BUREAU OF BANKING

Department of Professional and Financial Regulation

State of Maine

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Bulletin #73 Bank Owned Life Insurance Background and Purpose

The Bureau of Financial Institutions has noted in its examinations that Maine-chartered institutions are more frequently purchasing corporate or bank owned life insurance policies (BOLI) insuring the lives of directors, officers, and employees for the benefit of the institution. The Bureau has noted that the cash surrender value of life insurance (CSVLI) has become a significant asset for several institutions, in some cases approaching 25% of Tier 1 capital.

The purpose of this Bulletin is to update the original Bulletin 73, which was issued on October 1, 2002, for recent changes in federal guidance on BOLI. This Bulletin addresses the statutory lending limit, safety and soundness considerations, and due diligence.

Authority

The authority for Maine-chartered financial institutions[1] to purchase and hold life insurance is found at Title 9-B M.R.S.A. Section 441-A, which provides that financial institutions may exercise all powers necessary and convenient to effect the purposes for which the financial institution is organized or to further the business in which the financial institution is lawfully engaged. The Bureau finds that purchases of life insurance that facilitate the exercise of other powers conferred on financial institutions by Title 9-B M.R.S.A. or mitigate the risk of banking activities authorized by Title 9-B M.R.S.A. are permissible under Title 9-B M.R.S.A. Section 441-A. Permissible uses of BOLI include the purchase of key-person insurance, the purchase of life insurance to fund expenses associated with employee benefit plans, the purchase of insurance on borrowers, and insurance taken as security for loans.

Lending Limit

Title 9-B M.R.S.A. Section 439-A and Bureau of Financial Institutions' Regulation 28 limit loans or extensions of credit to any one person to 20% of total capital. The Bureau has determined that Cash Surrender Value of Life Insurance (CSVLI) is not an extension of credit. Therefore, Title 9-B M.R.S.A. Section 439-A and Regulation 28 do not apply to CSVLI. Nonetheless, because of the credit and liquidity risk associated with CSVLI, the Bureau expects financial institutions to establish internal limits in a policy adopted by the Board of Directors. The policy shall establish limits, based on Tier 1 capital, on the amount of CSVLI from any one insurance company and the aggregate CSVLI of policies from all insurance companies. The rationale for these limitations should be clearly documented, supported, and consistent with safe and sound banking practices.

Due Diligence

The Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) issued the Interagency Statement on the Purchase and Risk Management of Life Insurance (Policy Statement) on December 7, 2004.[2] The Policy Statement provides guidelines for banks when purchasing BOLI. The Bureau of Financial Institutions expects Maine-chartered financial institutions to adhere to the guidelines contained in the Policy Statement when purchasing BOLI. In particular, financial institutions should conduct and document a pre-purchase analysis as follows:

- Determine the need for insurance, the economic benefits, and the appropriate insurance type;
- Quantify the amount of insurance appropriate for the institution's objectives;
- Assess vendor qualifications;
- Review the characteristics of available insurance products;
- Document the selection of a carrier(s);
- Determine the reasonableness of compensation provided to the insured employee if the insurance results in additional compensation;
- Analyze the associated risks and the institution's ability to monitor and respond to those risks;
- Evaluate alternatives; and,
- Document the decision.

In the Bureau's experience, the most common use of BOLI is to fund expenses associated with non-qualified employee benefit plans, such as supplemental executive retirement plans and deferred compensation plans for executive officers and directors. In some cases, the use of BOLI has been flawed because financial institutions adopted plans that were essentially life insurance policies offered as non-qualified employee benefit plans. The Bureau considers it an essential component of due diligence for a financial institution to determine whether a particular executive benefit is necessary and reasonable given the market for comparable executive positions, the amount of existing compensation and benefits, and other relevant factors. If it is determined that a particular benefit is necessary and reasonable, then the financial institution should determine how best to fund the employee benefit. BOLI is just one of several options that can be considered.

Besides safety and soundness and regulatory considerations, it is also important to properly document the business reasons for purchasing BOLI for tax purposes. One of the benefits of BOLI is the tax advantage associated with the death benefit and the accumulation of cash surrender value. If an institution can not document a legitimate business reason for purchasing BOLI, the IRS may disallow tax benefits.[3] Also, BOLI must conform to the applicable provisions of the Maine Insurance Code, including Title 24-A M.R.S.A. Section 2404, regarding insurable interest and Title 24-A M.R.S.A. Section 2408, regarding consent of the insured. Financial institutions are urged to contact the Maine Bureau of Insurance with any questions about the applicable provisions of the Maine Insurance Code.

If you have any questions, please contact Chief Bank Examiner Donald W. Groves at 207-624-8577 or donald.w.groves@maine.gov.

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Note: This Bulletin is intended for informational purposes. It is not intended to set forth legal rights, duties, or privileges nor is it intended to provide legal advice. Readers are encouraged to consult applicable statutes and regulations and to contact the Bureau of Financial Institutions if additional information is needed.

[1] For the purposes of this Bulletin, the term "financial institution(s)" is defined in accordance with Title 9-B M.R.S.A. Section 131(17), which excludes credit unions.

[2] See FRB Supervision and Regulation Letter SR 04-19 or FDIC Financial Institution Letter 127-2004

[3] Bank Owned Life Insurance, American Bankers Association, May 2001