

# Developments in the Risk Management of Bank-Owned Life Insurance

By Brian W. Smith, Angela Angelovska-Wilson and Aman Solomon

*Banks must evaluate the ongoing suitability of their current and inherited third-party relationships and BOLI policies.*

An ever-increasing number of banks have made the strategic decision to purchase bank-owned life insurance ("BOLI") as a strategy to manage escalating employee benefits costs. In recent years, many banks have rapidly increased the percentage of their Tier I capital devoted to BOLI policies. This swift expansion is due to the very favorable tax treatment applied to these policies. Unlike traditional bank investments, the increase in the value of a BOLI policy each year is not subject to income tax liability. Upon the death of the insured individual, the bank receives the death benefit tax free. This favorable tax treatment makes large purchases of BOLI very attractive to banks.

The Office of the Comptroller of the Currency (OCC) has generally been tasked with providing regulatory guidance on the purchase of BOLI by financial institutions. Bulletin OCC 2004-56 ("Bulletin 2004-56") represents the latest guidance on the proper risk management of BOLI, detailing the regulatory expectations for banks in terms of their prepurchase analysis of BOLI policies and emphasizing the importance of strong oversight in the vendor selection process. The bulletin also stresses the importance of ongoing postpurchase monitoring of BOLI policies to ensure that they continue to remain consistent with safe and sound banking practices. The bulletin states: "The guidance concerning the ongoing risk management of BOLI subsequent to its purchase applies to all holdings of life insurance regardless of when purchased."

Regulatory scrutiny in this area has intensified with the result that effective management of risk for BOLI policies has increased in complexity for

banks. The trend toward consolidation in the banking industry has resulted in banks holding multiple inherited BOLI policies from acquired institutions. In many cases, when these policies are reexamined, it is apparent that the initial level of due diligence was insufficient or that the BOLI program may no longer be in compliance with the current standards of the institution. Remediating these problems is further complicated when the individuals who were responsible for implementing the BOLI program are no longer with the bank or when the documentation detailing proper prepurchase and postpurchase monitoring is lacking or unavailable.

Banks have sought the services of third-party brokers, consultants or agents to navigate the complexity of managing their BOLI policies. These vendors offer comprehensive assistance with both prepurchase analysis and selection of BOLI policies, as well as offering ongoing postpurchase management and reevaluation of existing BOLI. The OCC has warned against overreliance on the advice of vendors, placing the burden for proper compliance on banks, stating: "[R]eliance solely on prepackaged, vendor-supplied compliance information does *not* demonstrate prudence with respect to the purchase of insurance." Banks must focus on carefully man-

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aging the relationships with vendors and insurance carriers in order to properly manage their risk.

Many banks have extensive experience complying with the OCC regulations for the initial purchase of BOLI, but the industry is now moving into a phase where the management of risk for existing policies has become the most pressing issue. An expanding regulatory emphasis on postpurchase monitoring can be expected, and it is crucial that banks regularly reevaluate the design of their existing BOLI holdings, contractual relationships with third-party vendors and the ongoing adequacy of their compliance with regulatory requirements. Many banks have already begun or are considering creating formal postpurchase compliance programs in consultation with qualified legal counsel. The risks associated with failing to comply with the OCC guidance are substantial. The bulletin states that “[w]here 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.”

This article will discuss the history of BOLI, the current regulatory guidance on the risk management of BOLI and identify emerging risk issues that should be taken into consideration when managing BOLI policies. Banks should include these issues when examining existing BOLI policies in consultation with legal counsel. By implementing programs to address these issues, banks can improve relationships with third-party vendors and mitigate the risk of regulatory action.

### Development of BOLI Regulation

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BOLI is generally defined as a life insurance policy that is purchased on behalf of a group of bank employees, usually directors, officers or senior managers, by a bank. Banks use the death benefits from these policies to fund employee pensions, benefits plans or current and deferred benefits for executives. The policies are used to fund the costs of noninsured employees as well. BOLI policies can usually be structured as a general account policy or a separate account policy. In general account poli-

cies, the policy is pooled with many others in the insurance company’s general investment account. Separate accounts that are not part of the insurance company’s general investment assets provide some significant benefits to banks when selecting a BOLI strategy. In a separate account, the banks are able to select the investment style for the policy but not directly control the investments being made. The cash surrender value (“CSV”) of the policy is protected from the general creditors of the insurance company, unlike general accounts. However, these separate account policies are subject to more stringent regulation.

