that a corporation, such as a savings association, purchases and owns or has a beneficial interest in. The second part of this appendix includes discussions of the most common uses of COLI and the associated risks.

While there is no specific statutory authority for the purchase of life insurance, the banking agencies consider it legally permissible if it is incidental to banking. That is, useful in connection with the conduct of the savings association's business. Life insurance might be useful for the following purposes:

- Key-person insurance.
- Life insurance on borrowers.
- Life insurance purchased in connection with employee compensation and benefit plans.
- Cash value life insurance taken as security for loans.

This authority is subject to supervisory considerations outlined in this appendix. State-chartered associations must also comply with any applicable state laws.

Savings associations should complete a thorough analysis before purchasing material amounts of COLI. The supervisory policy, set forth below, includes minimum standards for pre-purchase analyses, applicable to such purchases by thrifts.

Supervisory Policy

The purchase of cash value life insurance is a long-term, illiquid, nonamortizing, and unsecured obligation of the insurance carrier. As such, it subjects the policyholder to credit, liquidity, and interest rate risks.

Savings associations holding life insurance in a manner inconsistent with safe and sound banking practices may be subject to supervisory action. These supervisory actions may include but are not limited to partial surrender or divestiture of affected policies.

Pre-Purchase Analysis

The safe and sound use of cash value life insurance by thrifts depends on effective senior management and board oversight. Regardless of the institution's financial capacity and risk profile, the board must understand the role institution-owned life insurance plays in the overall business strategies of the institution. The board's role in analyzing and overseeing cash value life insurance should be commensurate with the size, complexity, and risk inherent in the transaction. Although the board may delegate decision-making authority related to purchases of life insurance to management, the board remains responsible for ensuring that such purchases are consistent with safe and sound banking practices.

Institution management and the board of directors cannot rely solely on a third-party analysis of the benefits of COLI such as one that a vendor or carrier of the product may prepare. OTS considers this to be an inappropriate transfer of the fiduciary responsibilities of the board and management to an outsider with a vested interest in selling the insurance product. Institution management must thoroughly review any such third-party analysis and make its own determination as to whether the purchase of COLI is appropriate for the savings association. Such review should include a comparison of various products and investment alternatives, be well documented, and, prior to any purchase, approved by the board of directors.

The objective of the pre-purchase analysis is to help ensure that the savings association understands the risks, rewards, and unique characteristics of COLI. At a minimum, the pre-purchase analysis should consider the following standards.

I. Determination of the Need for Insurance

The institution should determine the need for insurance by identifying the specific risk of loss or obligation against which they are insuring. The existence of a risk of loss or an obligation does not necessarily mean that a savings association can purchase or hold an interest in life insurance. For example, a savings association may not purchase life insurance on a borrower as a mechanism for recovering obligations that the savings association charged off, or expects to charge off for reasons other than the borrower's death. Also, a savings association should surrender or otherwise liquidate permanent life insurance acquired through debts previously contracted (DPC) within a short time frame, generally 90 days, of obtaining control of the policy.

Additionally, the purchase of insurance to indemnify a savings association against a specific risk does not relieve it from other responsibilities related to managing that risk. For example, a savings association may purchase life insurance to indemnify itself from the loss of a "key person." However, savings associations should not use "key-person" life insurance in place of, nor does it diminish the need for, adequate management or "key-person" succession planning. Therefore, it may not be necessary to purchase a cash value product.

The savings association's authority to hold life insurance on a key person lapses if the individual is no longer a key person for the association. Specifically, the key person's retirement, resignation, discharge, or a change in the person's responsibilities will cause the association to lose its insurable interest in a key person.

II. Quantifying the Amount of Insurance Needed

The thrift should estimate the size of the obligation or the risk of loss and ensure that they do not purchase an excessive amount of insurance in relation to the estimate. For such estimates, savings associations may include the cost of insurance and the time value of money in determining the amount of insurance needed. The savings association should base the estimate of the amount of insurance needed on reasonable financial and actuarial assumptions. In situations where a savings association purchases life insurance on a group of employees or a homogenous group of borrowers, it can estimate the size of the obligation or the risk of loss for the group on an aggregate basis. The savings association can then compare the aggregate obligation or risk of loss to the aggregate amount of insurance purchased.

Purchasing or holding excessive permanent insurance may be an unsafe and unsound practice if it subjects the institution to unwarranted risks.

III. Vendor Selection

The thrift does not have to use a vendor. In deciding whether or not to use a vendor or what type of vendor to use, the institution should consider the following items:

- The savings association's knowledge of COLI.
- The resources the savings association can, and is willing to spend, servicing and administering the COLI.
- The benefits a vendor may provide.

