EXECUTIVE SUMMARY – INTERAGENCY STATEMENT ON THE PURCHASE AND RISK MANAGEMENT OF LIFE INSURANCE

Institutions purchase life insurance for a variety of purposes, including recovering the cost of providing employee benefits and protecting against the loss of "key persons." Institutions should have a comprehensive risk management process for purchasing and holding bank-owned life insurance (BOLI).

The two broad types of life insurance are temporary (term) insurance and permanent insurance. Temporary (term) insurance provides protection for a specified time period, its premiums do not have a savings component, and it does not create a cash surrender value (CSV). Permanent insurance is intended to provide life insurance protection for the entire life of the insured. Its premium structure includes a savings component, thereby creating a CSV. If permanent insurance is surrendered before death, surrender charges may be assessed against the CSV.

The ability of FDIC-supervised banks to purchase life insurance is governed by state law. Some state laws permit state-chartered banks to engage in activities (including making investments) that go beyond the authority of a national bank. Section 24 of the Federal Deposit Insurance Act generally requires FDIC-supervised banks to obtain the FDIC's consent before engaging as principal in activities that are not permissible for a national bank.

The safe and sound use of BOLI depends on effective senior management and board oversight. An institution's board of directors must understand the complex risk characteristics of the institution's insurance holdings and the role this asset is intended to play in the institution's overall business strategy.

Each institution should establish internal policies and procedures governing its BOLI holdings, including guidelines that limit the aggregate CSV of policies from any one insurance company as well as the aggregate CSV of policies from all insurance companies. It is generally not prudent for an institution to hold BOLI with an aggregate CSV that exceeds 25 percent of its Tier 1 capital. Therefore, the FDIC expects an institution that plans to acquire BOLI in an amount that results in an aggregate CSV in excess of this concentration limit, or any lower internal limit, to gain prior approval from its board of directors or the appropriate board committee. In this situation, management is expected to justify that any increase in BOLI resulting in an aggregate CSV above 25 percent of Tier 1 capital does not constitute an imprudent capital concentration.

The management of an institution should conduct a thorough pre-purchase analysis to help ensure that the institution understands the risks, rewards, and unique characteristics of BOLI. The nature and extent of this analysis should be commensurate with the size and complexity of the potential BOLI purchases and should also take into account existing BOLI holdings. An effective pre-purchase analysis involves the following actions by management:

(1) Identify the need for insurance and determine the economic benefits and appropriate insurance type, i.e., permanent or temporary (term) insurance.
(2) Quantify the amount of insurance appropriate for the institution's objectives.
(3) Assess vendor qualifications, including its reputation, experience, financial soundness, and commitment to the BOLI product and the adequacy of its services.
(4) Review the characteristics of the available insurance products and select those that best match the institution's objectives, needs, and risk tolerance.
(5) Select an insurance company after evaluating and performing credit analyses on the companies from which insurance may be purchased.
(6) Determine the reasonableness of compensation provided to the insured employee if the insurance provides additional compensation to the employee.
(7) Analyze the risks associated with the insurance and the institution's ability to monitor and respond to these risks.
(8) Evaluate alternatives to the purchase of BOLI for accomplishing the institution's objectives.
(9) Document the pre-purchase analysis and the purchase decision.

A comprehensive assessment of BOLI risks on an ongoing basis is an important element of the risk management process, especially for an institution whose aggregate BOLI holdings represent a capital concentration. Management should review the performance of the institution's insurance assets with its board of directors at least annually.

The BOLI risks that should be assessed, managed, monitored, and controlled include liquidity, transaction/operational (including the tax and insurable interest implications), reputation, credit, interest rate, compliance/legal, and price risk. All of these risks are present in permanent insurance. In particular, the CSV of permanent life insurance is one of the least liquid assets on an institution's balance sheet. In contrast, temporary insurance does not expose an institution to liquidity, interest rate, or price risk because it does not have a CSV. These risks need not be evaluated in the comprehensive assessment of the risks of temporary insurance.

Institutions should follow generally accepted accounting principles (GAAP) applicable to holdings of life insurance for reporting purposes. Under GAAP, only the amount that could be realized under an insurance contract as of the balance sheet date (that is, the CSV reported to the institution by the insurance carrier, less any applicable surrender charges not reflected by the insurance carrier in the reported CSV) is reported as an asset.

For risk-based capital purposes, an institution that owns general account permanent insurance should apply a 100 percent risk weight to its claim on the insurance company. If an institution owns a separate account policy and can demonstrate that it meets certain requirements, it may choose to apply a "look-through" approach to the underlying assets to determine the risk weight. In no case, however, may the risk weight for the separate account policy (excluding any general account and stable value protection portions, which generally receive a 100 percent risk weight) be less than 20 percent.