### Banking Circular 249

The OCC issued its first regulatory guidance on BOLI in 1991, with the release of Banking Circular 249 (“BC 249”), which detailed limitations on how much life insurance banks were allowed to hold in various situations. BC 249 was significant because it officially announced that the regulators did not view a bank’s investment in BOLI as improper. The OCC was particularly concerned about life insurance policies being used by banks as investment opportunities. BC 249 defined a strict set of rules that required that banks cancel insurance if the key person insured left the company or if the specific benefits that the insurance was designed to offset were no longer owed. The OCC also created “Test B,” which was a present-value test that compared the projections for future cash flows and death benefits of BOLI policies against the projected cost of employee benefit programs tied to the policy. The OCC required that these values be reasonably close.

This test was notoriously difficult to apply by banks when it came time to determine the appropriate level of insurance protection. The proper method for banks to make a reasonable determination of future benefits costs was unclear. Banks were able to effectively project costs for programs such as deferred compensation but had difficulty applying the test to benefits cost that could not be accurately predicted. There was also significant confusion on other issues, including whether the regulators allowed BOLI policies to be aggregated and considered as a whole and the proper method of administering “split-dollar” arrangements. This regulatory guidance did not explicitly discuss the vendor selection

process or detailed expectations for analyzing the risk of purchase of BOLI. BC 249 left banks with a lack of clarity on how to administer BOLI policies, but it did not prevent many banks from purchasing significant amounts of BOLI.

### OCC Bulletin No. 96-51

The OCC sought to provide more flexible and clear guidance with the release of OCC Bulletin No. 96-51 ("Bulletin 96-51"). Released September 20, 1996, Bulletin 96-51 designated a list of factors that should be considered as the baseline for proper due diligence in the purchase of BOLI. These standards replaced the much more rigid system espoused in BC 249 and instead provided significant flexibility for banks. Bulletin 96-51 reemphasized the OCC's stance that BOLI could not be purchased as an investment but, rather, had to be designed to offset the costs of necessary banking functions such as long-term employee benefits costs. Bulletin 96-51 required that the following factors be included in the due diligence for a BOLI purchase:

- A determination by the bank of the need for insurance
- Quantification of the amount of insurance needed
- Review of the reputation and qualifications of the vendor being considered
- Review of the performance, experience and reputation of the insurance carriers
- Analysis of the bank's ability to monitor and respond to risks associated with insurance
- An evaluation of the alternatives to insurance

For all of these factors, Bulletin 96-51 reemphasized that banks must maintain detailed documentation of these due-diligence procedures as well as continue to monitor and revise their analysis of BOLI purchases and holdings. In this bulletin, the OCC was already focusing on the importance of careful review during the vendor selection process. The requirement to revisit the prepurchase due diligence on an ongoing basis indicated that the OCC expected banks to engage in postpurchase monitoring, but these expectations were not fully defined.

### OCC Bulletin 2000-23

The OCC released OCC Bulletin 2000-23 ("Bulletin 2000-23") on July 20, 2000. Bulletin 2000-23 formally

recognized that "[l]ife insurance is a financial instrument which serves many necessary and useful business purposes." This OCC guidance included a breakdown of the relevant risk factors associated with the purchase of BOLI. The five risk factors associated with BOLI were transaction, credit, interest rate, liquidity and compliance risk. Bulletin 2000-23 established updated supervisory expectations for the analysis during the prepurchase process as well as the postpurchase risk-monitoring stage.