Depending on the vendor's role, the vendor's services can be extensive and critical to successful implementation and operation of a COLI plan. If the institution uses a vendor, it should make appropriate inquiries to satisfy itself about the vendor's ability to honor its commitments, general reputation, experience, and financial capacity. The institution should base their review on the size and complexity of the potential COLI purchase.

IV. Carrier Selection

COLI plans are typically of long duration and may represent significant risks for the institution. Therefore, carrier selection is one of the most critical steps in a COLI purchase. The institution should review the product design, pricing, and administrative services of the carrier(s) and compare them with the institution's needs. In addition, the institution should also review the carrier's ratings, general reputation, experience in the market place, and past performance. A broker or consultant, if used, may assist the institution in this regard.

Furthermore, before purchasing life insurance, the institution should perform a credit analysis on the selected carrier(s) in a manner consistent with safe and sound banking practices for commercial lending.

V. Review the Characteristics of the Available Insurance Products

There are a few basic types of life insurance products in the marketplace. However, providers can combine and modify these products in many different ways. The resulting final product can be quite complex. The institution should review the characteristics of the various insurance products available. It should select the product or products with characteristics that match the institution's objectives and needs. To do this, the institution should thoroughly analyze and understand the products under consideration.

When purchasing insurance on "key persons" and individual borrowers, the institution should consider that the institution's need for the insurance will likely disappear before the insured individual dies. In such cases, term or declining term insurance is often the most appropriate form of life insurance.

VI. Analyze the Benefits of COLI

The institution should analyze the benefits of COLI purchases under consideration. The analysis should include an assessment of how the purchase will accomplish the objective specified in (I), Determination of the Need for Insurance. It should also include an analysis of the anticipated performance of the insurance, including the interest crediting rate and the policy's net accumulation rate.[1] While the projected yield on some single-premium life insurance policies may seem attractive, the actual yield may be much lower. Also, insurance and administrative costs the issuer builds into the policy further reduce such yields and life insurance becomes more expensive as the insured person ages. Often insurance costs will greatly reduce a high stated yield on a cash value product.

VII. 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 savings association 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 institution should combine the compensation provided by the split-dollar arrangement with all other compensation to ensure that total compensation is not excessive. OTS prohibits excessive compensation as an unsafe and unsound practice. There are guidelines for determining excessive compensation in Appendix A to 12 CFR Part 570, Interagency Guidelines Establishing Standards for Safety and Soundness.

VIII. Analyze the Associated Risks and the Institution's Ability to Monitor and Respond to those Risks

Ownership of or beneficial interests in COLI may subject a savings association to several risks. These risks include: transaction, credit, interest rate, liquidity, compliance, and price. A savings association's pre-purchase analysis should include a thorough evaluation of these risks. Furthermore, the pre-purchase analysis should allow a savings association to determine whether the transaction is consistent with safe and sound banking practices. In making this determination, a savings association should consider, among other things:

- The complexity of the transaction.
- The size of the transaction relative to the institution's capital.
- The diversification of the credit risk.
- The financial capacity of the institution.
- The financial capacity of the insurance carrier(s).

[1] 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 the issuer periodically charges against the policy's cash value. Insurance companies frequently disclose a current interest crediting rate and a guaranteed minimum interest crediting rate. The guaranteed rate may be less than the current rate. As a result, the potential exists for future declines in the interest crediting rate. The net accumulation rate is the rate at which the policy increases after all costs are deducted, which may be materially less than the interest crediting rate.

- The institution's ability to identify, measure, monitor, and control the associated risks.

In assessing the size of the transaction, a savings association should consider the cash surrender value (CSV)[2] relative to its capital levels at the time of purchase. The institution should also consider projected increases in the CSV and projected changes in capital levels for the duration of the contract.

Consistent with prudent risk management practices, a savings association should establish internal quantitative guidelines. These guidelines should generally limit the aggregate CSV of policies from any one insurance company and the aggregate CSV of policies from all insurance companies. A savings association should limit investment in life insurance from any one issuer to the lending limits prescribed in 12 CFR §560.93. OTS generally considers a concentration to exist when a savings association invests more than 25 percent of its core capital in one industry or related group of companies or investments. A savings association should carefully evaluate its overall investment in life insurance to determine its own appropriate aggregate level. Institutions should not automatically assume that a concentration level as high as 25 percent is always appropriate.

IX. Evaluate Alternatives

Some COLI purchases involve indemnifying the institution against a specific risk. For example, savings associations sometimes purchase COLI to indemnify the institution against the potential for loss arising from the untimely death of a "key person." As an alternative to purchasing COLI, an institution may choose to self-insure against this risk. Other uses for COLI purchases are to recover costs or provide for employee benefits. In these cases, instead of purchasing COLI, an institution may choose to invest the money in other assets. Regardless of the purpose of COLI, a complete pre-purchase analysis will include an analysis of the alternatives.