### Bulletin 2004-56

Bulletin 2004-56, the current guidance from the OCC, retained much of the structure from Bulletin 2000-23, but it expanded and clarified the roles of bank management and reiterated the responsibility of the bank to monitor and respond to risk for both new BOLI policies and existing policies, regardless of when purchased. Bulletin 2004-56 defined the minimum requirements for risk management during the postpurchase phase. It also reaffirmed the emphasis on thorough due diligence in the vendor selection process. All of the risk factors that were defined by the OCC apply to the vendor selection process as well as the ongoing third-party relationships for BOLI management. The bank is required to analyze risk for the following factors that are relevant to ongoing BOLI monitoring and risks associated with third-party relationships:

- **Liquidity risk.** This is the risk to earnings and capital from an institution's inability to meet its obligations when they come due without incurring unacceptable losses. The illiquid nature of BOLI is a major reason banks must keep their total CSV well below the regulatory concentration guidelines. With the aggregation of inherited BOLI policies, banks run the risk of increasing their CSV well beyond regulatory limits. Banks must carefully review all BOLI assets, including those inherited from predecessor institutions, to ensure that the total value of their BOLI policies falls well below 25 percent.
- **Transaction/operational risk.** This is the risk to earnings and capital from problems caused by the institution's failure to understand fully or implement a transaction properly. Mitigating this risk requires that banks carefully monitor the performance of third-party relationships for the management of BOLI.

- **Tax and insurable interest risk.** This is the risk that banks' actions subsequent to purchase could jeopardize the tax-advantaged status of BOLI investments. This is particularly true in the separate account setting, where any appearance of control over investment strategies by the bank could result in regulators demanding the surrender of BOLI policies. Banks must be particularly careful when crafting administrative and service agreements with third parties to ensure that there are no concerns that the bank is exerting "control" over these policies.
- **Reputation risk.** This is the risk to earnings and capital from negative publicity regarding an institution's business practices. Banks must maintain full documentation of informed consent by insured employees. Furthermore, some banks have sought to insure a large portion of their employees, including lower-level employees, which could create a reputation risk. In the context of ongoing postpurchase risk monitoring, banks must be sure to reevaluate existing BOLI policies with a special emphasis on inherited BOLI policies that may be out of compliance with current standards.
- **Interest rate risk.** This is the risk to earnings and capital from movements in interest rates. In certain types of separate account investment strategies, banks may be exposed to risk from fluctuating interest rates. Banks cannot directly control the investment strategies used by their separate account policies, but the OCC states, "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." The contractual relationships with third-party brokers should be reviewed on an ongoing basis to aid in compliance with these regulations.
- **Compliance/legal risk.** This is the risk to earnings and capital from violations of, or non-conformance with, laws, rulings, regulations, prescribed practices or ethical standards. Banks should reevaluate all BOLI policies, especially those inherited from predecessor institutions, to ensure that they comply with the latest regulatory guidance. The OCC once again emphasized the importance of avoiding any actions that re-

semble "control" over separate account assets. Banks should constantly monitor existing BOLI policies and third-party contracts to ensure that there is no conflict with this requirement.

- **Price risk.** This is the risk to earnings and capital from changes in the value of portfolios of financial instruments. Banks must establish a monitoring program to track and respond to fluctuations in the value of separate account assets. Stable value features have been introduced in most separate account structures to moderate this risk.

### Risk Management for Third-Party Relationships

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Bulletin 2004-56 emphasizes the importance of thorough evaluation of third-party vendor qualifications during the BOLI prepurchase process. In addition, Bulletin 2004-56 places the responsibility for making an informed BOLI purchase squarely on the shoulders of bank management. Bulletin 2004-56 states: "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 risk associated with, the product design features they have selected." The OCC further states: "Reliance solely on prepackaged, 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." Banks must perform extensive diligence to examine the possible insurance risks, to determine the vendor's qualifications and to evaluate the extent to which the vendor will assume responsibility for administration and servicing of the BOLI policy.

The OCC guidance enumerates several of the myriad risks and conflicts of interest that can arise from the relationship between banks, vendors and insurance carriers. Much of the risk arises out of the long-term nature of BOLI contracts. The management of a BOLI policy on a single key individual could last 30 to 40 years (policies on a large group of employees perhaps longer); therefore, there are long-term risks even with the most reputable vendors. The OCC calls attention to 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." Bulletin 2004-56 also expresses concern over the incentives present in a typical BOLI deal. Vendors typically receive a significant portion of the commission for the sale of BOLI once the initial purchase is completed. At the same time, the vendor typically remains responsible for administering the BOLI policy. These responsibilities become more crucial in the case of separate account products, where constant monitoring will result in the best outcome. The OCC guidance notes: "The vendor's commitment to investing in the operational infrastructure necessary to support BOLI is a key consideration in vendor selection."

Most responsible banks have complied fully with the requirements of a rigorous prepurchase analysis of vendors and administrators, but the OCC has cautioned banks to focus on the postpurchase monitoring of these third-party relationships. Bank management is required to review all BOLI assets at least once a year but more frequently if there are "significant anticipated changes to the BOLI program." Banks must anticipate that this annual review extends to a thorough reevaluation of third-party relationships involved in the management of BOLI.

### OCC Bulletin 2001-47

Banks should review administration and service contracts for BOLI to ensure that they remain in compliance. OCC Bulletin 2001-47 ("Bulletin 2001-47") provided guidance on the proper management and oversight of third-party relationships. The OCC requires that banks engage in a "rigorous analytical process to identify, measure, monitor, and establish controls to manage the risks associated with third-party relationships." Banks should determine the risks associated with third-party BOLI vendors, perform appropriate due diligence when selecting vendors, and continue to monitor and control the relationship with the vendor after the purchase has been made. Most relevant in this context is the importance of ongoing management and review of third-party relationships. Banks should take particular notice of contractual issues and ongoing compliance requirements when designing their risk-management strategy for third-parties.

## Contract Issues

Banks that hold numerous BOLI policies face a number of possible contractual issues. Many of these policies and administrative agreements may have been inherited from a predecessor institution with insufficient compliance and monitoring procedures or may have been negotiated and purchased when the regulatory guidance was significantly different. Indeed, any bank might have inherited multiple administrators. Bulletin 2004-56 requires that all BOLI policies, regardless of when they were purchased, must comply with the latest regulatory guidance on postpurchase monitoring. Banks should therefore reexamine their contracts with third-party vendors and brokers for the administration and servicing of BOLI policies.

The administration and service agreements themselves are subject to regulation by the OCC, so banks should be aware of certain risk factors that must be taken into account when reviewing these BOLI contracts:

- **Scope of the arrangement.** BOLI contracts with vendors and brokers should clearly define what services the third-party vendor is obligated to provide to the bank. Many vendors or consultants offer comprehensive BOLI services that require them to manage the BOLI investment, track insured individuals and coordinate claims for death benefits on behalf of the banks. These duties must be clearly defined in the contract to ensure that the vendors comply with regulatory requirements.
- **Performance measures or benchmarks.** The contracts should clearly specify the expectations and responsibilities of third-party vendors for their performance managing BOLI policies. The two parties should agree to standard measures of performance.
- **Responsibilities for providing and receiving information.** Banks should negotiate clear provisions that require third-party vendors and brokers to provide ongoing accurate information about the performance and management of BOLI policies. Vendors often assume control of the majority of BOLI-related services, but the ultimate responsibility lies with the bank to ensure ongoing compliance and risk management. The contracts should include language requiring specific notification to

the bank when any significant event that could affect the risk of the BOLI policy occurs. These should include, but are not limited to, fluctuations in interest rate, price fluctuations or changes with the insurance carriers that could introduce risk.

- **The right to audit.** Banks should ensure that contracts allow them the right to audit third-party vendors whenever it is deemed necessary. Banks should draft provisions that provide for periodic internal and/or external audits of the third-party vendor. These audits serve to determine if the third-party vendor is maintaining the bank's standards for compliance/legal risk. By analyzing the results of these audits, banks can improve their knowledge of possible risks when renegotiating administration and service contracts.

- **Cost and compensation.** Banks should review the contracts to determine the cost of BOLI administration and service as well as the compensation being paid to third-party vendors and consultants. If the agreements present a price or operational risk, the bank should renegotiate to protect their return on the BOLI purchase.

- **Dispute resolution.** In the event of a dispute between a third-party vendor and the bank, the contract should provide for a specific dispute resolution process. Banks could be exposed to serious risk if there are protracted disputes. Banks should consider provisions that would require the third party to continue performance of the contract while the dispute is being resolved.