[2] The liquidation value of the insurance policy if the policyholder terminates it. In the first few policy years there may be a significant difference between the stated policy value and the cash surrender value due to early cancellation penalties.

X. Document Decision

A savings association should maintain documentation adequate to show that the institution made an informed decision. The institution should continue to monitor that decision based on the standards set forth in this Handbook Section.

Financial Considerations

Institution management should also understand and analyze how COLI will affect the institution's financial condition. Given the anticipated performance of the insurance, management should analyze the effect on the institution's earnings, capital, and liquidity. Management should also consider the impact on the institution's earnings and capital should the institution, for any reason, surrender the insurance before maturity at the death of the insured.

Accounting Considerations

Savings associations should follow generally accepted accounting principles (GAAP) for financial reporting and Thrift Financial Report purposes. Financial Accounting Standards Board (FASB) Technical Bulletin 85-4, Accounting for Financial Purchases of Life Insurance, discusses how to account for investments in life insurance. The guidance set forth in Technical Bulletin 85-4 is generally appropriate for all forms of COLI.

The savings association should follow FASB Technical Bulletin No. 85-4 when accounting for insurance policies where the association receives all the cash value benefits. Sometimes the association receives all the benefits, but separately agrees to provide those benefits to the employee as deferred compensation. In this case, the savings association should account for the cash surrender value in accordance with FASB Technical Bulletin No. 85-4. Also, they should record a deferred liability for the deferred compensation arrangements in accordance with Accounting Principles Board Opinion No. 12, as amended by SFAS No. 106.

Under employee benefit split-dollar policies, the association and the employee agree to share in the policy's cash surrender value and death benefits. Also, the savings association is not accruing a separate liability for the employee benefit. In this situation, the association should record an asset for its investment in the policy equal to the lower of one of the following values:

- The policy's cash surrender value, determined in accordance with FASB Technical Bulletin No. 85-4.
- The present value of the future cash flow(s) the savings association expects to receive discounted at an appropriate interest rate in accordance with Accounting Principles Board Opinion No. 21.

The savings association should immediately record the amount exceeding the investment as an employee benefit expense. The savings association may also, where appropriate, record it in other assets as a deferred charge. The savings association must amortize the asset as an employee benefit expense in a systematic and rational manner over the time remaining until the employee's full eligibility date. The association should update its interest in the CSV at least quarterly.

Other Considerations

A savings association should evaluate the financial condition of the insurance company before purchasing a life insurance policy. The association should continue to monitor its condition while the policy is in force.

The association should consider the tax and economic consequences of surrendering a cash value insurance policy before its maturity should that become necessary. The savings association should also consider the effect of any significant holdings of cash value life insurance (considered a long-term investment) on its capital and liquidity.

In addition, savings associations should determine the applicability of, and ensure compliance with, 12 CFR §§ 563.41, 563.42, and 563.43. For example, split-dollar arrangements may be subject to 12 CFR § 563.41 when a savings association purchases an insurance policy and the beneficiary is its holding company or a management official of the holding company. You must consider this an unsecured extension of credit. This is because the association pays the holding company's portion of the premium and the holding company will not fully reimburse the savings association for its payment until some time in the future. Federal savings associations may not make unsecured loans to affiliates.

In other cases, the parent holding company may actually own the insurance policy and pay the entire premium. A subsidiary association may make annual loans to the holding company in an amount equal to the premiums paid or, equal to the annual increase in the cash surrender value of the policy, with the insurance policy serving as collateral for the loan. The holding company repays the loans upon either the termination of employment or death of the insured employee. These loans are subject to the quantitative restrictions of 12 CFR § 563.41, including the collateral requirements, 130 percent of the amount of the loan in this case. Therefore, the transactions must also comply with the provisions of 12 CFR § 563.42.

Because the holding company is the beneficiary of the insurance policy, it is a participant in a transaction between a savings association and a third party.

Moreover, certain insurance arrangements may be subject to Regulation O. In cases where the savings association purchases the insurance to provide a fringe benefit to an executive officer of the savings association and the association pays the cost of the policy, the employee must perform one of the following actions:

- Reimburse the association for the amount of the premiums.
- Report the economic value of the insurance benefit to IRS as additional taxable income.

If the employee fails to take action, the value of the insurance represents a loan by the association to the executive officer and is subject to Regulation O.

The savings association should ensure execution of the appropriate policy endorsements, assignments, and related agreements. The savings association should also ensure that the policy provides adequate safeguards and controls to protect its interest in the policy. You should determine whether the association's share of any cash surrender value and death benefits was appropriately endorsed or assigned to the association.

You should evaluate all significant holdings and future purchases of life insurance by savings associations in light of the above guidelines. You should consider any formal or informal contracts with the executives for deferred compensation or other benefit payments linked to the insurance arrangements. Review related contracts with the insurance policies.