- **Default and termination.** Banks should place special emphasis on clearly defined termination and default provisions in the administration and service contracts. Banks should attempt to negotiate terms that allow the termination of the relationship with minimal risk and expense if the bank determines the performance of the third party is unacceptable. These provisions should be drafted to interface with the provisions that control audit rights and set performance measures and benchmarks. Some vendors' and consultants' arrangements with carriers tend to bind these intermediaries to the policy "permanently." This is not consistent with

the bank's responsibility to determine and monitor the risks of third-party relationships. Without a provision to allow termination of the third party, it may become more difficult for a bank to motivate vendors or consultants to manage BOLI policies properly. The contract should also include a provision that allows the bank to terminate the relationship if the OCC objects to any aspect of the third-party agreement. In order to reduce the risk associated with a conversion to a different

third party, the contract should contain provisions that obligate the vendor or consultant to facilitate the transfer of relevant data and documentation in a timely manner.

Regulators have signaled the intention to place great-

er scrutiny on these contracts. Banks that have not taken significant steps to examine and/or renegotiate these administration and service contracts could face future regulatory action. Third-party vendors and brokers are also at risk if their contractual relationships with the bank become a significant risk issue. For this reason, it is in the best interest of both vendors and banks to conform to the OCC guidance on the topic. Banks that have not created a formal review mechanism to manage these contracts should seek legal counsel on the design and review of these risk issues.

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## Continuing Compliance Requirements

Beyond the language of the contracts governing third-party relationships, Bulletin 2001-47 also discussed the importance of continuing oversight of third-party activities and performance to ensure that they are consistent with safety and soundness requirements. The bank is expected to dedicate sufficient staff with expertise in the area to review the activities of the third party. According to Bulletin 2001-47, the bank should monitor the third party's financial condition, its controls and the quality of its service and support. Regulators expect the banks to take a more hands-on approach to the management of relationships with third parties.

Banks should embark on a review of the financial condition of third parties on at least an annual basis.

If there is any indication of an increase in risk associated with the third party, these reviews should be conducted more often. The bank should be able to provide audited financial statements for significant relationships with third parties. The bank should also compare the projected costs provided by the third party with actual costs incurred.

As far as monitoring the controls of third parties, the bank should review all audit reports related to the relationship, review the third party's security guidelines and internal control procedures to ensure that they are in compliance with the bank's own standards, review the third party's compliance with any applicable laws and regulations to minimize compliance/legal risk and review the third party's contingency plans to ensure that in the event of an unexpected contingency, the services provided can be restored in a reasonable amount of time.

Banks should regularly assess the quality of the third party's service and support. Third-party performance should be regularly evaluated to ensure that the contractual terms are being met. Any issues with performance should be promptly documented. The bank should also maintain an open dialogue with the vendor to discuss performance and operational issues.

### Other Risk Issues

Banks should identify if any of their existing third-party relationships could possibly pose risk outside of the existing OCC guidance. Some banks have BOLI policies that are managed by third parties that do not have a contractual relationship to the bank. Often, the insurance company has directly hired these consultants to manage certain aspects of the BOLI program, such as tracking key employees and administering death benefits. Banks are exposed to significant risk in these situations, because despite having no contractual relationship with the third party, they are still deemed responsible for their actions. If this

type of situation exists, the bank should consider renegotiating the terms of the BOLI agreement to exert the proper risk management and monitoring of the third-party administrator.

Banks should carefully evaluate relationships between insurance carriers and third-party vendors and consultants, which can result in less-than-independent evaluation and recommendation of a particular BOLI program. Banks should seek independent vendors with a good reputation in the business and extensive experience handling BOLI products. These vendors should help the banks to review a number of different BOLI alternatives, rather than a limited selection that reduces flexibility. Banks should also pay close attention to the compensation structure of the third party to ensure that it is designed to serve the best interests of the bank.

### A Need to Address Postpurchase Compliance

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The existing regulatory environment for BOLI requires that banks focus on creating comprehensive postpurchase compliance programs that fully address the risk management of existing policies and third-party relationships. For banks that have not yet addressed this issue, it is crucial that they evaluate the ongoing suitability of their current and inherited third-party relationships and BOLI policies and design a postpurchase compliance program to respond to the evolving regulatory requirements and to assist in the restructuring of programs that are found to be insufficient to meet regulatory scrutiny. These steps will serve to ameliorate risk for an asset that serves a vital role in the successful operation of many banks. These steps are becoming the baseline expectation of regulators. Banks that do not comply with these requirements in a responsible manner will be exposed to the risk of regulatory enforcement action.

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